

**The SEC's Municipal Advisor Rules:
Compliance Considerations for Investments
by Municipal Clients**

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Background

- The Dodd-Frank Act created a new class of registrants under federal securities law. Under Dodd-Frank, municipal advisors are:
 - required to register with the SEC and the Municipal Securities Rulemaking Board,
 - subject to a fiduciary duty to their clients that are municipal entities, and
 - subject to a new set of MSRB rules (now in process) governing municipal advisors, including training, standards of conduct, supervision, and prohibitions on gifts and gratuities and pay-to-play activities.

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1

Registration of Municipal Advisors

- The SEC issued municipal advisor registration rules in September 2013 which became effective July 1, 2014.
- The SEC registration rules are not about financial advisors.
- The rules are all about limiting the communications and interactions of persons that are not registered municipal advisors with municipal entities and obligated persons:
 - broad in scope,
 - granular in detail, and
 - a facts-and-circumstances analysis for what constitutes municipal advisory activity.

The Fiduciary Duty

- The fiduciary duty:
 - requires the municipal advisor to act in its client's best interests, and to put its client's interests ahead of its own, and
 - includes a broad conflicts of interest prohibition.
- MSRB proposed Rule G-42 (in process) will define the scope of the duty and will impose specific standards of conduct on municipal advisors.

Who is a Municipal Advisor?

- Any person that:
 - provides advice
 - with respect to a municipal financial product or an issuance of municipal securities
 - to/on behalf of a municipal entity or obligated person.
- Unless an exemption is available, any person that meets these three elements is a municipal advisor even if he or she does not intend to be an advisor.
- Soliciting an engagement relating to a bond issue or an investment of bond proceeds for an unrelated third party for compensation is also a municipal advisory activity.

Municipal Financial Products Investments of Proceeds

- All investments of and investment strategies for “bond proceeds,” including:
 - the proceeds of municipal securities, and
 - municipal escrow investments (refundings).
- Bond proceeds include both sale proceeds and moneys to be used or pledged as security for the payment of debt service.
- Moneys lose their character as bond proceeds when they are “spent” under federal tax arbitrage rules.
- Bond proceeds commingled with other moneys can taint an investment account.

Municipal Financial Products Municipal Derivatives

- Swaps and security-based swaps
- With a municipal entity counterparty (including swaps unrelated to an issue of municipal securities), or
- With an obligated person counterparty (but only in connection with an existing or proposed issue of municipal securities).

Municipal Securities

- All types of tax exempt, tax advantaged and taxable notes, bonds and other debt securities issued or guaranteed by municipal entities, as well as bonds issued by a municipal entity for a conduit borrower.
- A commercial loan is not itself a municipal security, but the repayment obligations of the borrower may be evidenced by a note or bond that could be considered to be a municipal security.

Municipal Entities and Obligated Persons

- Municipal entity: any State, political subdivision of a State or a corporate instrumentality of a State or a political subdivision, and includes:
 - public pension, retirement and benefit plans, and
 - local government investment pools.
- Obligated person: an entity committed by contract or other arrangement to pay some or all of the debt service on an issuance of municipal securities.
 - Obligated persons will most often be non-profit higher education and healthcare organizations that engage in tax-exempt financings.

What is “Advice”?

- A recommendation that is particularized to the specific needs, objectives, or circumstances of a covered entity with respect to a covered transaction, including structure, timing, terms and similar matters.
- The more individually tailored the communication to a covered entity, the greater the likelihood that the communication may be viewed as a recommendation that constitutes covered advice.
- A recommendation can be implied from the amount and detail of information that is provided to a covered entity (too much information can be a “call to action”).

What is “Advice”?

- Advice includes:
 - incidental communications,
 - gratuitous communications, and
 - communications with third-party professionals that are seeking advice on behalf of a covered entity.
- The SEC will apply a facts-and-circumstances analysis (“we know it when we see it”) standard to what constitutes “advice.”

Exemptions and Exceptions

- Blanket exemptions (cover all advice):
 - Persons responding to RFPs and RFQs, and
 - Persons interacting with an entity that is represented by an independent registered municipal advisor (an “IRMA”).
- Activity-based exemptions (limited in scope):
 - Banks with respect to deposit and sweep accounts,
 - Federally-registered (‘40 Act) investment advisers, and
 - Federally-registered swap advisors and swap dealers.
- General information exception
 - Covers factual information, including current market information.

Bank Exemption

- The SEC registration rules exempt “banks” (depository institutions, but not their non-bank affiliates) who provide advice with respect to:
 - Investments that are held in a deposit account, savings account, certificate of deposit or other deposit instrument issued by a bank, or funds held in certain sweep accounts;
 - Investments made by a bank acting in the capacity of an indenture trustee or similar capacity; and
 - Any “extension of credit” by a bank to a municipal entity or obligated person.

Investment and Swap Advisors

- The exemptions for SEC-registered investment advisers and CFTC-registered swap advisors are activity-based and are limited in scope.
 - SEC Staff has provided guidance that an RIA may provide advice on the use of derivatives in an investment portfolio.
- Registered swap dealers may discuss and negotiate swaps with municipal entities and obligated persons under the CFTC’s business conduct standards for transactions with “special entities.”
 - Does not cover security-based swaps.

Baseline Analysis

1. Is the investor a municipal entity or obligated person?
 - For municipal entities this is usually straightforward, but care needs to be taken to identify non-traditional governmental entities and instrumentalities.
 - Much more difficult to determine whether the investor is an obligated person, but a direct connection to a municipal bond as borrower or guarantor is necessary.
2. Are the moneys to be invested bond proceeds?
 - SEC Staff guidance provides that, for investment accounts held by municipal entities, market participants must utilize (a) information within its actual knowledge and (b) a reasonable diligence process to determine whether the account holds bond proceeds.

Diligencing Investment Accounts

- Actual Knowledge:
 - Does the account name indicate a nexus to a bond issue?
 - “Bond Fund,” “Debt Service Account,” “Series 2015 Bonds XYZ Account”
 - Pattern of prior investment activity.
- Reasonable Diligence
 - “Negative consent” letters for accounts opened and amounts on deposit prior to July 1, 2014.
 - Affirmative “no proceeds” certifications from investors for accounts opened or amount deposited after July 1, 2014.
 - SEC Staff expects there to be file documentation that establishes a reasonable diligence process.

Compliance Considerations

- Free communication is still possible in certain contexts:
 - Many munis are now using requests-for-bids to solicit investment recommendations under the RFP exemption.
 - Financial advisors to munis that are registered municipal advisors are often handling requests for investments and strategies under the IRMA exemption.
 - General information exception enables communication regarding securities available for sale and current market prices.
- Exercising what the SEC views as “reasonable diligence” can be a challenge.
 - Clients can be non-responsive or unable to certify that they are not investing bond proceeds.

Compliance Considerations

- Use of “no advice” letters to clients that are unwilling or unable to certify that they are investing bond proceeds.
- Responding to requests for investment recommendations from an investment adviser can be problematic under the “on behalf of” advice component of the rules.
 - No blanket/bootstrapping exemption for munis that are represented by an RIA.
 - Some RIAs work almost exclusively with state and local governments and bond proceeds.
 - But is the advice “particularized” if you don’t know the identity of the RIA’s client?

Questions?

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