

SEC Releases Final Municipal Advisor Registration Rule

Part I: Who is a Municipal Advisor?

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On September 18, 2013, the Securities and Exchange Commission (“SEC”) adopted its **final rule** on the permanent registration of municipal advisors (the “**Final Rule**”). The Final Rule replaces the current temporary registration scheme for municipal advisors with a permanent registration scheme, and provides extensive guidance concerning when a person or firm is acting as a municipal advisor.

This memorandum comprises Part I of a two-part series of client memoranda on the Final Rule. This Part I focuses on the entities that are subject to regulation and registration as municipal advisors. Part II (the “**Part II Memo**”), which will be published shortly, will address in detail the mechanics and timing of registration under the permanent registration scheme.

The Final Rule and related guidance reflect significant changes from the SEC’s highly controversial 2010 proposed permanent registration rule (the “**Proposed Rule**”), including the following:

- narrowing the proposed scope of activities and types of advice that are required for registration, including **limiting the extent of “investment strategies” as to which advice to a municipal entity or obligated person will trigger municipal advisor status** to only those relating to plans or programs for the investment of the proceeds of municipal securities issuances or the recommendation of and brokerage of municipal escrow investments;
- **clarifying what it means to provide “advice,”** including: (i) specifying that even uncompensated advice may trigger municipal advisor status; (ii) providing an exemption for persons responding to requests for proposals (unless such persons receive direct or indirect compensation); and (iii) stating that general information that is not a “particularized” recommendation will not constitute advice;
- **creating new, expanding or interpreting existing statutory exemptions** for (i) investment advisers; (ii) banks and identified banking products; (iii) employees, appointed officials and board members of municipal entities; (iv) swap dealers; and (v) situations where the municipal entity has its own independent registered municipal advisor, subject to conditions;
- specifying that a **solicitation of a municipal entity by a broker-dealer to invest in a private fund is not considered a solicitation on behalf of the fund’s investment adviser;**
- indicating that **functions similar to underwriting, such as private placement, remarketing and tender agents, would generally not trigger municipal advisor status;**

“Municipal Entity”

A municipal entity is defined to include: any State or political subdivision, agency, or instrumentality; any plan, program or pool of assets sponsored or established by any of the foregoing; and any other issuer of municipal securities. Examples of municipal entities include public employee retirement systems, and public employee benefit plans and pension plans.

“Obligated Persons”

Obligated persons generally include entities such as private universities, non-profit hospitals, private corporations and charter schools that borrow proceeds from a municipal security offering and are obligated by contract or other arrangement to repay all or some portion of the amount borrowed.

The Final Rule excludes certain persons from the definition of “obligated persons,” including issuers of letters of credit and municipal bond insurance, persons whose financial information or operating data is not material to a municipal securities offering (without reference to any letters of credit or other credit support), and the federal government.

The SEC has clarified that dealing with an obligated person will only result in municipal advisor status where the obligated person is acting in its capacity as such.

“Municipal Financial Products”

A municipal financial product is a municipal derivative, guaranteed investment contract or investment strategy.

- **eliminating proposed requirements that individuals** associated with a municipal advisor and engaged in municipal advisory activities on behalf of the municipal advisor must **separately register** and that the firm and individuals must complete compliance certifications;
- defining what funds constitute “proceeds” of municipal securities offerings, and indicating that such **funds lose their character as “proceeds” once used to “carry out the authorized purposes of municipal securities”**; and
- **permitting registration of a separately identifiable division or department of a bank (“SID”)** rather than the bank itself.

Importantly, the **SEC rejected a number of significant comments** that were advocated by industry participants. Specifically, the Final Rule and related guidance:

- clarify that the **underwriter exemption does not extend to incidental advice concerning derivatives or the investment of proceeds** from municipal securities offerings; and
- **do not include blanket exemptions for regulated banks** and similar entities.

The Final Rule becomes effective 60 days after publication in the Federal Register. Upon effectiveness of the Final Rule, persons who meet the new definition of “municipal advisor” (discussed below) and do not qualify for an exemption will (i) need to register with the SEC under its existing temporary registration regime and the Municipal Securities Rulemaking Board (“**MSRB**”), if they are not already registered, and (ii) be subject to a statutory fiduciary duty with respect to any municipal entity for whom they act as a municipal advisor and, upon MSRB registration, to MSRB rules. SEC registration under the permanent regime will be required on a phased-in basis starting on July 31, 2014, as more fully described under “Next Steps” below.

