

## **MUNICIPAL ADVISOR RULE – HOW IT AFFECTS LOCAL GOVERNMENTS**

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On February 28, 2014, the executive board of the Government Finance Officers Association (“GFOA”) approved revisions to three of its Best Practices relating to choosing the method of bond sale, selecting underwriters, and engaging municipal advisors. The revisions are intended to assist GFOA’s members in adjusting to the Securities and Exchange Commission’s (“SEC”) new Municipal Advisor Rule which will become effective on July 1. In addition to defining who is a Municipal Advisor, the SEC’s Municipal Advisor Rule also sets forth new regulations regarding the role and advice that can be provided by underwriters. As a result, the Municipal Advisor Rule will alter the way issuers interact with most of the members of their financing team.

For issuers that normally engage a financial advisor for their bond or lease transactions, it is likely that there will be very few changes in the manner in which transactions are completed. However, issuers that have worked solely with underwriters, may find that their relationship to their underwriter and the type of advice given will be substantially different after July 1.

### **BACKGROUND OF THE MUNICIPAL ADVISOR RULE**

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (also known as the Dodd-Frank Act) became law. The Dodd-Frank Act includes numerous provisions affecting the financial industry. Among the provisions affecting local governments, the Act regulates Municipal Advisors.

Prior to passage of the Dodd-Frank Act, independent financial advisors and certain other advisors were unregulated. Historically, anyone could provide advice to municipalities regarding the issuance of securities.

The SEC defines a Municipal Advisor as anyone that provides “Municipal Advisory Activities.” The SEC defined “Municipal Advisory Activities” as 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.” Anyone that provides Municipal Advisory Activities must be registered as a Municipal Advisor and will be subject to rules promulgated by the Municipal Securities Rulemaking Board (the “MSRB”). Anyone that is deemed to be a Municipal Advisor for a particular transaction has a fiduciary duty to their municipal entity clients and may not underwrite securities for that transaction.

The Dodd-Frank Act exempts from the definition of Municipal Advisor municipal entities and employees of a municipal entity.

The Dodd-Frank Act also granted exemptions to certain market participants who do not provide services considered to be Municipal Advisory Activities. The exemptions are as follows:

1. A broker, dealer, or municipal securities dealer serving as an underwriter (as defined in the Securities Act of 1933),

2. An investment adviser registered under the Investment Advisers Act of 1940, or persons associated with such investment advisors who are providing investment advice,
3. A commodity trading advisor registered under the Commodity Exchange Act or persons associated with a commodity trading advisor who are providing advice related to swaps,
4. Attorneys offering legal advice or providing services that are of a traditional legal nature, and
5. Engineers providing engineering advice.
6. In a December 2010 release, the SEC also indicated that preparation of audits and financial statements by accountants does not constitute the provision of advice within the meaning of the Dodd-Frank Act.

These exemptions only apply to the extent that the individual is not engaged in Municipal Advisory Activities. Accordingly, a broker-dealer is not exempt from the definition of Municipal Advisor and the Municipal Advisor regulations if the individual is serving as a financial advisor and not as an underwriter.

Broadly speaking, there are two types of Municipal Advisors.

1. “Independent Municipal Advisors” who are individuals whose primary business is assisting with the structuring and issuance of municipal securities but are not associated with any brokerage firm, and
2. “Broker-Dealer/Municipal Advisors” who are individuals at brokerage firms, are registered broker-dealers, serve as underwriters and periodically serve as Municipal Advisors.

## **WHAT IS THE MUNICIPAL ADVISOR RULE?**

Under the Dodd-Frank Act all individuals deemed to be Municipal Advisors must register with the SEC and are subject to rules promulgated by the MSRB. While the Dodd-Frank Act provided a framework for regulation, the SEC was left to establish a rule specifically defining who is a Municipal Advisor.

The Municipal Advisor Rule was adopted on September 18, 2013. The Municipal Advisor Rule together with the Adopting Release sets forth the specifics as to who will be considered to be a Municipal Advisor. The rule will become effective on July 1, 2014.

