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SEC Issues New FAQs on Municipal Advisor Rule

On May 19, 2014, the SEC issued an updated set of FAQs on the rule defining and requiring municipal advisors to register with the SEC (the Rule). The updated FAQs provide clarification on several important issues for certain market participants, most notably regarding (1) due diligence requirements regarding proceeds of municipal securities, (2) the status of proceeds of municipal securities in public pension funds and (3) advising a municipal entity or obligated person indirectly through a third party. We discuss these clarifications below, along with other significant new interpretations contained in the FAQs. Please note that we have not addressed every topic that the SEC covers in the FAQs; the full text is available here: <http://www.sec.gov/info/municipal/mun-advisors-faqs.pdf>.

Transitional Guidance for Identifying Proceeds of Municipal Securities

In Question 11.1, the SEC clarifies the diligence required to make a determination as to whether the advice that a market participant is providing is regarding the investment of proceeds of municipal securities. Noting the difficulties in making such a determination, the FAQs ease the diligence burden with respect to accounts or investments in place before July 1, 2014. The SEC states that, unless a market participant actually knows or reasonably should have known that an existing account or investment contains proceeds of municipal securities, a market participant may conclude that such an account or investment does not contain such proceeds. The guidance provides that a market participant may use a reasonable diligence process, based on all facts and circumstances, to form the basis of this determination. Factors that may be considered in this process include, but are not limited to “(1) the quantity of existing accounts and the relative administrative burdens and costs of determining whether such accounts contain proceeds of municipal securities, (2) the nature and term of existing investments and the relative potential for future advice on those investments, and (3) an assessment of the potential likelihood that a particular client uses proceeds of municipal securities in light of the nature of the particular client’s business.”

The SEC provides as specific examples of a potentially reasonable diligence effort both (1) a review of account names for those that suggest a connection to municipal securities and (2) sending a written notice to clients stating that if the client does not respond with written representations regarding the nature of the account’s proceeds, it will be assumed that the account contains no proceeds of municipal securities. Taking these factors in their totality, to the extent that advice is being provided to a municipal entity, this would allow a market participant to satisfy the diligence requirement by using negative consent letters or notices with respect to accounts or investments in place prior to July 1, 2014. For those accounts or funds accepted after July 1, 2014, market participants will need to obtain written representations from the municipal entity regarding proceeds as set forth in the Rule.

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Maintaining Status as Proceeds of Pension Obligation Bonds

In Question 11.2, the guidance provides that proceeds of pension obligation bonds lose their character as proceeds of municipal securities when contributed to the public pension plan only if, upon such contribution, the proceeds are required to be used for the exclusive benefit of pension beneficiaries and *are treated as spent under applicable state law*. If the municipal entity segregates the proceeds or retains control over them for any purpose other than for the exclusive benefit of pension beneficiaries, the proceeds continue to constitute proceeds of municipal securities until they are spent (that is, until they are used to pay pension benefits or carry out other authorized purposes of the bonds). As this clarification does not provide a blanket carve out for proceeds of municipal securities contained in pension funds, it appears market participants will still need to engage in diligence efforts to determine the nature of the funds in question.

Indirect Advice

In Question 1.3, the SEC states that a market participant that provides advice with respect to municipal financial products or the issuance of municipal securities to a municipal entity or obligated person indirectly through a third party professional retained by such municipal entity or obligated person would be required to register as a municipal advisor unless an exclusion or exemption applies. The SEC makes clear that even if the third party is a registered municipal advisor (unless that third party satisfies the independent registered municipal advisor (IRMA) exemption) providing advice to that third party regarding actions to be taken by the municipal entity or obligated person is covered and could trigger registration. The SEC bases this interpretation on the language in the Rule defining municipal advisor activities to include providing advice “on behalf of” a municipal entity or obligated person.

“Relying” on Advice of an IRMA

In Question 3.5, the SEC clarifies that for a municipal entity or obligated person to “rely” on the advice of an IRMA to satisfy the IRMA exemption, the municipal entity or obligated person must seek and consider the advice, analysis and perspective of the IRMA. However, it is not necessary to follow the advice of the IRMA in order to satisfy the exemption. Accordingly, a market participant may still rely on the IRMA exemption (assuming all of its requirements are satisfied) even in cases where its and the IRMA’s recommendations diverge and the client follows the advice of the market participant; provided that the client has considered the IRMA’s analysis.

Independence of an IRMA

In Question 3.6, the SEC elaborates on the independence requirement for IRMAs. This clarification makes clear that both the IRMA entity and the employees of the IRMA entity working on the applicable matter must be independent from the market participant entity seeking to rely on the exemption. Conversely, the market participant’s employees working on the applicable matter must also be independent from the IRMA firm.

Entity Level Analysis:

The SEC states in the guidance that a registered municipal advisor will be deemed independent from a market participant if it is not, and within the prior two years was not, directly or indirectly, controlling, controlled by or under common control with the market participant.

Individual Employee Level Analysis:

The SEC goes on to clarify that individual employees of a registered municipal advisor participating in the municipal advisory activities at hand must not be, and within the prior two years must not have been, employed by the market participant seeking to rely on the IRMA exemption in the capacity of an Associated Individual (defined as an individual serving in one of the capacities described in Section 15B(e)(7)(A) or (B) of the Securities Exchange Act of 1934) for the exemption to be satisfied. Conversely, the independence requirement is not satisfied if an employee of the market participant who is engaged in the applicable municipal advisory activities is, or within the prior two years was, employed by the registered municipal advisor in the capacity of an Associated Individual.

Obligated Person Capacity*Advice on a New Money Issuance of Municipal Securities:*

In Question 10.1, the guidance confirms that with respect to a new money issuance of municipal securities, a private entity is not an obligated person until it begins the process of applying to, or negotiating with, a municipal entity to issue conduit bonds on its behalf. As an example, the guidance provides that advising a private university on debt-financing alternatives, one of which is to seek financing from a new money issuance of municipal securities by a municipal entity, is not advice to an obligated person and does not trigger municipal advisor status. However, once the private university decides to seek such financing and begins the process of applying to or negotiating with the municipal entity to issue conduit bonds, the university becomes an obligated person. At that point, advising the municipal on its debt-financing alternatives is covered advice to an obligated person acting in such capacity, absent an applicable exemption.

Advice on an Outstanding Issue of Municipal Securities:

Regarding an outstanding issue of municipal securities on which the private university is an obligated person, the guidance provides that advising the private university regarding redeeming such outstanding issue early or refinancing it is advice to an obligated person acting in such capacity. However, advising the private university on a refunding issue only becomes advice to an obligated person acting in such capacity once the private university has begun the process of applying to or negotiating with the municipal entity.

Advice by Dual Employees

In Question 13.1, the guidance confirms that a dual-hatted employee may provide advice within the scope of the bank exemption while acting in the capacity of a bank employee, and advice within the scope of the underwriter exclusion while acting in the capacity of a broker-dealer, if such employee first discloses to the municipal entity or obligated person the capacity in which the employee is acting. The guidance notes that any person serving in more than one capacity in the same transaction should consider any potential conflicts of interest that may arise.

Please contact us with questions.