The Final Rule prescribes permanent registration forms for municipal advisors (“**Form MA**” and additionally, for foreign firms, “**Form MA-NR**”) and forms to be submitted by registrants for individual associated persons (“**Form MA-I**”). These forms call for extensive information that may not in all cases currently be gathered by firms, and will likely require firms to implement new processes for capturing such information for purposes of initial registration and to support ongoing required updates (which must be made on an annual basis and when certain information on previous filings becomes outdated). The forms, registration process, timing and other practical considerations associated with the permanent registration regime will be addressed in our forthcoming Part II Memo.

Background

The Securities Exchange Act of 1934 (the “**Exchange Act**”), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, requires municipal advisors to register with the SEC. The statute defines a “municipal advisor” as a person (who is not a municipal entity or an

Statutory Exclusions

The statute excludes the following persons from the definition of municipal advisor:

- brokers, dealers and municipal securities dealers serving as underwriters;
- investment advisers registered under the Investment Advisers Act of 1940 (“**registered investment advisers**”) who provide investment advice, and registered commodity trading advisors who provide swaps-related advice, and persons associated with them; and
- attorneys that offer legal advice or provide services of a traditional legal nature and engineers that provide engineering advice.

employee of a municipal entity) that (i) 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, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues, or (ii) undertakes a solicitation of a municipal entity. The Exchange Act further defines various terms that are used in the municipal advisor definition and excludes from the definition of municipal advisor the persons listed in the sidebar.

Municipal advisors that provide advice to municipal entities are subject to a fiduciary duty under the Exchange Act. However, neither the statute nor the Final Rule provides any interpretive guidance regarding a municipal advisor’s fiduciary duties. Instead, the Exchange Act provides the MSRB with the authority to adopt rules governing the conduct of municipal advisors, including their fiduciary duty.

In 2010, the SEC instituted a temporary registration regime for municipal advisors, which is currently in effect.

Key Definitions in the Final Rule

A person is required to register as a municipal advisor if it engages in activities that trigger either the “advice prong” or the “solicitation prong” of the definition of municipal advisor above. The following section describes the activities that trigger each prong and then discusses certain statutory exclusions and rule-based exemptions.

Providing Advice to a Municipal Entity or Obligated Person with Respect to Municipal Financial Products or the Issuance of Municipal Securities

“Advice”

Under the Final Rule, whether a communication with a municipal entity or obligated person triggers the “advice” prong of the municipal advisor definition is based on all relevant facts and circumstances, including whether the communication (i) involves a “recommendation,” (ii) is particularized to the specific needs of a municipal entity or obligated person, and (iii) relates to municipal financial products or the issuance of municipal securities. The SEC clarified that the determination of whether a “recommendation” has been made is an objective inquiry and may include whether the information communicated to the municipal entity or obligated person reasonably would be viewed as a suggestion that the municipal entity or obligated person take action or refrain from taking action regarding municipal financial products or the issuance of municipal securities. Generally, the more individually tailored the information is to a municipal entity or obligated person (or a targeted group of municipal entities or obligated persons of a similar type), the more likely it will be considered advice for purposes of the Final Rule. The SEC, however, declined to limit the definition of advice to engagements for compensation only.

Under the Final Rule, advice does not include:

“Issuance of Municipal Securities”

The SEC intends to interpret the term “issuance of municipal securities,” to include advice throughout the life of an issuance of municipal securities, including from the pre-issuance planning stage to the repayment stage.

- providing general information regarding municipal financial products or issuance of municipal securities, including with respect to the structure, timing and terms of the products or issues;
- banks that act as principals in securities purchase transactions, including providing municipal entities or obligated persons with the terms under which such banks would purchase securities or by effecting such purchases;
- factual information without subjective assumptions, opinions or views;
- information that is not particularized to a specific municipal entity or obligated persons or type of municipal entity or obligated persons;
- widely disseminated information for use by the public, clients or market participants other than municipal entities or obligated persons; or
- general educational materials.

