

January 31, 2011

MEMORANDUM TO CLIENTS

RE: SEC Proposes Registration Requirement for "Municipal Advisors"

On January 6, 2011, the Securities and Exchange Commission ("SEC") issued proposed regulations under the Dodd-Frank financial reform legislation that would require "municipal advisors" to register with the SEC. 76 Fed. Reg. 824. The proposed regulations have caught many by surprise by potentially including within the definition of "municipal advisors" board members of municipal and state retirement systems, who would now be required to register with the SEC. Some in the industry have suggested that the SEC has vastly exceeded both the scope of its authority and the intent of Congress in enacting this legislation. Comments on the proposed rule must be submitted to the SEC by February 22, 2011.

The SEC also issued an "interim final temporary" rule requiring registration by municipal advisors pending issuance of permanent regulations. We discuss below some thoughts regarding application of this interim rule to individual board members.

Proposed Regulation – Key Terms

1. "Municipal Entity"

Section 15B(e)(8) of the Exchange Act, as amended by Dodd-Frank, defines "municipal entity" as:

any State, political subdivision of a State, or municipal corporate instrumentality of a State, including - (A) any agency, authority, or instrumentality of the State, political subdivision, or municipal corporate instrumentality; (B) any plan, program, or pool of assets sponsored or established by the State, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof; and (C) any other issuer of municipal securities. 15 U.S.C. 78o-4(e)(8).

On its face, this language seems innocuous; however, the SEC further takes the position that "municipal entities" include "public pension funds, local government investment pools, and other state and local government entities or funds." 76 Fed. Reg. 828.

2. "Municipal Advisor"

Section 15B(e)(4)(A) of the Exchange Act defines "municipal advisor" as

a person (who is not a *municipal entity* or an employee of a municipal entity) (i) 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*, including advice with respect to the structure, timing, terms, and other similar

matters concerning such financial products or issues, or (ii) that undertakes a solicitation of a municipal entity. 15 U.S.C. 78o-4(e)(4)(A)

[emphasis added]. Exceptions to this definition include employees of "a municipal entity" and elected officials.

Again, on its face this language would not seem to be controversial. However, the proposed regulations make it clear that the definition of "municipal advisor" may sweep in many public plan board members and other statutorily appointed positions (e.g., advisory boards) who are not current employees or (past or present) elected officials:

The Commission believes that the exclusion from the definition of a "municipal advisor" for "employees of a municipal entity" should include any person serving as an elected member of the governing body of the municipal entity to the extent that person is acting within the scope of his or her role as an elected member of the governing body of the municipal entity. "Employees of a municipal entity" should also include appointed members of a governing body to the extent such appointed members are ex officio members of the governing body by virtue of holding an elective office. The Commission does not believe that appointed members of a governing body of a municipal entity that are not elected ex officio members should be excluded from the definition of a "municipal advisor." The Commission believes that this interpretation is appropriate because employees and elected members are accountable to the municipal entity for their actions. In addition, the Commission is concerned that appointed members, unlike elected officials and elected ex officio members, are not directly accountable for their performance to the citizens of the municipal entity. 76 Fed. Reg. 834.

3. "Municipal Financial Products" & "Investment Strategies"

Section 15B(e)(5) of the Exchange Act defines "municipal financial product" as covering "municipal derivatives, guaranteed investment contracts, and investment strategies."

Section 15B(e)(3) notes that the term "investment strategies" 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.

