

# SEC Implements Dodd-Frank Municipal Advisor Regulatory Regime Against Backdrop of Pending Legislation

## Highlights

- ✓ Municipal advisors providing advice to, on behalf of, or soliciting municipal entities must register with the SEC
- ✓ There is an exemption for any funds held in a sweep account or any investment made by a bank acting in the capacity of an indenture trustee or similar capacity
- ✓ The final rule preserves the municipal advisor registration requirement for banks that provide advice with respect to municipal derivatives
- ✓ The Municipal Advisor Oversight Improvement Act is designed to allow for more appropriate oversight and implementation by the SEC

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Section 975 of the Dodd-Frank Act created a new class of regulated persons – municipal advisors – and required them to register with the SEC. This new registration requirement makes it unlawful for any municipal advisor to provide advice to or on behalf of, or to solicit, municipal entities or certain other persons without registering with the Commission. Moreover, a person is deemed under the Exchange Act to have a statutory fiduciary duty to any municipal entity for which such person acts as a municipal advisor.

The new registration requirements and regulatory standards are intended to mitigate some of the problems observed with the conduct of some municipal advisors, including pay-to-play practices, undisclosed conflicts of interest, issuance of financial advice without adequate training or qualifications, and failure to place the duty of loyalty to their clients ahead of their own interests.

In December 2010, the Commission began to implement Section 975 by proposing a permanent registration regime to govern municipal advisor registration. The proposal was broad; many commenters and members of Congress believed it would sweep into the SEC regime many persons and entities that Dodd-Frank never intended to reach.

In consideration of the views expressed, suggestions for alternatives, and other information provided by commenters, the Commission adopted the rules with significant modifications from the proposal. The adopted regulations narrowed the scope of the registration requirement, including by providing certain activity-based exemptions from the definition of municipal advisor, and provide additional guidance to market participants about what constitutes municipal advice and who is required to register as a municipal advisor. ([Release No. 34-70462](#))

The final rule provides a broad exemption from municipal advisor registration for all employees, governing body members, and other officials of municipal entities and obligated persons, to the extent that they act within the scope of their employment or official capacity. The Commission does not expect that the ordinary performance of the duties of an appointed member of a governing body of a municipal entity, such as voting, providing a statement or discussion of views, or asking questions at a public meeting, would cause that individual to be a municipal advisor with respect to the municipal entity on whose board he or she serves.

The Exchange Act definition of “investment strategies” includes (1) plans or programs for the investment of the proceeds of municipal securities that are not municipal derivatives or guaranteed investment contracts; and (2) the recommendation and brokerage of municipal escrow investments. The proposal would have interpreted the “investment strategies” definition broadly to cover not only the statutorily identified matters but also plans, programs, or pools of assets that invest any

funds held by or on behalf of a municipal entity. The Commission received approximately 60 comment letters to the effect that the proposal's broad interpretation would pick up advice to municipal entities regarding plans or programs for the investment of all public funds of municipal entities, rather than limiting "investment strategies" to investments more narrowly associated with proceeds of municipal securities and the recommendation and brokerage of municipal escrow arrangements.

The Commission adopted the statutory definition of "investment strategies," but also adopted an exemption for certain persons that will result in a narrower application of "investment strategies" than originally proposed. As a result, many investment advisers and a significant portion of the bank activities identified by commenters will not be subject to municipal advisor registration.

The Exchange Act does not exclude banks from the definition of municipal advisor. The Commission received approximately 300 comment letters to the effect that the proposal did not provide needed exemptions for traditional banking activities. Most of these comments regarding the impact on banks related to the proposed broad interpretation of the investment strategies definition. Many commercial banks and banking associations asserted that the Commission's interpretation of investment strategies was overly broad and would potentially cover traditional banking products and services, such as deposit accounts, cash management products, and loans to municipalities. As a result, according to commenters, banks or bank employees that provide advice regarding such products and services could be considered municipal advisors, adding a new layer of regulation to bank products for no meaningful public purpose.

The SEC believes that the narrowing of the application of investment strategies in the final rule is designed to address the main concerns raised by these commenters. In addition, the final rule provides a new tailored exemption from the definition of municipal advisor for a bank providing advice with respect to any investments that are held in a deposit account, savings account, certificate of deposit, or other deposit instrument issued by a bank and any extension of credit by a bank to a municipal entity or obligated person, including the issuance of a letter of credit, the making of a direct loan, or the purchase of a municipal security by the bank for its own account. There is also an exemption for any funds held in a sweep account or any investment made by a bank

acting in the capacity of an indenture trustee or similar capacity.