“Proceeds of Municipal Securities”

The SEC defines “proceeds of municipal securities” to include;

- money derived by a municipal entity from the sale of municipal securities, and investment or reinvestment income,
- money of a municipal entity or obligated person held in funds under legal documents for the municipal securities that are reasonably expected to be used as security or a source of payment for the payment of the debt service on the municipal securities, and investment or reinvestment income.

“Investment Strategies”

In response to commenters voicing concerns that the Proposed Rule’s definition of investment strategies was overly broad and would have effectively expanded investment strategies to include advice with respect to *all assets* of a municipal entity, the SEC adopted an exemption that significantly narrows the definition of investment strategies. The Final Rule exempts from the definition of municipal advisor persons who provide advice with respect to “investment strategies” that are not plans or programs for the investment of proceeds of municipal securities (as defined in the sidebar), or the recommendation of and brokerage of municipal escrow investments. With respect to brokerage of municipal escrow investments, the SEC clarifies that there must be advice, and not just brokerage, to constitute investment strategies.

Pooled Investment Vehicles

In the adopting release for the Final Rule, the SEC indicates that an investment adviser to a pooled investment vehicle that contains *any* proceeds of municipal securities or municipal escrow investments is a municipal advisor, absent an exemption, irrespective of the amount of the investment assets in the pooled vehicle that are derived from such proceeds. Many investment advisers to such pooled investment vehicles will qualify for the registered investment adviser exemption; however, this exemption is not available for banks and state-registered investment advisers.

The SEC also clarifies that fund managers may rely upon representations from investors regarding whether investment funds constitute proceeds of municipal securities. This explicit acknowledgment of compliance through reliance on representations may spur investment firms to modify standardized forms to obtain such representations where appropriate.

Solicitation of a Municipal Entity or Obligated Person

Under the statute, “solicitation of a municipal entity or obligated person” means a direct or indirect communication with a municipal entity or obligated person made by a person, for direct or indirect compensation, on behalf of an unaffiliated broker, dealer, municipal securities dealer, municipal advisor or investment adviser for the purpose of obtaining or retaining an engagement for such unaffiliated person for or in connection with municipal financial products, the issuance of municipal securities or of an investment adviser to provide investment advisory services to or on behalf of a municipal entity.

The Final Rule clarifies that the following activities, among others, would not trigger registration under the solicitation prong:

- solicitation without receiving compensation (or any form of economic benefit), either directly or indirectly;
- solicitation of an obligated person not in connection with the issuance of municipal securities or municipal financial products; and
- solicitation of a municipal entity on behalf of a pooled investment vehicle (e.g., a hedge fund or mutual fund).

Independent Municipal Advisor Exemption Conditions:

- the independent registered municipal advisor must provide advice with respect to the same aspects of the municipal financial product or issuance of municipal securities as the exempted person;
- the independent registered municipal advisor has not been associated with the exempted person for the previous two years;
- the municipal entity or obligated person must represent in writing that it is represented by, and will rely on the advice of, an independent registered municipal advisor, and the exempted person must have a reasonable basis to rely on the representation; and
- the exempted person must provide certain disclosures, as described in the Final Rule, to the municipal entity or obligated person and their independent registered municipal advisor.

Exclusions and Exemptions from the Definition of “Municipal Advisor”

The following persons are excluded from the definition of municipal advisor in the Final Rule:

Public officials and employees of municipal entities and obligated persons, to the extent they are acting within the scope of their official capacity.

Municipal entities or obligated persons represented by an independent municipal advisor, subject to the conditions in the sidebar.

Broker-dealers and municipal securities dealers serving as underwriters, commencing when the municipal issuer engages the underwriter on a particular transaction and continuing until the end of the underwriting period for such transaction. The following activities fall within the underwriter exemption:

- acting as a private placement agent;
- providing ancillary advice with respect to the structure, timing and terms concerning the issuance of municipal securities and with respect to retail order periods and institutional marketing; and
- structuring of refunding escrow cash flow requirements necessary to provide for the refunding and defeasance of an issuance of municipal securities.

