

SEC Extends Temporary Registration of Municipal Advisors

On December 21, 2011, the Securities and Exchange Commission (the “SEC”) extended the term of the interim final temporary rule providing for the temporary registration of municipal advisors (the “Interim Rule”) to September 30, 2012. The Interim Rule had been scheduled to expire on December 31, 2011, and other rules proposed by the SEC in December 2010 that had provided guidance for, and definitions of, terms relating to the municipal advisor registration scheme had also been expected to be finalized by the end of December 2011. Given the extension of the Interim Rule, it is now expected that the SEC may adopt permanent rules defining the contours of municipal advisor registration in the second half of 2012. As discussed in greater detail below, the municipal advisor registration regime may have significant implications for investment advisers and broker-dealers, though the current state of the rulemaking leaves open several interpretive questions.

I. Background on the Interim Rule and Need for Clarity

Prior to the passage of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the “Dodd-Frank Act”), municipal advisors generally were not required to register with the SEC or other governmental entities with respect to their municipal advisory activities. The Dodd-Frank Act amends the *Securities and Exchange Act of 1934* (the “Exchange Act”) to prohibit municipal advisors from soliciting or providing certain advice to municipal entities without first registering with the SEC. In September 2010, the SEC adopted an Interim Rule to establish a registration process to allow municipal advisors to temporarily satisfy the registration requirement mandated by the Dodd-Frank Act prior to adoption of a final rulemaking relating to municipal advisor registration. Under the Dodd-Frank Act, initial registration of municipal advisors with the SEC was required by October 1, 2010. Entities required to register with the SEC were also required to register with the Municipal Securities Rulemaking Board (the “MSRB”) by December 31, 2010. On December 20, 2010, the SEC also proposed rules on municipal advisor registration to give effect to provisions of the Dodd-Frank Act establishing a permanent municipal advisor registration regime (the “Proposed Permanent Rules”).

For those entities who have temporarily registered as municipal advisors, the extension of the Interim Rule provides that their registration will be extended to September 30, 2012, unless their registration is rescinded by the SEC or the SEC adopts a final permanent rule for the registration of municipal advisors.

The MSRB has expressed concern on several occasions since adoption of the Interim Rule that some market participants who are engaged in municipal advisory activities have not yet registered with the SEC and MSRB. Without final guidance on municipal advisor registration, some entities remain uncertain as to whether they are required to register. Indeed, some have registered with the SEC as a defensive measure, stating in their applications that such registration is precautionary in the event the SEC deems them a municipal advisor.

We note that given the volume and tenor of comments and input the SEC has received regarding the Proposed Permanent Rules, the permanent municipal advisor registration scheme may take on a very different form from what had been initially proposed in the Proposed Permanent Rules. The SEC’s Proposed Permanent Rules and forms may be found at the SEC’s website [here](#).

II. Interpretation of “Municipal Advisor,” “Solicitation of a Municipal Entity” and Related Terms under the Proposed Permanent Rules

A. Definition and Examples of a “Municipal Advisor”

Post-Dodd-Frank, the Exchange Act defines a “municipal advisor,” in part, as a person (not including a municipal entity or a municipal employee) that (1) undertakes a solicitation of a municipal entity or obligated

person or (2) provides advice to or on behalf of a municipal entity or obligated person¹ with respect to municipal financial products or the issuance of municipal securities. As described below, the Exchange Act also provides for exclusions from the statutory definition of a municipal advisor.

According to the release discussing the Proposed Permanent Rules, a “municipal advisor” includes three principal types of municipal advisors:

“(1) financial advisors, including, but not limited to, broker-dealers already registered with the [SEC], that provide advice to municipal entities with respect to their issuance of municipal securities and their use of municipal financial products;

(2) investment advisers that advise municipal pension funds and other municipal entities on the investment of funds held by or on behalf of municipal entities (subject to certain exclusions from the definition of a ‘municipal advisor’); and

(3) third-party marketers and solicitors.”

In light of the breadth of this definition and the complexity of the contacts between the financial services industry and municipal entities, several fundamental interpretive questions arise.