The Municipal Advisor Rule, as adopted, maintains the exemptions set forth in the Dodd-Frank Act, but adds clarification to the exemptions for many of the parties named in the Dodd-Frank Act. The final rule narrowed the definition of Municipal Advisor and exempted appointed municipal officials from the definition.

Surprising, the Act significantly changes the timing and type of advice that can be given by underwriters.

While some broker-dealers purposefully serve periodically as Municipal Advisors, broker-dealers that intend to serve as underwriters must now be careful not to give advice that is considered to be Municipal Advisor Activities. Such advice would cause the broker-dealer to be deemed to be a Municipal Advisor, subject the broker-dealer to the fiduciary duty standards and bar the broker-dealer from serving as an underwriter for the transaction for which the advice was given.

## **WHAT IS ADVICE?**

An individual is a Municipal Advisor only if the individual provides advice. The SEC did not offer a “bright line” definition of what constitutes advice but rather indicated that the determination is based on the particular facts and circumstances. The SEC indicated that a “recommendation” with respect to the structure, timing, terms or similar matters concerning a municipal financial product or an issuance of municipal securities will constitute “advice.” Accordingly, general information would not be considered to be advice and does not include the following:

- Information of a factual nature without subjective assumptions, opinions, or views;
- Information that is not particularized to a specific municipal entity or type of municipal entity;
- Information that is widely disseminated for use by the public, clients, or market participants other than municipal entities or obligated persons; or
- General information in the nature of educational materials.

The more the information is tailored to a specific municipal entity or transaction the more likely it is that the information could be considered to be a recommendation and therefore advice that would make the broker-dealer be deemed to be a Municipal Advisor.

## **HOW DOES THE RULE IMPACT THE RELATIONSHIP BETWEEN AN ISSUER AND AN ADVISOR?**

The relationship between a financial advisor and an issuer should remain substantially unchanged after July 1, 2014. However, the MSRB has just begun drafting rules so it is impossible to determine what changes may occur between financial advisors and issuers. The following are a few possibilities where changes may occur:

- 1) Contracts. The MSRB is drafting a rule which if adopted will require Municipal Advisors to enter into written contracts with their clients.
- 2) Disclosures. The MSRB is drafting a rule which if adopted will require Municipal Advisors to disclose conflicts of interest.
- 3) Fees and Recordkeeping. The MSRB is imposing fees and record keeping rules that may result in higher fees to issuers.

## **HOW DOES THE RULE IMPACT THE RELATIONSHIP BETWEEN AN ISSUER AND AN UNDERWRITER?**

The timing and nature of conversations underwriters can have with issuers will change.

The SEC made it clear that unless an individual has satisfied one of three exemptions, a broker-dealer that provides advice, even in response to the issuer's request for such advice, could cause the broker-dealer to be deemed to be a Municipal Advisor. In addition, broker-dealers submitting unsolicited ideas for a transaction in which they do not have an underwriting relationship may result in the broker-dealer being considered a Municipal Advisor for the transaction.

A broker-dealer that wants to serve as the underwriter of a transaction and not as the financial advisor will need to be careful not to give the type of advice that could ban the broker-dealer from underwriting under the MSRB's Rule G-17 and Rule G-23 as described hereinafter.

As noted above, an underwriter can give certain types of advice without becoming a Municipal Advisor if it meets one of three exemptions. The exemptions are referred to as follows:

1. The Underwriting Exemption.
2. The Independent Registered Municipal Advisor Exemption ("IRMA Exemption").
3. The Request for Proposal Exemption ("RFP Exemption").

If the underwriter meets one of the exemptions, then the underwriter can give advice without being deemed to be a Municipal Advisor and without acting in a fiduciary capacity. The following is a further description of the three exemptions.

### **1. Underwriting Exemption**

The Dodd Frank Act excludes from the definition of "Municipal Advisor" a broker, dealer, or municipal securities dealer serving as an underwriter.

The term "underwriter" is defined under Section 2(a)(11) of the Securities Act of 1933, and states, *inter alia*, that the term "underwriter" is:

Any person who *has purchased* from an issuer *with a view to*, or offers or sells for an issuer in connection with, *the distribution* of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking.