In addition, the Final Rule and interpretive guidance indicate that dealer-managers (for a tender or exchange offer) and remarketing agents (acting only in their capacity as remarketing agents) will generally not trigger municipal advisor status. The SEC provides a number of examples of

Outside the Scope of the Underwriter Exemption (Abridged):

- assisting issuers with competitive sales, including bid verification, true interest cost calculations and reconciliations, verifications of bidding platform calculations and preparation of notices of sale;
- budget planning and analyses and budget implementation issues with respect to debt issuance and collateral budgetary impacts;
- providing advice on investment strategies or with respect to a related municipal derivative, including derivative valuation services;
- providing advice that is not specific to a particular issuance of municipal securities on which a person is serving as underwriter;
- preparing financial feasibility analyses with respect to new projects; and
- providing advice on the terms of Requests for Proposals (“RFPs”) or Requests for Qualifications (“RFQs”) for the selection of underwriters or other professionals for a project financing and advice regarding review of responses to such requests.

Banks will not become municipal advisors solely by virtue of providing advice regarding:

- investments held in a deposit account, savings account, certificate of deposit or other deposit instrument issued by a bank;
- extensions of credit by a bank to a municipal entity or obligated person;
- funds held in a sweep account that meet certain statutory requirements; or
- investments made by a bank acting as an indenture trustee or in a similar capacity.

activities that are not within the underwriter exemption, including those set forth in the sidebar, among others.

Banks providing advice with respect to the categories listed in the sidebar. However, banks that engage in municipal advisory activities and provide advice on municipal derivatives to municipal entities or obligated persons are not exempt from registering as municipal advisors. Where a bank’s municipal advisory activities are conducted through a SID, however, the bank may register the SID, rather than the bank as a whole.

Persons who provide responses to RFPs, without receiving compensation, for services in connection with a municipal financial product or the issuance of municipal securities.

Registered investment advisers, but only when providing advice regarding (i) the investment of the proceeds of municipal securities, (ii) non-securities if under an advisory agreement, and (iii) municipal escrow investments. This investment adviser exemption, however, does not extend to advice regarding whether and how to issue municipal securities, the structure, timing and terms of an issuance of municipal securities, or municipal derivatives.

Registered commodity trading advisors providing advice solely in relation to swaps.

Registered swap dealers that recommend municipal derivatives or trading strategies that involve municipal derivatives, as long as the swap dealer is not “acting as an advisor” to the municipal entity or obligated person in accordance with the CFTC’s business conduct rules. This exemption does not apply to security-based swap dealers.

Accountants, attorneys, engineers and vendors, subject to limitations.

Next Steps

As will be more fully described in the Part II Memo, firms that are already temporarily registered as municipal advisors, those who have become municipal advisors by virtue of the Final Rule, or those who enter the business in the interim, will need to start gathering extensive information with respect to their own activities and those of their affiliated and associated persons in order to file the applicable registration forms with the SEC (and, in the case of new registrants, to register with the MSRB). Foreign entities will need to gather additional documentation, including specified consents to service of process and a legal opinion, concerning, among other things, that they can provide the SEC with access to the advisor’s books and records.

The Final Rule allows market participants to remain temporarily registered under the SEC’s temporary registration regime and provides staggered compliance dates for municipal advisors to register under the permanent regime based on a municipal advisor’s temporary registration number. The permanent municipal advisor registration scheme on the SEC’s public online filing system, EDGAR, will be available to accept registration applications for municipal advisors with the first set of temporary registration numbers beginning July 1, 2014. Municipal advisors that seek

to enter into the municipal advisory business after September 30, 2014 must file an application via EDGAR beginning on or after October 1, 2014 and must be registered before commencing municipal advisory activities.

As market participants analyze the SEC's 777-page rulemaking release, we expect that numerous questions will arise and that there will be requests to the SEC for FAQs and further interpretive guidance.

Moreover, the MSRB previously proposed Rule G-36 and a related interpretation with respect to the fiduciary duty of a municipal advisor when advising a municipal entity, as well as an interpretation of Rule G-17 concerning the duty of fair dealing of a municipal advisor in other engagements, but subsequently withdrew the proposals because the SEC had not yet adopted final rules specifying who is a municipal advisor. We therefore expect that the MSRB will shortly file various rule proposals concerning municipal advisors now that there is greater definitional clarity.

Municipal advisors will need to establish policies and procedures to ensure compliance with their fiduciary duties and duties of fair dealing. In addition, those relying upon exclusions from the definition of municipal advisor (such as the independent municipal advisor exclusion) will need to establish protocols for ensuring that the terms of the exemptions are complied with.

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