B. Interpretation of the “Solicitation of a Municipal Entity”

By its terms, the Dodd-Frank Act amended the Exchange Act to exempt from the municipal advisor definition all affiliates of a registered investment adviser (or a broker, dealer, municipal securities dealer or municipal advisor) who solicit municipal entities on behalf of the affiliated entity.² Unless an exclusion applies, however, a third-party solicitor that seeks business on behalf of a broker, dealer, municipal securities dealer, municipal advisor or investment adviser from a municipal entity would be required to register as a municipal advisor. This would include a third-party solicitor that seeks business on behalf of an investment adviser from a municipal pension fund or a local government investment pool. However, the release proposing the Proposed Permanent Rules suggests that such solicitation must be for the purpose of obtaining an engagement in connection with municipal financial products or the issuance of municipal securities.

¹ An “obligated person” is defined as “any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person, committed by contract or other arrangement to support the payment of all or part of the obligations on the municipal securities to be sold in an offering of municipal securities.”

² Amendments proposed by the SEC on November 19, 2010 to the “pay to play” rule (Rule 206(4)-5 of the *Investment Advisers Act of 1940*) would have permitted registered investment advisers to pay any “regulated municipal advisors” who solicit government entities on their behalf. In order to comply with these proposed amendments, the staff of the SEC suggested that affiliated solicitors of a registered investment adviser (*e.g.*, captive broker-dealers of registered investment advisers, who are otherwise statutorily exempt from registration as a municipal advisor for their solicitation activities) should voluntarily register as municipal advisors. The SEC withdrew this proposal in the final adopted amendments to the “pay to play” rule, stating in the adopting release that commenters had noted that affiliated broker-dealers would not meet the statutory definition of “municipal advisor” if they solicit government entities only on behalf of affiliates. In the adopted amendments to the “pay to play” rule, the SEC added municipal advisors to the definition of “regulated persons.” Therefore, a covered investment adviser may compensate a registered municipal advisor for soliciting municipal entities on the condition that these entities are subject to restrictions at least as stringent as the restrictions imposed by the “pay to play” rule.

C. Definition of “Municipal Financial Products” and Interpretation of “Investment Strategies”

“Municipal financial products” are statutorily defined to mean municipal derivatives, guaranteed investment contracts, and investment strategies, which includes “plans or programs for the investment of the proceeds of municipal securities that are not municipal derivatives, guaranteed investment contracts, and the recommendation of and brokerage of municipal escrow investments.” Under the Proposed Permanent Rules, the SEC interprets investment strategies to include plans, programs, or pools of assets that invest funds “*held by or on behalf of a municipal entity*.” The SEC notes that merely providing advice to a pooled investment vehicle in which a municipal entity along with non-municipal entities have invested funds would not require an entity to register as a municipal advisor because the pooled investment vehicle would not be considered funds “held by or on behalf of a municipal entity.”

D. Definitions of “Municipal Entity,” “Obligated Person” and “Municipal Derivatives”

In the release describing the Proposed Permanent Rules, the SEC explained its view that a “municipal entity” includes, but is not limited to, public pension funds, local government investment pools and other state and local governmental entities or funds, charter schools, 529 plans, 403(b) plans and 457 plans. The SEC noted that the definition of an “obligated person” should be interpreted consistently with the definition for purposes of rule 15c2-12 under the Exchange Act, which defines the term to mean “any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations on the municipal securities to be sold in the Offering (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities).” The SEC also proposed that “municipal derivatives” means any swap or security-based swap to which a municipal entity or obligated person is a counterparty.

E. Exclusions from the Definition of “Municipal Advisor”

Brokers, dealers or municipal securities dealers serving as underwriters are excluded from the statutory definition of a “municipal advisor.” The Proposed Permanent Rules clarify that this exclusion would not apply when the entity is acting in a capacity other than as an underwriter on behalf of a municipal entity or obligated person. The release accompanying the Proposed Permanent Rules does not provide a great deal of clarity on specific types of roles that a broker-dealer might play that would be deemed to be acting in a non-underwriter capacity and would therefore preclude the broker-dealer’s reliance on this exemption.³ The SEC also notes that it does not believe the issue of whether a municipal advisor is compensated for providing municipal advice should determine whether the municipal advisor is required to register.