The MSRB offers a shorter definition:

"Underwriting is the process of purchasing all or any part of a new issue of municipal securities from the issuer and offering such securities for sale to investors."

The SEC indicated that the exclusion of a broker-dealer from the definition of Municipal Advisor applies only "to the extent that the broker, dealer, or municipal securities dealer engages in activities that are within the scope of an underwriting of such issuance of municipal securities."

Accordingly, the SEC limited the scope of the underwriter exclusion by stating that it only applies to activities it considers to be (a) specific to a particular issue of municipal securities and (b) integral to fulfilling the role of an underwriter.

The Adopting Release includes a list of activities that the SEC considers to be within the scope of the underwriting exception. These activities include, but only with respect to the specific municipal securities issue being underwritten, the following:

- (1) advice regarding the structure, timing, terms, and other similar matters concerning a **particular** issuance of municipal securities;
- (2) preparation of rating strategies and presentations related to the issuance being underwritten;
- (3) preparations for and assistance with investor “road shows” and investor discussions related to the issuance being underwritten;
- (4) advice regarding retail order periods and institutional marketing if the municipal entity has engaged an independent registered municipal advisor;
- (5) Advice regarding retail order periods and institutional marketing if the issuer has decided to engage in a negotiated sale;
- (6) Assistance in the preparation of the preliminary and final Official Statement;
- (7) Assistance with the closing of the issue, including negotiation and discussion with respect to all documents, certificates, and opinions needed for the closing;
- (8) Coordination with respect to obtaining CUSIP numbers and the registration of the issue with the Depository Trust Company (DTC);
- (9) Preparation of post-sale reports for the issue; and
- (11) Structuring of refunding escrow cash flow requirements, but not the recommendation of and brokerage of particular municipal escrow investments.

In addition to limiting the type of advice that can be considered to be within the scope of any underwriting, the SEC limited the period during which the underwriter exclusion applies. The SEC stated that the exclusion (a) is not available until such time as a broker-dealer has been engaged as the underwriter with respect to a specific issue of municipal securities, and (b) it terminates at the “end of the underwriting period.” Advice with respect to municipal financial products or the issuance of municipal securities that is given before a specific engagement or after the end of the underwriting period would, in the SEC’s view, constitute Municipal Advisory Activities.

As previously noted, the Municipal Advisor Rule does not permit an underwriter to provide advice that is not related to a specific underwriting for which the underwriter is engaged. In other words, an underwriter cannot give **any** “advice” if it is not engaged for a particular transaction.

Furthermore, an underwriter cannot give advice that is outside of the scope of the underwriter exclusion. The SEC indicated that it considers the following activities, to be outside of the scope of the underwriter exclusion:

- (1) advice on investment strategies;
- (2) advice on municipal derivatives (including derivative valuation services);
- (3) advice on what method of sale (competitive sale or negotiated sale) a municipal entity should use for an issuance of municipal securities;
- (4) advice on whether a governing body of a municipal entity or obligated person should approve or authorize an issuance of municipal securities;
- (5) advice on a bond election campaign;
- (6) advice that is not specific to a particular issuance of municipal securities on which a person is serving as underwriter and that involves analysis or strategic services with respect to overall financing options, debt capacity constraints, debt portfolio impacts, analysis of effects of debt or expenditures under various economic assumptions, or other impacts of funding or financing capital projects or working capital;
- (7) assisting issuers with competitive sales, including bid verification, true interest cost (TIC) calculations and reconciliations, verifications of bidding platform calculations, and preparation of notices of sale;
- (8) preparation of financial feasibility analyses with respect to new projects;
- (9) budget planning and analyses and budget implementation issues with respect to debt issuance and collateral budgetary impacts;
- (10) advice on an overall rating strategy that is not related to a particular issuance of municipal securities on which a person is serving as an underwriter, including advice and actions taken on behalf of a municipal entity or obligated person between financing transactions;
- (11) advice on overall financial controls that are not related to a particular issuance of municipal securities on which a person is serving as an underwriter; or
- (12) advice regarding the terms of requests for proposals or requests for qualifications for the selection of underwriters or other professionals for a project financing and advice regarding review of responses to such requests, including matters regarding compensation of such underwriters or other professionals.

