

Client Alert

Current Issues Relevant to Our Clients

May 21, 2014

SEC Releases Additional Interpretive Guidance on Municipal Advisor Rules

On May 19, 2014, the Staff of the Office of Municipal Securities of the Securities and Exchange Commission issued additional guidance on the SEC's registration rules for municipal advisors. The additional guidance was issued in the form of 14 new Frequently Asked Questions that were added to the initial guidance that the Office of Municipal Securities issued on January 10, 2014. Our Client Alert on the initial guidance can be found [here](#).

This Client Alert summarizes the new FAQs. The new FAQs and the initial guidance (which was also issued in FAQ format) are contained in a single document, which can be found [here](#). The initial FAQs and the new FAQs are identified by "[January 10, 2014]" or "[May 19, 2014]," which appear at the end of each answer.

Background

Under the SEC's municipal advisor registration rules, a person that provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities is a "municipal advisor" and is required to register with the SEC and the Municipal Securities Rulemaking Board. In addition, under the municipal securities provisions of the Dodd-Frank Act, a municipal advisor has a fiduciary duty to its municipal entity clients and, under current MSRB rules, has a fair dealing obligation to its obligated person clients.

The Advice Standard

Indirect Advice. A market participant who provides advice to a municipal entity or an obligated person indirectly by communicating through a third-party professional that has been engaged by the municipal entity or an obligated person, such as a financial advisor or bond counsel, is giving "advice" for purposes of the municipal advisor rules and, absent an available exemption, would be required to register as a municipal advisor.

Direct Purchase of Securities by Institutional Buyers. An institutional buyer engaged in a direct purchase transaction (the purchase of municipal securities directly from a municipal entity) is not engaged in municipal advisory activities when it provides information regarding the terms under which it would purchase securities for its own account, and does not provide advice with respect to the structure, timing, terms, or other similar matters regarding an issuance of municipal securities to be offered to other investors. The Staff stated that it views

information regarding the terms of a direct purchase transaction as falling within the general information exception to the advice standard that is discussed in the SEC's adopting release and the Staff's January guidance.

Independent Registered Municipal Advisor Exemption

Meaning of "Rely On." In order to establish the independent registered municipal advisor ("IRMA") exemption, a municipal entity or obligated person is required to provide a written representation that it will "rely on" the advice of its IRMA. In the FAQs, the Staff stated its view that the term "rely on" does not require the municipal entity or obligated person to follow the advice of its IRMA, but rather to seek and consider the advice, analysis and perspective of its IRMA.

Independence of the Registered Municipal Advisor. In applying the standard for independence, the determination of whether or not a registered municipal advisor is independent of another transaction participant seeking to rely on the IRMA exemption must be considered at both the firm level and at the individual employee level.

First, there needs to be a determination that the registered municipal advisor firm is independent from the transaction participant firm. This means that the two firms could not have been under common control (direct or indirect, controlling or controlled).

The second determination is whether the current employee of a registered municipal advisor firm who was formerly employed by a transaction participant is able to exercise independent judgment when engaging in the

municipal advisor activities. The firms are not considered to be independent if (1) there is a current employee who meets the definition of “Associated Individual” (described below) and that individual was formerly employed, within the past two years, by the transaction participant in the capacity of an Associated Individual and (2) such Associated Individual participates in the municipal advisory activities for a particular municipal entity or obligated person client in which such Associated Individual’s former employer is involved in any role as a transaction participant, during the applicable two year period.

An “Associated Individual” is defined as a partner, officer, director or branch manager (or similar status), or other employee who is engaged in the management, direction, supervision or performance of any activities relating to providing advice to or on behalf of a municipal entity or an obligated person with respect of financial products or the issuance of municipal securities.

In a notable development that further restricts the availability of the IRMA exemption, the Staff stated that this same analysis also applies to what it labeled the “converse situation,” in which a current employee of a transaction participant firm was employed, within the past two years, by the registered municipal advisor firm representing the municipal entity or obligated person on the same transaction.

In all such cases, the registered municipal advisor is not considered to be “independent” of the transaction participant, with the result that the transaction participant cannot rely on the IRMA exemption.

Public Discourse; Public Officials and Employees of Municipal Entities and Obligated Persons

State-level Employees Providing Advice to Municipal Entities. The exemption for public officials and employees of municipal entities and obligated persons acting within the scope of their official capacity or employment applies if an employee of a state-level municipal entity provides advice on an issuance of municipal securities to another municipal entity in that state.