The SEC proposes an expansive reading of this definition, interpreting "investment strategies" to include "plans, programs, or pools of assets that invest funds held by or on behalf of a municipal entity." 76 Fed. Reg. 830. Under this position, therefore, "any person that provides advice with respect to such funds must register as a municipal advisor unless it is covered by [an express exclusion]." *Id.*

It is important to note that the proposed definition of "investment strategies" includes "pools of assets that invest funds held by or on behalf of a municipal entity." **The SEC expressly contemplates that assets held by public pension plans are included within this definition.** *Id.*

4. "Provides Advice"

What exactly constitutes the "provision of advice" is not defined in the proposal or in the Exchange Act, although the "municipal advisor" definition notes that "advice" includes "advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues." 15 U.S.C. 78o-4(e)(4)(A). Other areas of the proposal, however, suggest the types of "advice" which the SEC believes should trigger status as a "municipal advisor":

- "Advice which is primarily financial in nature, such as advice concerning the financial feasibility of a project or financing, advice estimating or comparing the relative cost to maturity of an issuance depending on various interest rate assumptions or advice recommending a particular structure as being financially advantageous under prevailing market conditions..." 76 Fed. Reg. at 834
- "...cash-flow modeling or the provision of information and education relating to municipal financial products or the issuance of municipal securities" *Id.*
- "...preparing feasibility studies concerning municipal financial products or the issuance of municipal securities" *Id.*

Thus, it appears that the SEC intends broadly to include within the definition normal debate regarding risk tolerance, asset allocation strategies, and the like, such that these normal board activities might be included within the definition of "providing advice."

Further, the SEC also would include in its definition of "advice" recommendations and advice relating to the selection of other "advisors." In this regard, in describing 'types' of municipal advisory activities on its proposed registration forms, the SEC includes the following activities:

"...solicitation of investment advisory business from a municipal entity (including, without limitation, municipal pension plans) on behalf of an unaffiliated person (e.g., third party marketers, placement agents, solicitors and finders)" 76 Fed. Reg. at 843

"... advice or recommendations concerning the selection of other municipal advisors ... with respect to municipal financial products ..." *Id.*

Questions and Concerns

The proposal suggests that the SEC may not fully understand the nature and structure of public employee retirement plans or the composition of public plan boards. Many unanswered questions remain:

- Arguably, public plan board members should not be considered as advisors under these provisions, but *advisees*. Nonetheless, the thrust of this language suggests that the SEC believes that public plan board members are somehow providing advice to municipal entities in the form of the retirement systems they represent, even though in their capacities as board members they themselves *embody* the system. Thus, to whom are they providing advice – the "plan" itself as an entity, or themselves/each other/staff?
- The SEC has carved out from the definition of who is a "municipal advisor" current employees, elected officials, and appointed ex officio (former) elected officials. Boards often also include former *employees*, e.g., retirees and public employee union members who are elected to board membership.
- Would it suffice to make someone an "employee" of a retirement system by paying them a stipend or per diem?
- Does an employee of "a municipal entity" include an employee of a different municipality than the system itself or the sponsor of the system? E.g., many boards invest the assets of multiple public plans under a single umbrella structure. Is an employee of a school district an "employee" when serving on a board that also invests assets of a police and firefighters plan? Given that all municipalities within a state ultimately are creatures of state law, we would assume that all municipal employees and elected officials within a state ultimately are municipal employees with respect to any public plan, but the proposal is far from clear.
- As noted, in addition to the governing board some jurisdictions also provide for the creation of advisory boards and councils to provide a sounding board and technical advice to public plan boards and staff members - generally, they have no authority to make any binding investment decisions. These positions may be filled by civic-minded volunteers who may be reluctant to serve if required to register.

Interim Registration Requirement

Interim regulations and forms required registration of municipal advisors effective as of October 1, 2010. It has been reported that the SEC has exempted individuals from this interim registration requirement. Nothing on the face of the regulations or the forms suggests that this is the case; however, we have discussed the matter with SEC staff and have been advised that it was not the intent of the SEC to require individual board members *as such* to register, even if they might otherwise be required to do so under the proposed rules. However, the registration

requirements clearly apply to individuals in the form of "sole proprietors." SEC staff have suggested that it may be reasonable to read this as referring to individuals who are holding themselves out as "in the business" of providing advice on municipal securities for a fee. Thus, an appointed board member who incidentally advises on municipal securities may not be required to register, though one who has been expressly appointed for his/her investment expertise might wish to consider a "defensive" registration pending clarification.

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If you have any questions, please contact your regular Groom contact or any of the attorneys listed below:

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