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Investment Banks Face Challenges Under New Municipal Advisor Rules

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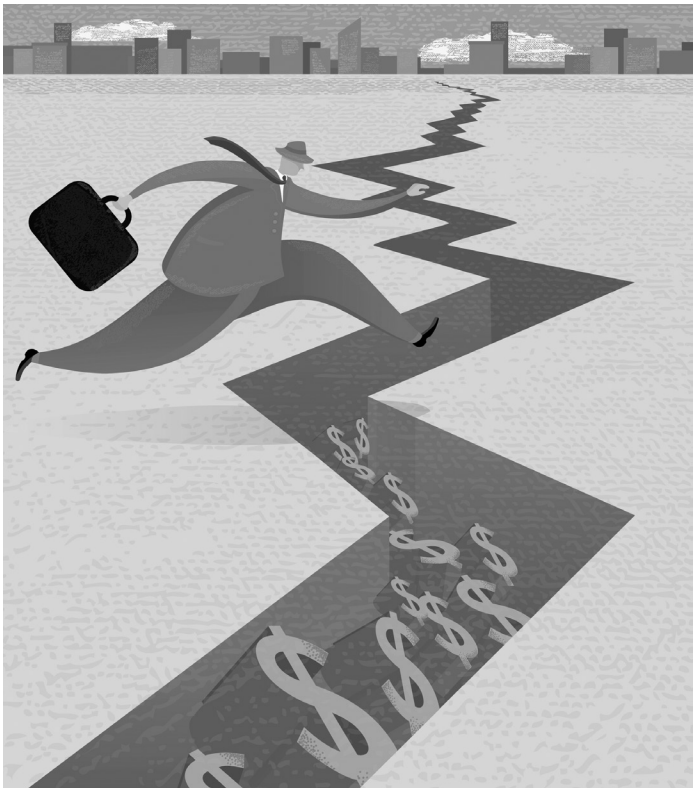
Responding to a perceived gap in the regulatory framework, as well as losses experienced by certain municipalities during the financial crisis, Congress adopted as part of the Dodd-Frank Wall Street and Consumer Protection Act amendments to the Securities Exchange Act of 1934 (the Exchange Act) that create a new registration and regulatory scheme for "municipal advisors."

The law requires municipal advisors to register with the Securities and Exchange Commission (SEC) and comply with the rules of the Municipal Securities Rulemaking Board (the MSRB), including its registration requirements.[1] It also imposes on municipal advisors a fiduciary duty when advising municipal entities.

While the law affects virtually all providers of financial services to the municipal sector, the fiduciary duty provision poses a particular challenge for investment banking. For example, where a fiduciary duty attaches, it could limit, or preclude altogether, acting as a principal on the other side of a transaction with a municipal entity, such as acting as a dealer or underwriter. While the statute recognizes these concerns by including several exclusions from being considered a municipal advisor, the scope and contours of these provisions are not clear in the text of the law.

The SEC addressed some of the issues affecting investment banking in its final municipal advisor registration rule (the Final Rule), which was issued on Sept. 18, 2013.[2] However, there remain uncertainties that may require further guidance from the SEC and the MSRB. Moreover, it is likely that the municipal advisor requirements will drive significant changes in market practices within municipal investment banking, irrespective of any further regulatory guidance that may be forthcoming.



Municipal Securities Issuance and the Underwriter Exclusion. Among other triggers, a person is a municipal advisor if they provide "advice" to or on behalf of a municipal entity or obligated person[3] with respect to the issuance of municipal securities, municipal derivatives, plans or programs for the investment of proceeds of municipal securities or municipal escrow investments.[4] Absent an available exemption, a communication to a municipal entity that includes advice on the structure, timing or terms of an issuance of municipal securities generally may only be engaged in by a registered municipal advisor, and would be subject to a fiduciary duty.

Of course, underwriters of municipal securities regularly engage in these sorts of communications with their municipal entity clients. On the one hand, municipal entity clients want to know their underwriter's view and recommendations for their transaction structure. On the other hand, an underwriter purchases securities from its municipal entity client as principal and must negotiate at an arm's length and also must consider the interests of investors. By definition, an underwriter that acts as an issuer's advisor is conflicted, making

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it essentially impossible for the underwriter to be a fiduciary to the municipal entity. As a result, investment banking firms that engage in underwriting must make sure that they are excluded or exempt from being considered their municipal entity client's municipal advisor, even if the firm is already registered as a municipal advisor.

Congress sought to resolve this conundrum by adopting an exclusion from the definition of "municipal advisor" for any broker, dealer or municipal securities dealer serving as an underwriter (the Underwriter Exclusion). The Final Rule, however, narrowed the Underwriter Exclusion by specifying that it only applies with respect to underwriting a "particular issuance of municipal securities" and only with respect to activities "within the scope" of that underwriting. In the Adopting Release, the SEC further explained that the Underwriter Exclusion applies only once an underwriter has been engaged on a particular transaction and terminates at the end of the underwriting period. In addition, the SEC interprets the Underwriter Exclusion to not apply to certain incidental or ancillary advice or services that many underwriters have historically provided. As a result, absent another exemption, underwriters effectively cannot provide these services.