Registered investment advisers and their associated persons who are providing investment advice are also excluded from the definition of “municipal advisor.” The release describing the Proposed Permanent Rules clarifies that this exclusion would not apply if the registered investment adviser or an associated person engages in any municipal advisory activities that would not be investment advice under the *Investment Advisers Act of 1940* (the “Advisers Act”), such as providing advice with respect to how a municipal entity should structure or issue municipal securities or soliciting a municipal entity on behalf of a municipal advisor

³ The release accompanying the Proposed Permanent Rules provides the following limited examples that might be instructive to the narrowness with which the SEC preliminarily views this exception: “For example, a broker-dealer advising a municipal entity with respect to the investment of bond proceeds or the advisability of a municipal derivative, would be a municipal advisor with respect to those activities. In addition, a broker-dealer acting as a placement agent for a private equity fund that solicits a municipal entity or obligated person to invest in the private equity fund would be a municipal advisor with respect to that activity.”

(“municipal advisory activities”). Also, the exclusion from the definition of a “municipal advisor” for commodity trading advisors (or their related persons) would only be available when the entity is providing advice related to swaps. (The statutory language does not extend, however, to grant an exclusion for commodity trading advisors engaged in non-swap transactions that would be similarly under the jurisdiction of the Commodity Futures Trading Commission, such as futures or options on futures.) However, the release accompanying the Proposed Permanent Rules indicates that a commodity trading advisor would have to register if, for example, it simultaneously provides advice to a municipal entity *both* with respect to engaging in a swap transaction *and* with respect to the structure of a municipal securities offering.

Attorneys offering legal advice or providing traditional legal services and engineers providing engineering advice are also excluded from the definition of a “municipal advisor.” The Proposed Permanent Rules expand this exclusion to include accountants preparing financial statements, auditing financial statements or issuing letters for underwriters for, or on behalf of, a municipal entity or obligated person.

III. What it means to be a Municipal Advisor: Fiduciary Duty, Application for Municipal Advisor Registration, Self-Certification and Books and Records

The Dodd-Frank Act amends the Exchange Act to impose a fiduciary duty on municipal advisors when advising municipal entities. The Dodd-Frank Act also grants the MSRB rule-making authority over municipal advisors and requires the MSRB to prescribe, among other requirements, records retention requirements, periodic examinations, reasonable fees, and means reasonably designed to prevent practices that are not consistent with a fiduciary duty to clients and to provide continuing education requirements and professional standards. The MSRB may also set tests for individuals associated with municipal advisors. Certain MSRB rules already apply to municipal advisors, including registration and fee requirements and rules on fair dealing and disciplinary actions. The MSRB is in the process of proposing rules and withdrew certain rule proposals in September 2011 because the SEC had not yet finalized the municipal advisor registration scheme.

The Proposed Permanent Rules would require municipal advisory firms to submit a Form MA (which had been modeled after Part 1 of Form ADV) and individuals who act as municipal advisors to submit a Form MA-I (which is similar to the Financial Industry Regulatory Authority’s Form U4). Under the Proposed Permanent Rules, municipal advisory firms and individual municipal advisors would be required to submit an initial application with the SEC. Municipal advisory firms would be required to amend Form MA annually and when certain updates are necessary, and individual municipal advisors would only be required to amend Form MA-I when any of the required information needs to be updated. Similar to the requirements of Form ADV, the Proposed Permanent Rules would require a municipal advisory firm to amend its Form MA if identifying information, form of organization or disciplinary information has become inaccurate, or if certain other disclosures required by the form become materially inaccurate. The Proposed Permanent Rules would impose additional compliance obligations on municipal advisors, such as submitting more detailed information than is currently required, maintaining certain records (similar to the records required for investment advisers under Rule 204-2 of the Advisers Act and for broker-dealers under Rules 17a-3 and 17a-4 of the Exchange Act, modified to reflect the activities of municipal advisors), and certifying that they meet the qualifications and regulatory obligations required of them.

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If you have any questions relating to your potential status as a municipal advisor, please contact your usual Ropes & Gray advisor.

If you would like to learn more about the developments discussed in this alert, please contact the Ropes & Gray attorney with whom you regularly work or any partner in the Ropes & Gray Investment Management group, listed below.

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