The SEC indicated that the above-listed activities are not within the scope of the underwriter exclusion because the activities are either not specific to a particular issuance of municipal securities for which a broker-dealer could be serving as an underwriter or the activities are not integral to fulfilling the role of an underwriter.

## **2. IRMA Exemption**

Under certain circumstances an underwriter may provide advice to a municipal entity if the municipal entity is represented by an Independent Registered Municipal Advisor (“IRMA”). In order to qualify for this exemption the following conditions must be met.

- (1) To be considered as “independent” the registered municipal advisor is not, and for the past 2 years has not been associated with the underwriter relying on this exemption.
- (2) The IRMA must be providing advice with respect to the same aspects of the municipal financial product or issuance of municipal securities as the underwriter.
- (3) The underwriter seeking to rely on this exemption must receive a written representation from the municipal entity that it is represented by and that it will rely on the advice of the IRMA.
- (4) The underwriter relying on this exemption must provide written disclosures to the municipal entity, with a copy to the IRMA, stating that the underwriter is not a municipal advisor and is not subject to the fiduciary duty imposed on municipal advisors.

## **3. RFP Exemption**

Under certain circumstances an underwriter may freely provide advice to a municipal entity if the underwriter is responding to a Request for Proposal (“RFP”), a Request for Qualifications (“RFQ”) or mini-RFP.

The SEC indicated that the RFP exemption represents a way for municipal entities to solicit ideas, including advice, from market participants regarding municipal financial products or the issuance of municipal securities in a competitive process. According to the SEC’s staff, an RFP or RFQ process with the following parameters generally would be consistent with the requirements of the RFP exemption:

- (1) The municipal entity or a registered municipal advisor acting on their behalf, conducts the RFP or RFQ process;
- (2) A particular objective is identified in the RFP or RFQ (e.g., ideas on how to structure a particular issuance of municipal securities to finance an identified capital project or program);
- (3) The RFP or RFQ is open for a specified period of time that is reasonable under the facts and circumstances and that is not indefinite (e.g., absent particular complexity or exigent or other circumstances that might support a longer or shorter specific period of time, an open period of up to six months generally is considered reasonable); and
- (4) The RFP or RFQ involves a competitive process under the facts and circumstances (e.g., the RFP or RFQ is sent to at least three reasonably competitive market participants or the RFP or RFQ is publicly disseminated by posting it on the official website of the municipal entity or obligated person).

It should be noted that if a broker-dealer assists a municipal entity with the preparation of the RFP or RFQ, advice provided as part of that preparation would likely cause the broker-dealer to be deemed to be a Municipal Advisor and banned from underwriting the transaction.

According to the SEC's staff an RFP or RFQ does not need to be part of a municipal entity's formal procurement process to be consistent with the requirements of the RFP exemption.

The SEC also allows the RFP exemption for a type of RFP it designated as "mini-RFPs." A mini-RFP may be distributed in a targeted way to market participants that the municipal entity has pre-screened or pre-qualified. While it is permissible for a mini-RFP to be distributed in a more discrete and targeted manner than a general RFP or RFQ, the SEC's staff believes that, to be consistent with the RFP exemption, the process should still follow the types of parameters similar to those described above, but with slight modifications that take into consideration that the recipients of the mini-RFP will already have been pre-screened and pre-qualified in a process administered by the related municipal entity or a Municipal Advisor acting on their behalf.

Accordingly, in the SEC staff's view, a mini-RFP process with the following parameters generally would be consistent with the requirements of the RFP exemption:

- (1) A municipal entity or obligated person, or a registered municipal advisor acting on their behalf, conducts the mini-RFP;
- (2) One or more particular questions is identified in the mini-RFP;
- (3) The mini-RFP is open for a specified period of time that is reasonable under the facts and circumstances and that is not indefinite (e.g., absent particular complexity or exigent or other circumstances that might support a longer or shorter specific period of time, an open period of up to three months generally is considered reasonable); and
- (4) The mini-RFP is sent to either the entire pool of pre-screened or pre-qualified market participants or at least three firms.

