

HAWKINS ADVISORY

SEC Staff Posts Additional FAQs and Related Responses Regarding the Municipal Advisor Rules

Introduction

On May 19, 2014, the staff¹ of the Securities and Exchange Commission (the “SEC”) posted on the SEC’s website an updated set of “Frequently Asked Questions” (“FAQs”) and related responses [<http://www.sec.gov/info/municipal/mun-advisors-faqs.shtml>] regarding the SEC’s final rules (the “Rules”) governing the definition, registration, and regulation of municipal advisors that were issued on September 18, 2013.² A Hawkins Advisory dated October 3, 2013 [<http://www.hawkins.com/docs/news.154.pdf>], described and analyzed the Rules, and a Hawkins Advisory dated January 24, 2014 [<http://www.hawkins.com/docs/news.163.pdf>], summarized and analyzed the initial FAQs (released January 10, 2014). This Hawkins Advisory summarizes and analyzes the updated FAQs (the “FAQs II”).

The Rules provide definitions, clarify the statutory exclusions, and establish new exemptions from the definition of “municipal advisor.” The initial FAQs had provided useful guidance, in particular regarding what constitutes “advice”; the scope of the underwriter exclusion; and the scope of the RFP/RFQ and “independent registered municipal advisor” (“IRMA”) exemptions. Key issues addressed by the FAQs II, which are described further below, include the following:

- What does it mean to “rely on” the advice of an IRMA (as required by the Rules to qualify for the IRMA exemption)?
- How to determine whether a registered municipal advisor is “independent” (as required by the Rules to qualify for the IRMA exemption).
- For obligated persons, what constitutes “advice” both in the context of new municipal bond issues and outstanding municipal bond issues?
- Transitional guidance and relief for identifying proceeds of municipal securities held in existing accounts or existing investments, to assist those persons who provide advice regarding investment strategies for the investment of such proceeds.
- Additional guidance regarding the bank exemption from the definition of municipal advisor.
- Additional guidance regarding the statutory exclusions for engineers and attorneys from the definition of municipal advisor.

¹The guidance was provided by the staff of the Office of Municipal Securities. The guidance cautions that the responses were prepared by and represent the views of the staff and that the SEC neither approved nor disapproved the FAQs or the interpretive answers.

²SEC Rel. No. 34-70462 (Sept. 20, 2013), 78 Fed. Reg. 67467 (Nov. 12, 2013) (the “Release”).

Advice

Indirect Advice. Under the statute,³ the term “municipal advisor” is defined to include 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.” The FAQs II caution that a person that provides such advice indirectly through a third-party professional (including a registered municipal advisor) engaged by a municipal entity or obligated person would be a municipal advisor (absent an applicable exclusion or exemption).

We understand that the staff intended this FAQ to address the situation in which advice is given to a third-party professional on the understanding that such advice will be passively transmitted to a municipal entity or obligated person, in an attempt by the advising entity to avoid the “municipal advisor” characterization that would result from direct communication of its advice. However, the answer seems broad enough to include any advice with respect to municipal financial products or the issuance of municipal securities that is communicated by a market participant to a registered municipal advisor, whether or not there is an understanding, express or otherwise, that such advice will in turn be conveyed to the municipal entity or obligated person.

Institutional Buyer. The FAQs II state that an institutional buyer that “only provides information regarding the terms under which [it] would purchase securities for its own account” is not a municipal advisor.

IRMA Exemption

“Rely On”. A person who performs municipal advisory activities in a circumstance in which a municipal entity or obligated person is otherwise represented by an IRMA with respect to the same aspects of a municipal financial product or an issuance of municipal securities will be exempt from the definition of “municipal advisor.” One element of the IRMA exemption is that the municipal entity or obligated person must provide “a representation in writing that it is represented by, and will *rely on* the advice of, an independent registered municipal advisor.” In the FAQs II, the staff clarified that reliance does not require that the advice be followed. The FAQs II state:

In the staff’s view, for purposes of this exemption, the term “rely on” means that the municipal entity or obligated person will seek and consider the advice, analysis, and perspective of the independent registered municipal advisor. The staff does not believe, however, that, for purposes of this exemption, “rely on” means that the municipal entity or obligated person must follow the advice of the independent registered municipal advisor.

Independence. For purposes of the IRMA exemption, the Rules define “independent” to mean a registered municipal advisor “that is not, and within at least the last two years was not, associated . . . with the person seeking to rely” on the IRMA exemption. It was unclear whether the firm or the individual is required to be independent. The FAQs II explain that both the individual advisor and the firm must be independent.