As described below, prospective underwriters of municipal securities must consider carefully: (i) whether communications with an issuer constitute "advice;" (ii) when the firm is considered to be "engaged" as an underwriter and therefore eligible to rely upon the Underwriter Exclusion; (iii) what types of advice may be given within the scope of the Underwriter Exclusion; (iv) what other exemptions and exclusions may be available with respect to advice; and (v) what requirements and disabilities attach to having given advice, such as registration and compliance requirements and fiduciary and other duties

"Advice." Determining whether a particular communication is "advice" requires a "facts-and-circumstances" analysis. In general, a communication would generally constitute "advice" if it includes any recommendation, especially if it is particularized to the specific needs of a municipal entity or obligated person. Bankers may try to avoid giving "advice" by limiting the information that they provide to municipal entity and obligated person clients to factual and generalized information. Investment banks may also attempt to provide, as part of a facts-and-circumstances "context," disclaimers, disclosures and written notifications clarifying that the investment bank is not giving advice.

Becoming Engaged as an Underwriter. In order to qualify for the Underwriter Exclusion, a broker-dealer or municipal securities dealer must be "contractually engaged" to serve as an underwriter for a particular securities offering. Market practice does not currently entail underwriters being "engaged" until they actually agree to purchase the securities. A bond purchase agreement or underwriting agreement, however, is not executed until late in the process—well after advice that would benefit from the Underwriter Exclusion (such as transaction structuring advice) has been given.

It is likely that the municipal advisor requirements will **drive** significant **changes in market practices** within municipal investment banking, irrespective of any further regulatory guidance that may be forthcoming.

In addition, to qualify for the Underwriter Exclusion, the underwriter must have "a relationship to a particular transaction." This raises significant concerns regarding how investment bankers can pitch ideas to clients before being formally engaged to underwrite a transaction, without becoming the issuer's municipal advisor. It is common for underwriters to meet with issuers to discuss ideas and concepts outside the context of a particular ongoing offering. For example, an investment banker may notice that a municipal entity could lower its existing debt service costs by refinancing at lower rates. Because the investment banker would not yet be engaged to underwrite the transaction being suggested, it is not clear whether the suggestion by the investment banker to do so would be eligible for the Underwriter Exclusion, or (absent another exemption) trigger municipal advisor status.

To address these concerns, some investment bankers have considered limiting interaction with municipal entity or obligated person clients until some form of engagement is in place. For example, a firm may require that a municipal entity execute a document confirming that it is considering engaging the firm as an underwriter, even though it is not yet clear that any transaction will be effected. It is not yet clear whether this will become market practice, or what the content of such a document would need to be in order to constitute an "engagement" for purposes of the Underwriter Exclusion.

Advice Within and Outside the Scope of the Underwriter Exclusion. Generally, once a broker-dealer has been engaged as an underwriter, it may advise its municipal entity or obligated person clients, without being a municipal advisor, with respect to the structuring, timing, terms, and other related matters concerning the transaction for which it has been engaged. Additionally, underwriters may, for example, (i) prepare presentations, rating strategies and investor "road shows" related to the issuance at hand and (ii) assist in preparing preliminary and final official statements.

However, even if an underwriter has been formally engaged, the Underwriter Exclusion would not cover advice regarding (among other things): (i) investment strategies; (ii) municipal derivatives; (iii) whether a negotiated or competitive sale should be used for a municipal securities issuance; or (iv) overall financial controls that are not related to the particular municipal securities issuance for which the underwriter is engaged.

Other Exemptions That May Be Useful for Underwriting and Investment Banking. Because advice concerning related derivatives or the investment of proceeds from the offering and other matters that are not covered by the Underwriter Exclusion are an integral part of what issuers or their bankers often want to communicate about, investment bankers may need to consider the availability of other exemptions. One possibility that may be available in some cases is where a municipal entity or obligated person is represented by an "independent registered municipal advisor" (an IRMA) with respect to the same matters being advised on. It may therefore become more common for banks to encourage an issuer to retain an IRMA on each transaction, which could allow the underwriter more latitude for

free discussion without fear of becoming a municipal advisor.

Additionally, a prospective underwriter that is also a registered swap dealer may seek to comply with a separate exclusion for registered swap dealers. Under this exclusion, swap dealers that recommend municipal derivatives or trading strategies that involve municipal derivatives are exempt from the definition of municipal advisor, as long as the swap dealer is not "acting as an advisor" to the municipal entity or obligated person in accordance with the Commodity Futures Trading Commission's (CFTC) external business conduct rules for swap dealers.

The Final Rule also provides an exemption for advice given in response to a request for proposals (RFP). As a result, a broker-dealer that is considering pitching a securities issuance proposal to a municipal entity may have greater latitude to provide advice to an issuer in response to an RFP than it would under the Underwriter Exemption.

