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COMMENTARY

Exemptions May Ease Pain of Advisor Rule

By Justin Cooper

The SEC's Municipal Advisor Rule, adopted in September, continues to provoke conversation in the public finance industry. As the July 1 implementation date looms, industry participants are particularly concerned about the Rule's potential to inhibit, or effectively prevent, broker-dealers from communicating freely with issuers and obligated persons (i.e. conduit borrowers) unless certain exclusions or exemptions from the rule are met.

The rule treats any broker-dealer who provides advice to an issuer or borrower with respect to municipal securities as a "municipal advisor," with the dual consequences that the broker-dealer automatically incurs a fiduciary duty to the advisee and cannot be an underwriter on the transaction with respect to which the advice was provided. One of the most fundamental and important aspects of the Rule, therefore, is the definition of the term "advice." In essence, advice constitutes making a recommendation to a municipal entity, including an obligated person, relating to municipal securities. For example, recommending a refunding transaction would constitute "advice" under the Rule.

One sees immediately how this framework may disrupt the normal conduct of business in the municipal marketplace: investment bankers routinely approach issuers and borrowers and present ideas and recommendations regarding possible transactions. Many issuers and borrowers value the analysis and advice they receive in this manner, particularly since bankers often perform this work on speculation rather than charging fees for their analysis and recommendations. Banks and bankers are unlikely in the future to be willing to offer this service if doing so will disqualify them from acting as underwriters and potentially expose them to legal liability.

So, what is to be done? If investment bankers and other broker-dealers are to continue to be able to communicate and work relatively freely with issuers and borrowers, they need to fit within one of the exclusions or exemptions provided for in

the Rule. Of the various possible exclusions and exemptions, a handful are particularly likely to be applicable to the underwriter-issuer/borrower relationship described above.

The Underwriter Exclusion

Broker-dealers serving as underwriters do not have to register as municipal advisors and are excluded from the Rule if their advisory activities involve the structure, timing and terms of a particular issue of municipal securities. Key elements of the underwriter exclusion are that it requires a formal engagement, that it exists for a finite period of time, and that it exists for finite purposes.

The exclusion begins when the issuer or borrower engages the underwriter on a particular transaction and continues until the end of the underwriting period for that transaction. Engagement may be accomplished by way of a formal engagement letter or, potentially, something less formal such as an exchange of e-mails, provided that the record is sufficiently clear as to the particular issuance or proposed issuance of securities in question and certain other terms of the engagement. Note that a broker-dealer firm that is selected to be part of a pool of potential underwriters, without being selected for a specific deal, is not viewed as serving as an underwriter on a particular issuance of municipal securities and therefore does not meet the requirements for the exclusion.

In addition to being time-limited, the underwriter exclusion is finite in that it permits the underwriter to provide only certain types of advice on a non-fiduciary basis. These include, in each case only with respect to the particular proposed issuance of municipal securities for which the broker-dealer has been engaged, advice regarding structure, timing and terms, preparation of rating strategies and presentations, assistance with investor "road shows" and investor discussions, advice regarding retail order periods

and institutional marketing, assistance in the preparation of offering documents, and assistance with the closing of the issue. Certain other types of advice, such as advice on investment strategies, advice on municipal derivatives, and advice on whether to pursue a competitive or a negotiated sale, fall outside the Underwriter Exclusion and therefore may not be given on a non-fiduciary basis.

The RFP Exemption

The RFP (Request for Proposals) exemption provides a way for issuers and borrowers to solicit ideas, including “advice” as defined in the Rule, from market participants without making those market participants into municipal advisors. The issuer or borrower’s RFP is required to identify clearly the objective of the issuer or borrower; it must be open for a specified period of time—the SEC suggested in its responses to “Frequently Asked Questions” on the Rule that a period of up to six months would be reasonable; it must involve a competitive process; and it must be sent to at least three reasonably competitive market participants or be publicly disseminated by posting on an official website. If these requirements are met, market participants may provide advice to the issuer or borrower in response to the RFP on a non-fiduciary basis and without being treated as municipal advisors.

The IRMA Exemption

The IRMA exemption provides a broad exemption from the definition of a municipal advisor for any person engaging in municipal advisory activities when the issuer or borrower is otherwise represented by an “independent registered

municipal advisor” with respect to the matter at hand. A registered municipal advisor is “independent” of a proposed underwriter if it has not been associated with proposed underwriter within the previous two years.

For a broker-dealer to rely on the IRMA exemption, certain requirements must be met: the issuer or borrower must provide a written representation that it is represented by, and will rely on the advice of, a designated IRMA; and the broker-dealer must provide the issuer or borrower (with a copy to the IRMA) with written disclosure that the broker-dealer is not a municipal advisor with respect to the municipal financial product or issuance of municipal securities. The written disclosure from the broker-dealer must be made at a time and in a manner reasonably designed to allow the issuer or borrower to evaluate potential conflicts of interest, and in the case of a municipal entity (as opposed to an obligated person) it must contain certain additional language to the effect that the broker-dealer is acting in a non-fiduciary capacity

A number of market participants view the IRMA Exemption as the broadest and most promising exemption available to issuers/borrowers to enable them to communicate relatively freely with investment bankers and other advisors. It remains to be seen whether and to what extent issuers, borrowers and potential advisors will work with these and other exclusions and exemptions after the Rule goes into effect and as authorities and best practices develop in this area.

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