The entity level analysis is as follows:

The entity level analysis focuses on whether the registered municipal advisor *firm* is independent from the transaction participant *firm* seeking to rely on the exemption Accordingly, in the staff’s view, if the registered municipal advisor firm is not, and within the last two years was not, directly or indirectly, controlling, controlled by, or under common control with the transaction participant firm seeking to rely on the exemption, then such registered municipal advisor firm would be independent at an entity level from the transaction participant firm.

³Section 15B(e)(4) of the Securities Exchange Act of 1934.

The individual level analysis is as follows:

In the staff's view, a registered municipal advisor firm is not considered to be independent from a transaction participant firm for purposes of the independent registered municipal advisor exemption under the Final Rules if (1) an individual is a current employee of a registered municipal advisor firm in the capacity of an Associated Individual⁴ and that individual formerly was employed, within the past two years, by the transaction participant firm in the capacity of an Associated Individual; and (2) such Associated Individual of a registered municipal advisor firm participates in any matter, including participation in the management, direction, supervision, or performance of activities relating to the matter, that involves municipal advisory activity 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 firm, during the applicable two-year period.

The FAQs II further provide that the individual level analysis is performed with respect to both of the following situations: (i) a current employee of a registered municipal advisor firm formerly was employed by a transaction participant firm seeking to rely on the IRMA exemption, and the converse, by which (ii) a current employee of a transaction participant firm formerly was employed by a registered municipal advisor firm.

Municipal Entity Employees

The statute excludes from the definition of a municipal advisor "a person (who is not a municipal entity or an employee of a municipal entity)," and defines "municipal entity" to mean "any State, political subdivision of a State, or municipal corporate instrumentality of a State." It was unclear whether the statutory exclusion applied if an employee of a municipal entity was providing advice to a municipal entity for which it was not an employee. The FAQs II use the example of an employee in a state treasurer's office providing advice on an issuance of municipal securities to a municipal entity located within such state, and clarify that "an employee of a state-level municipal entity may provide advice to another municipal entity within the state to the extent the employee acts within the scope of his or her employment."

Obligated Persons

A municipal advisor includes a person who provides advice to an obligated person with respect to municipal financial products or the issuance of municipal securities. But when does a person become an "obligated person?" For a new bond issue, in the specific context where the menu of "debt financing alternatives do not relate to any outstanding issues of municipal securities," the FAQs II provide an answer in the context of a financing for a university. The FAQs II state as follows:

[I]f the university is considering its debt financing alternatives and has not begun the process of applying to, or negotiating with, the municipal entity to issue the new money municipal securities on the university's behalf, the university is not an obligated person with respect to such issuance of municipal securities.

The FAQs II provide that advice at any time while the bonds are outstanding will be treated as advice with respect to the issuance of municipal securities. In effect, the staff interprets the term "issuance" as being equivalent to the term "issue." This is consistent with an equally broad interpretation of the statute in the Release (note the phrase "life of an issuance"), which provides:

⁴ "Associated Individual" is defined in the FAQs II to include, with respect to either a municipal advisor firm or the transaction participant seeking to use the IRMA exemption, "(A) any partner, officer, director, or branch manager (or any person occupying a similar status or performing similar functions); or (B) any other employee who is engaged in the management, direction, supervision, or performance of any activities relating to the provision of advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities."

“advice with respect to the issuance of municipal securities” should be construed broadly from a timing perspective to include advice throughout the life of an issuance of municipal securities, from the pre-issuance planning stage for a debt transaction involving the issuance of municipal securities to the repayment stage for those municipal securities.

Based on this interpretation, the FAQs II provide “that the broker-dealer’s advice to the university with respect to an outstanding issue of municipal securities on which the university is an obligated person . . . would constitute advice to an obligated person with respect to the issuance of municipal securities under the Final Rules.”