The final rule preserves the municipal advisor registration requirement for banks that engage in municipal advisory activities, such as banks that act as financial advisors to municipal entities in structuring issues of municipal securities. Also, the final rule preserves the municipal advisor registration requirement for banks that provide advice with respect to municipal derivatives.

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***The following is a list of how the final rules treat entities under the new registration regime.***

***Public Officials and Employees.*** Public officials do not have to register to the extent that they are acting within the scope of their official capacity. This exemption addresses an unintended consequence of the original proposal that generated significant public comment and created the impression that public officials and municipal employees would be required to register if they provide internal advice. The exemption covers people serving as members of a governing body, an advisory board, a committee, or acting in a similar official capacity as an official of a municipal entity.

For example, it covers: members of a city council, whether elected or appointed, who act in their official capacity and members of a board of trustees of a public or private non-profit university acting in their official capacity, where the university is an obligated person by virtue of borrowing proceeds of municipal bonds issued by a state governmental educational authority. Similarly, this exemption covers employees of a municipal entity or

an obligated person to the extent that they act within the scope of their employment.

**Underwriters.** Brokers, dealers, and municipal securities dealers serving as underwriters do not have to register if their advisory activities involve the structure, timing, and terms of a particular issue of municipal securities. This exemption begins when the municipal issuer engages the underwriter on a particular transaction and would continue until the end of the underwriting period for that transaction.

The exemption does not apply to advice on investments of proceeds of municipal securities or related municipal escrow investments in refinancings or municipal derivatives. That is because this type of advice is outside the scope of underwriting the issuance of municipal securities and involves potential conflicts of interest.

**Registered Investment Advisers.** Registered investment advisers and associated persons do not have to register if they provide investment advice regarding the investment of the proceeds of municipal securities or municipal escrow investments. This exemption helps ensure that the new regulations do not create duplicative regulation of investment advisers. But the exemption does not apply to advice on the structure, timing, and terms of issues of municipal securities or municipal derivatives. That is because advice in these areas is outside the focus of investment adviser regulation.

**Registered Commodity Trading Advisor.** Registered commodity trading advisors under CFTC rules and their associated persons do not have to register if the advice they provide relates to swaps. This exemption helps ensure the rule does not create duplicative regulation with existing CFTC regulation of swap advisers.

**Attorneys.** Attorneys do not have to register if they are providing legal advice or traditional legal services with respect to the issuance of municipal securities or municipal financial products. This exemption does not apply to advice that is primarily financial in nature or to an attorney representing himself or herself as a financial advisor on municipal advisory activities.

**Engineers.** Engineers do not have to register if they provide engineering advice such as feasibility studies and cash flow analysis and similar activities related to engineering aspects of a project. This exemption does not apply to activities in which an engineer provides advice regarding municipal financial products or the issuance of municipal securities.

**Banks.** Banks do not have to register to the extent they provide advice on certain identified banking products and services (such as deposit accounts, extensions of credit, or bond indenture trustee services). This tailored exemption does not apply to banks that engage in other municipal advisory activities such as providing advice on municipal derivatives or the issuance of municipal securities or providing advice on municipal derivatives, in part because municipal derivatives were a source of significant losses by municipalities in the financial crisis.

**Accountants.** Accountants do not have to register if they are providing accounting services that include audit or other attestation services, preparation of financial statements, or issuance of letters for underwriters.

**Independent Registered Municipal Advisor.** People who provide advice in circumstances in which a municipal entity has an independent registered municipal advisor with respect to the same aspects of a municipal financial product or issuance of municipal securities do not have to register, provided that certain requirements are met and certain disclosures are made.

**Swap Dealers.** Registered swap dealers under CFTC rules do not have to register as municipal advisors if they provide advice with respect to swaps in circumstances in which a municipal entity is represented by an independent advisor. This exemption helps ensure that the rule does not create duplicative regulation with existing CFTC regulation of swap dealers and recognizes a similar exemption under CFTC rules. But the exemption does not apply to swap dealers that engage in other municipal advisory activities such as providing advice on the issuance of municipal securities or the investment of the proceeds of municipal securities or municipal escrow investments.