## **WHAT HAPPENS IF A BROKER-DEALER PROVIDES ADVICE WITHOUT AN EXEMPTION?**

There are two key MSRB rules that broker-dealers must consider in the context of the Municipal Advisor Rule. These rules are

- Rule G-23 which relates to the activities of financial advisors, and
- Rule G-17 which is referred to as the fair dealing rule.

### Rule G-23

The MSRB's Rule G-23 was first adopted in September 1977. The primary purpose of Rule G-23 is to prevent conflicts of interest by prohibiting an underwriter from serving as a financial advisor. Amendments to Rule G-23 were adopted by the MSRB and became effective November 27, 2011 which prohibit the practice of a broker-dealer terminating their engagement as a financial advisor and subsequently serving as the underwriter of the issue. Stated differently,



the November 27 Amendments are intended to stop the practice of role-switching that allowed an individual to serve as both the financial advisor and underwriter on the same transaction.

The MSRB's Rule G-23 states that the "purpose and intent of this rule is to establish ethical standards and disclosure requirements for brokers, dealers, and municipal securities dealers who act as financial advisors to issuers with respect to the issuance of municipal securities." The rule defines the financial advisory relationship as follows: a financial advisory relationship shall be deemed to exist when a broker, dealer, or municipal securities dealer renders or enters into an agreement to render financial advisory or consultant services to or on behalf of an issuer with respect to the issuance of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such issue.

An exception is provided that recognizes that certain matters are integral to an underwriting engagement. The Rule indicates that "a financial advisory relationship shall not be deemed to exist when, in the course of acting as an underwriter and not as a financial advisor, a broker, dealer or municipal securities dealer renders advice to an issuer, including advice with respect to the structure, timing, terms and other similar matters concerning the issuance of municipal securities."

Accordingly, along with the passage of the amendments to Rule G-23, the MSRB released an Interpretive Notice stating that an underwriter may provide advice concerning the structure, timing, terms, and other similar matters concerning an issue of municipal securities, provided that the underwriter undertakes certain specific actions relating to their role to the issuer. The actions are as follows:

- 1) From the earliest stages of its relationship with the issuer with respect to a particular issue, the Underwriter must clearly identify itself in writing as an underwriter and not as a financial advisor;
- 2) The writing must indicate that the "primary role of an underwriter is to purchase securities in an arm's-length commercial transaction between the issuer and the underwriter and that the underwriter has financial and other interests that differ from those of the issuer"; and
- 3) The underwriter may not engage in a course of conduct that is inconsistent with an arm's-length relationship with the issuer in connection with such issue of municipal securities.

#### Rule G-17

Rule G-17 is the MSRB's fair dealing rule. Rule G-17 is as follows: "In the conduct of municipal securities or municipal advisory activities, each broker, dealer, municipal securities dealer, and municipal advisor shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice."

With the passage of the Dodd-Frank Act, the MSRB's responsibilities were expanded to include the protection of state and local government issuers as well as investors. As a result, the MSRB released an Interpretive Notice to address its obligations to issuers.

In a June 2012 presentation regarding the Interpretive Notice the MSRB stated that

*“In the underwriting process issuers often will engage firms to serve as their financial advisors which under the Dodd-Frank Act are bound as municipal advisors by a fiduciary duty to put the issuer’s best interest first and to sit on the same side of the table with the issuer as compared to the across the table, or arms-length relationship, of underwriters.”*

The Interpretive Notice became effective in August 2012 and describes the fair practice duties of broker-dealers owed to issuers of municipal securities when acting as underwriters for new issues of municipal securities.