Obligated Persons

When Does an Entity Become an Obligated Person? The FAQs confirm the guidance in the SEC’s adopting release that a non-municipal entity does not become an obligated person for purposes of the municipal advisor rules until it decides to seek financing from a new money issuance of municipal securities and begins the process of applying to or negotiating with a municipal entity to issue securities on its behalf. Until that time, discussions with market

participants on various debt financing alternatives are not “advice” under the municipal advisor rules.

Advice to an Obligated Person on an Outstanding Issue of Municipal Securities. Responding to questions submitted by a number of market participants, the FAQs provide that advice to an obligated person with respect to outstanding municipal securities, such as whether to redeem them or refinance them with another issuance, is considered “advice” for purposes of the municipal advisor rules and, absent an available exemption, the market participant would be required to register as a municipal advisor.

Investment of Proceeds of Municipal Securities

Transitional Guidance. The municipal advisor rules will apply to a market participant who provides investment advice on or after July 1, 2014 to a municipal entity or obligated person regarding investments of proceeds of municipal securities, including proceeds already existing or arising after that date. In determining whether or not funds are proceeds of municipal securities, a market participant may rely on representations in writing made by the municipal entity or obligated person so long as there is a reasonable basis for such reliance.

Accounts or Investments Existing prior to July 1, 2014. For investment advice provided with respect to accounts or investments that existed before July 1, unless the market participant actually knows or reasonably should have known that such account or investment contains proceeds of municipal securities, a market participant could use a reasonable diligence process to determine whether the account or investment includes proceeds of municipal securities. The Staff’s view is that a reasonable diligence process should include a determination of whether the account holder is a municipal entity and whether the account name suggests a connection to municipal securities (for example, a “bond fund”). The diligence process could also include sending so-called “negative consent” notices to account holders stating that the market participant will assume that the investment or deposit does not include proceeds of municipal securities unless notified otherwise.

Accounts or Investments Established on or after July 1, 2014. For the investment of newly-arising proceeds received from municipal securities that are issued on or after July 1, 2014, the Staff stated its view that market participants should develop policies and procedures to determine whether or not the advice involves such investments. The Staff’s view indicates that market participants should consider obtaining affirmative written representations from account holders that the funds to be invested are not proceeds of municipal securities.

Proceeds of Pension Fund Obligations. Proceeds of pension obligation bonds will generally lose their character as proceeds of municipal securities upon their contribution to the public pension plan, so long as the municipal entity that issued the pension obligation bonds treats the proceeds as being spent for its own accounting purposes and no longer retains the ability to redirect the proceeds for another purpose.

The Bank Exemption

Advice by Dual Employees. If an individual is employed by a bank and is also an associated person of the bank's broker-dealer affiliate, he may provide advice to a municipal entity or obligated person within the scope of the bank exemption when acting as a bank employee and may also provide advice within the scope of the underwriter exclusion while acting as a broker-dealer, so long as the employee discloses to the municipal entity or obligated person the capacity in which he is acting in advance of providing any advice.

Bank Direct Purchase of Municipal Securities. The Staff affirmed the guidance in the SEC's adopting release that a bank is not engaged in municipal advisory activities when it provides advice and recommendations to a municipal entity or obligated person with respect to an issuance of municipal securities to be purchased by the bank for its own account.

Bond Counsel Advice to Obligated Persons

The FAQs confirm that if a municipal entity engages bond counsel to act on its behalf in connection with a conduit issue, bond counsel could provide advice to the obligated person within the scope of its representation of the municipal entity and its role as bond counsel without being required to register as a municipal advisor.

Summary

The new FAQs cover a number of topics on which guidance had been requested by market participants. In particular, the guidance on the actions that need to be taken to establish a reasonable basis that investment accounts do not contain proceeds of municipal securities and when the proceeds of pension obligation bonds are considered spent provide much-needed clarity for compliance measures. As was the case with the January FAQs, some of guidance in the new FAQs will ease compliance burdens under the municipal advisor rules, while other guidance will make compliance somewhat more difficult, particularly the guidance on the independence most of an IRMA and the Staff interpretation that "converse" independence must also be established.

For More Information

Please contact your primary attorney at Chapman and Cutler if you have any questions on the municipal advisor registration rules or the FAQs, or visit us at chapman.com.

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