Conduct Standards Under MSRB Rules. Underwriters of municipal securities, as well as municipal advisors, must register with the MSRB and comply with MSRB rules. A frequently voiced concern is how the Final Rule will interplay with MSRB Rule G-23, which generally prohibits a broker-dealer that has a "financial advisory" relationship from switching roles to act as an underwriter. Similar to the municipal advisor scheme, Rule G-23 provides an exception for advice provided in a broker-dealer's capacity as an underwriter and not as a financial advisor. Since underwriters might provide advice in the context of a pitch, the MSRB has said that a firm will not be considered to have a financial advisory relationship (and therefore precluded from them serving as an underwriter) if it "clearly identifies itself in writing as an underwriter and not as a financial advisor from the earliest stages of its relationship with the issuer with respect to that issue" and makes certain disclosures regarding its role and interests.[5] As a result, broker-dealers seeking to obtain underwriting business are in the practice of sending letters clarifying that they are not acting as advisors and are seeking to act as an underwriter in a principal capacity.

Rule G-23 does not determine whether an MSRB member is acting as a municipal advisor, or define what the nature of a municipal advisor's fiduciary duty is; rather, Rule G-23 governs conflicts of interest. However, the interaction between the Final Rule and Rule G-23 may raise significant confusion and potentially lead to anomalous results. The Final Rule definition of "municipal advisor" likely includes a Rule G-23 "municipal financial advisor," but each are subject to different exceptions and interpretations. For example, suppose a broker-dealer makes a pitch to act as an underwriter that includes a recommendation to the municipal entity and dutifully delivers a letter containing a Rule G-23 disclosure that it is seeking underwriting business and not acting as a financial advisor. For Rule G-23 purposes, the broker-dealer should not be a municipal financial advisor and would be free to act as an underwriter. But it is not at present clear that the letter would suffice to qualify the broker-dealer for the Underwriter Exclusion; as a result, if the broker-dealer gives "advice" in connection with an issuance of municipal securities and was not yet engaged in connection with that particular issuance, it is unclear if it would be consistent with its fiduciary duty to switch roles and act as an underwriter.

Relatedly, in August 2012, the MSRB adopted an interpretive notice regarding the application of MSRB Rule G-17 on fair dealing to underwriters, including a requirement that underwriters provide certain disclosures and representations to municipal issuers.[6] It is not clear whether it would be workable to combine in a single document any required Rule G-17 disclosures with terms evidencing the engagement of a firm as an underwriter to establish the Underwriter Exclusion.

Possible Changes in Market Practice for Underwriters. The Final Rules and related guidance are likely to lead to a number of changes in market practice driven by investment bankers seeking to assure that they do not trigger municipal advisor status or run afoul of fiduciary or other duties. Some changes may include:

- Increased use of RFPs, which may take varying forms;
- Encouragement of municipal issuers to use IRMAs to permit a broader range of advice by prospective underwriters;
- Development of forms of "engagement agreements" that would permit prospective underwriters to rely upon the Underwriter Exclusion more fully earlier in the process; and
- Limitation by prospective underwriters of information provided at the pre-engagement stage to more strictly factual communications not tailored to specific issuers—perhaps coupled with disclaimers or notices which state that the information provided is not intended to be a "recommendation" or otherwise constitute "advice."

Depending upon whether the SEC or the MSRB provide guidance concerning the interplay between the Final Rule and MSRB Rules G-23 and G-17, the potential approaches listed above may be interwoven with notifications and other compliance procedures under these MSRB Rules.

In any case, firms will need to revise their compliance policies and procedures and standard documents and templates for customer communications to implement these changes.

Conclusion. In light of the ambiguities and practical considerations raised by the Final Rule, we understand that several industry groups are engaged in discussions seeking clarifications and guidance from the staff of the SEC and MSRB. Until the issues discussed above are resolved, investment banks need to analyze whether their underwriting or other activities would require them to register as municipal advisors, and even if registered, whether they need to adjust their practices in order to avoid triggering a fiduciary or other duties to issuers.

1. The SEC initially adopted a temporary registration process, which has been in effect since 2010. Exchange Act Release No. 62824 (Sept. 1, 2010). Many financial institutions are already registered under this temporary registration regime.

2. The SEC also provided significant interpretive guidance along with the Final Rule. See Exchange Act Release No. 70462 (Sept. 18, 2013) (the Adopting Release).

3. "Obligated persons" are generally private entities that are obligated to repay or support payment of all or some portion of municipal securities.

4. In addition, municipal advisor status also applies to persons undertaking a solicitation of a municipal entity or obligated person, for direct or indirect compensation, on behalf of certain unaffiliated financial service providers.

5. MSRB Guidance on the Prohibition on Underwriting Issues of Municipal Securities for Which a Financial Advisory Relationship Exists under Rule G-23 (Nov. 27, 2011).

6. MSRB Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities (Aug. 2, 2012).