Consequently, the MSRB now requires that under Rule G-17 underwriters must provide written disclosures to issuers stating, among other things, the following:

- (1) The underwriter must deal fairly at all times with both municipal issuers and investors,
- (2) The underwriter’s primary role is to purchase securities with a view to distribution in an arm’s-length commercial transaction with the issuer and it has financial and other interests that differ from those of the issuer;
- (3) **Unlike a municipal advisor, the underwriter does not have a fiduciary duty to the issuer under the federal securities laws and is not required by federal law to act in the best interest of the issuer** without regard to the underwriter’s own financial or other interests; and
- (4) The underwriter has a duty to purchase securities from the issuer at a fair and reasonable price, but must balance that duty with its duty to sell municipal securities to investors at prices that are fair and reasonable.

Rule G-17 also prohibits underwriters from recommending to an issuer **not** to retain a municipal advisor.

Upon the adoption of the Rule G-17 Interpretive Notice the MSRB stated that the:

*“MSRB rules previously prohibited an underwriter from engaging in any deceptive, dishonest or unfair practice with respect to an issuer of municipal securities. The new requirements significantly clarify the different roles, responsibilities and relationships of the financial professionals involved in municipal bond deals...”*

## **DO YOU NEED A FINANCIAL ADVISOR?**

For many years the GFOA has had a “Best Practice” recommending the engagement of financial advisors for municipal securities transactions. When the Municipal Advisor Rule was adopted, Tim Firestone, president of the GFOA said,

*“The final Rule aims to set a clear line between advice and the underwriting of bonds. Differentiating these two practices is key to the implementation of the*

*municipal advisor rule and will encourage best practices by issuers and other professionals.”*

While engagement of a financial advisor is a GFOA “Best Practice” it is important to note that the Municipal Advisor Rule does not require the use of a Municipal Advisor. However, unlike the past, there are no longer blurred lines between the roles of an underwriter and a financial advisor in a municipal bond or lease transaction. Underwriters will be limited with respect to the timing and type of advice provided.

Unlike an underwriter, a Municipal Advisor may provide advice on any aspect of a municipal securities transaction. Unlike an underwriter, a financial advisor, acts in a fiduciary capacity as agent for the governmental unit, assisting it in determining the debt structure, determining the method and timing of the sale, and preparing or assisting in the preparation of documents to be used in connection with the sale. Ultimately, the financial advisor works to ensure the lowest possible interest cost by either selling the issue competitively or by negotiating the pricing with the underwriter. In the absence of a financial advisor, an underwriter assists the issuer in structuring the securities in order that the issue can be sold; however, this is not the same as serving as a financial advisor. An underwriter provides advice required for the sale of the issue, establishes the terms of the sale and sets the final rates and prices. These terms and the final pricing might not reflect the issuer’s best interest.

Consider for example, structuring a bond issue. Advice regarding the structure of an issue may be provided by either an underwriter or a financial advisor. The structure that is best for the issuer may not be a structure that all underwriters would be able to sell. It is unlikely that any underwriter would recommend a structure that they are unable to sell.

On July 1, 2014, the manner in which municipal securities transactions are completed will change. Now may be a good time to consider engaging a financial advisor. The use of a financial advisor provides issuers the following benefits.

- (1) A Municipal Advisor is the only party to a municipal securities transaction working solely in the interest of the municipal entity.
- (2) Without a Municipal Advisor no party can appropriately advise an issuer of the merits of a competitive sale compared to a negotiated sale.
- (3) Without a Municipal Advisor no party can fairly assess whether the financing terms and covenants are favorable.
- (4) Without a Municipal Advisor no party can fairly assess whether the rates and yields are favorable.
- (5) Without a Municipal Advisor most issuers do not have sufficient knowledge of the bond market to negotiate the transaction in their own best interest.

Municipal entities should consider using a financial advisor even when they have a preference for a particular underwriter. Municipal entities that engage financial advisors will be able to obtain the greatest amount of ideas, recommendations and advice under the new Municipal Advisor Rule.

For several years the bond market has been subjected to regulatory changes including recent amendments to the MSRB's Rule G-23 and G-17. The Municipal Advisor Rule represents a major change in the manner in which municipal financing transactions are completed. Embrace the change and prepare for an improved municipal securities market.