## Industry Reaction

The American Bankers Association applauded the SEC for providing exemptions for a few traditional banking products and services, such as depository products, extensions of credit, and indenture trustees, as well as for individuals who are serving in an official capacity with a municipality. In another positive development for bankers, individuals working for a registered municipal advisory firm do not need to individually register as a municipal adviser, but may rely on their firm's registration. However, the ABA noted that the final rule does not exempt banks in their entirety. The industry association said that remaining

concerns for bankers include the definition of what is captured as “advice” given on “investment strategies” and what exactly is exempted as a “traditional banking product or service.”

SIFMA was encouraged that the SEC expanded the underwriter exemption, although the securities industry group said it would need further review to determine if this exemption is broad enough so as not to restrict traditional public finance investment banking activity. SIFMA also supports the SEC’s effort to narrow its definition of investment strategies with regard to the investment of funds other than bond proceeds, and to exempt registered investment advisers and certain bank products and services.

## Legislation

The final SEC rules come against the backdrop of pending bipartisan legislation, [H.R. 797](#), introduced in the House by Representatives Steve Stivers (R-OH) and Gwen Moore (D-WI), clarifying that Section 975 does not require municipal advisor registration by dealers, banks, investment advisers, members of municipal governing bodies, and others who were either already regulated before the enactment of Dodd-Frank or are appointed, volunteer public servants. The Municipal Advisor Oversight Improvement Act; by clarifying the Dodd-Frank Act’s definition for “municipal advisors,” is designed to allow for more appropriate oversight and implementation by the SEC.

Everyone acknowledges that the Dodd-Frank definition for municipal advisors was too broad, said Rep. Stivers. The original language that defines municipal advisors includes people who are already regulated somewhere else, like volunteers on boards, bank tellers, attorneys, accountants, and other professionals. The intent of Congress in enacting Section 975 was not to impose a regulatory structure on previously regulated entities that are active in the financial markets. The Municipal Advisor Oversight Improvement Act would clarify the Dodd-Frank Act’s municipal advisor definition to prevent financial market participants who do not advise municipalities from facing improper, duplicative, and onerous regulations under securities, banking, commodities, and other laws.

This bill is very similar to legislation, [H.R. 2827](#), passed by the House during the 112th Congress with unanimous support. After being voted out of the Financial Services Committee by a vote of 60-0, H.R.

2827 passed the House by voice vote. According to then-Ranking Member Barney Frank (D-MA), the SEC supported the bill as approved by the full Committee. H.R. 2827 was never taken up in the Senate.

The then-full Committee Chair, Rep. Spencer Bachus (R-AL), expressed concern over the scope of Section 975. While he supports efforts to police this segment of the municipal market, Rep. Bachus, who is currently Chairman Emeritus of the Committee, believes that Section 975 and the SEC’s proposed regulations implementing the statute are overly

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broad and would require appointed, non-ex officio municipal board members and officials to register with the SEC. In an earlier letter to the SEC, he said that the broad definition of municipal financial products combined with the failure to define “advice” would also result in thousands of bank employees conducting routine business with municipal entities having to register with the SEC.

According to Rep. Moore (D-WI), a cosponsor of the bill, H.R. 2827 eliminates confusion around the SEC proposed regulations implementing Section 975. The definition of municipal advisor is the heart of the legislation. It is an exclusionary definition that creates certainty for market participants. H.R. 2827

also created a federal fiduciary standard for municipal advisors with no blanket exemptions. The bill specifies that municipal advisors have a fiduciary duty to their municipal entity clients and specifies when such duties begin and terminate in relation to municipal advisor activities. The legislation specifies that municipal advisors could engage in principal transactions with their clients, subject to MSRB regulation. This is consistent with the fiduciary duty that applies to registered investment advisors.

## Financial Market Impact

It is unclear if the more narrowly tailored regulations adopted by the SEC fully address Congressional concerns over the scope of Section 975 and obviate the need for legislation. Similarly, the reaction of the securities and banking industries, while initially generally positive, indicates the advent of a period of watchful waiting to ascertain how the new regulatory regime for municipal advisors is working. ■

## About the Author

*James Hamilton* is a Principal Analyst at *Wolters Kluwer Law & Business*, a leading provider of corporate and securities information and a prolific blogger (Jim Hamilton's World of Securities Regulation, at <http://jimhamiltonblog.blogspot.com>). Hamilton has been tracking, analyzing and explaining securities law and regulation for over 30 years as an analyst for Wolters Kluwer Law & Business. He has written and spoken extensively on federal securities law and is cited as an authority in the Senate Banking Committee Report (S. 111-176) of the Dodd-Frank Act. His analysis of that legislation, the *Dodd-Frank Wall Street Reform and Consumer Protection Act: Law, Explanation and Analysis*,

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