Investment Strategies; Proceeds of Municipal Securities

The term “municipal advisor” includes a person who provides advice to a municipal entity or obligated person with respect to municipal financial products. “Municipal financial products” is defined to include “investment strategies,”⁵ and investment strategies is defined to include “plans or programs for the investment of the proceeds of municipal securities . . . and the recommendation of and brokerage of municipal escrow investments.”⁶

If a person is providing investment advice to a municipal entity or obligated person, how does such person determine whether the funds being invested are proceeds of municipal securities or municipal escrow investments? The Rules provide a “reasonable reliance” guideline for both such proceeds and such investments:

[A] person may rely on representations in writing made by a knowledgeable official of the municipal entity or obligated person whose funds are to be invested or reinvested regarding the nature of such investments, provided that the person seeking to rely on such representations has a reasonable basis for such reliance.⁷

In the FAQs II, the staff stressed that the reasonable reliance guideline in the Rules provided one means, but not the exclusive means, to determine whether funds to be invested were proceeds of municipal securities or municipal escrow investments. The staff distinguished between (i) funds held in existing accounts or existing investments and (ii) proceeds received on or after July 1, 2014 (the effective date of the Rules). With respect to the former, the staff advised as follows:

In recognition of the administrative burdens and challenges market participants raised with respect to identifying existing proceeds of municipal securities . . . the staff believes that, unless a market participant actually knows or reasonably should have known that an existing account or existing investment contains proceeds of municipal securities, a market participant may determine that such existing accounts or existing investments do not contain proceeds of municipal securities.

With respect to the phrase “reasonably should have known,” the staff advises that “a market participant could utilize a reasonable diligence process . . . [which] should include a review of relevant information within the market participant’s possession.” The staff also addresses the situation where a client does not respond to a market participant’s request for information regarding the source of funds being invested, and allows for the market participant to make an assumption that “unless notified otherwise, that the funds on deposit or held in existing investments in the client’s account do not include proceeds of municipal securities.”

⁵Section 15B(e)(5) of the Securities Exchange Act of 1934.

⁶Section 15B(e)(3) of the Securities Exchange Act of 1934.

⁷§ 240.15Ba1-1(h)(2) and (m)(3).

The FAQs II state that for “investment advice provided on or after July 1, 2014 regarding investments of newly-arising proceeds received from municipal securities that are issued on or after that date, market participants should develop policies and procedures” consistent with the Rules and prior SEC guidance.

For pension obligation bonds, the FAQs II provide that “proceeds of pension obligation bonds lose their character as proceeds of municipal securities under the Final Rules upon their contribution to the public pension plan” if such proceeds “are commingled with other pension funds for collective investment and treated as spent to carry out their authorized purposes to fund the public pension plan under applicable state law upon their contribution to the pension plan.”⁸ Therefore, a person providing advice with respect to the investment of such proceeds would not be a municipal advisor. The FAQs II do, however, draw the following distinction:

By contrast, however, in the staff’s further view, if a municipal entity segregates proceeds of pension obligation bonds and continues to account for them separately as proceeds of the pension obligation bonds or retains control over the ability to use such funds for any purpose other than the exclusive benefit of pension beneficiaries, such proceeds continue to constitute proceeds of municipal securities under the Final Rules until used ultimately to pay pension benefits to pension fund beneficiaries or to carry out other authorized purposes of the pension obligation bonds.

Miscellaneous

The FAQs II provide additional guidance regarding the statutory exclusions from the definition of municipal advisor for engineers and attorneys, and the exemption in the Rules for banks, which in general simply re-emphasizes the statutory language, the language in the Rules, and the initial FAQs. The Rules provide exemptions for banks, including if the advice concerns “the purchase of a municipal security by the bank for its own account.”⁹ In contrast:

[I]f a bank provides advice to a municipal entity or obligated person regarding the structuring, timing, terms, and similar matters with respect to an issuance of municipal securities that extends beyond those municipal securities that the bank plans to purchase for its own account, such advice would constitute municipal advisory activity that is outside the scope of the bank exemption under the Final Rules.

⁸Such analysis is consistent with the spending exceptions to the arbitrage rebate requirement set forth at 26 C.F.R. § 1.148-7.

⁹§ 240.15Ba1-1(d)(3)(iii)(B).

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New York

One Chase Manhattan Plaza
New York, NY 10005
Tel: (212) 820-9300

Washington, D.C.

601 Thirteenth Street, N.W.
Washington, D.C. 20005
Tel: (202) 682-1480

Newark

One Gateway Center
Newark, NJ 07102
Tel: (973) 642-8584

Hartford

20 Church Street
Hartford, CT 06103
Tel: (860) 275-6260

Sacramento

1415 L Street
Sacramento, CA 95814
Tel: (916) 326-5200

Los Angeles

333 South Grand Avenue
Los Angeles, CA 90071
(213) 236-9050

San Francisco

One Embarcadero Center
San Francisco, CA 94111
Tel: (415) 486-4200

Portland

200 SW Market Street
Portland, OR 97201
Tel: (503) 402-1320

Hawkins
DELAFIELD & WOOD LLP