

# Regulatory Update: Municipal Advisor Rules Go into Effect on July 1, 2014

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## Background

Section 975 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) amended Section 15B of the Securities Exchange Act of 1934 (Exchange Act) to create a new class of regulations for a formerly unregulated category of “municipal advisors,” which are now required to register with the Securities and Exchange Commission (Commission). On September 20, 2013, the Commission adopted final rules for municipal advisor registration (Final Rules). **The Final Rules went into effect on July 1, 2014**, followed by a phase-in period ending on October 31, 2014, to comply with the registration requirement.

## Executive Summary

As of July 1, 2014, Regional and Community Banks who are not registered “Swap Dealers” under the Dodd-Frank Act (Banks or Bank) cannot offer derivatives to municipal entities or obligated persons (i.e., conduit borrowers in bond financings) without complying with the Final Rules. To comply, Banks must register as a municipal advisor or seek an exemption, one of which is to retain an independent registered municipal advisor to represent the customer in its derivatives transactions with the Bank (among other requirements discussed below).

In addition, Banks must be cognizant of upcoming final rules to be promulgated by the Municipal Securities Rulemaking Board, which may or may not include a complete ban on “principal transactions” in which the Bank acts as counterparty to its municipal entity or obligated person clients. These rules will likely add to the regulatory requirements applicable to municipal derivatives and change the manner of required compliance.

## Discussion

### *General Rule and Defined Terms*

- **Registration Requirement for Municipal Advisors.** Section 15B(a)(1) of the Exchange Act, as amended by Section 975(a)(1)(B) of the Dodd-Frank Act, makes it unlawful for a “municipal advisor” to provide “advice” to a “municipal entity” or “obligated person” with

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respect to “municipal financial products” unless the municipal advisor is registered with the Commission.

- **Definition of Municipal Advisor.** The statutory definition of a “municipal advisor” is very broad. The Exchange Act defines the term “municipal advisor” to mean a person (other than a municipal entity or an employee of a municipal entity) that: (1) 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 (2) undertakes a solicitation of a municipal entity.

The statutory definition of “municipal advisor” explicitly **excludes**: (1) a broker, dealer, or municipal securities dealer serving as an underwriter (as defined in Section 2(a)(11) of the Securities Act of 1933); (2) any investment adviser registered under the Investment Advisers Act of 1940, or persons associated with such investment advisers who are providing investment advice; (3) any commodity trading advisor registered under the Commodity Exchange Act or persons associated with a commodity trading advisor who are providing advice related to swaps; (4) attorneys offering legal advice or providing services of a traditional legal nature; and (5) engineers providing engineering advice.

The Exchange Act **does not** exclude banks from the definition of municipal advisor. However, the rule provides a limited exemption from the definition of municipal advisor for a bank providing advice with respect to: (1) any investments that are held in a deposit account, savings account, certificate of deposit, or other deposit instrument issued by a bank; (2) any extension of credit by a bank to a municipal entity or obligated person, including the issuance of a letter of credit or the making of a direct loan; (3) any funds held in a sweep account; or (4) any investment made by a bank acting in the capacity of an indenture trustee or similar capacity.

The Exchange Act also does not exclude registered swap dealers from the definition of municipal advisor, however, the final rules exempt any registered swap dealer from the registration requirement to the extent that such dealer recommends a municipal derivative or a trading strategy, so long as such dealer is not “acting as an advisor” to the municipal entity or obligated person, and complies with its obligations as a swap dealer under Commodity Futures Trading Commission (CFTC) rules.

Finally, under the Final Rules, a person may provide advice with respect to municipal financial products so long as: (1) an independent registered municipal advisor is providing advice with respect to the same aspects of the municipal financial product; (2) the person receives a written representation from the municipal entity or obligated person that it is represented by, and will rely on the advice of, an independent registered municipal advisor; and (3) such person provides written disclosure to the municipal entity or obligated person that such person is not a municipal advisor and, with respect to a municipal entity, is not subject to the statutory fiduciary duty applicable to municipal advisors under the Exchange Act, and such person provides a copy of such disclosure to the municipal entity’s or the obligated person’s independent registered municipal advisor.

- **Definition of Municipal Securities.** Section 3(a)(29) of the Exchange Act defines municipal securities to include securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a municipal entity, or any security which is an industrial development bond, the interest on which is excludable from gross income under section 103(a)(1) of such Code.

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- **Definition of Municipal Financial Product.** The Exchange Act defines the term “municipal financial product” to include municipal derivatives.
  - **Definition of Municipal Derivatives.** Exchange Act Rule 15Ba1-1(f) defines “municipal derivatives” to include any swap (as defined in Section 1a(47) of the Commodity Exchange Act and section 3(a)(69) of the Exchange Act to which: (1) [a] municipal entity is a counterparty; or (2) [a]n obligated person, acting in such capacity, is a counterparty.
  - **Definition of Municipal Entity.** Exchange Act Section 15B(e)(8) defines “municipal entity” to include “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.”
  - **Definition of Obligated Person.** Exchange Act Section 15B(e)(10) defines “obligated person” to include “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.” Exchange Act Rule 15Ba1-1(k) excludes from the meaning of “obligated person”: (1) a person who provides municipal bond insurance, letters of credit, or other liquidity facilities; (2) a person whose financial information or operating data is not material to a municipal securities offering, without reference to any municipal bond insurance, letter of credit, liquidity facility, or other credit enhancement; or (3) the federal government. Although subsection (2) above appears to offer some hope for Banks offering derivative products to conduit borrowers who are Obligated Persons (i.e., because financial information or operating data of the conduit borrower is not relevant to an offering of Municipal Securities), the Commission has taken the position that conduit borrowers which are hedging an interest rate swap in connection with a conduit borrowing are in fact “municipal advisors” who are required to register with the Commission. However, conduit borrowers who are entering into derivatives transactions which are unrelated to municipal securities are not “Obligated Persons” in such for purposes of those unrelated derivatives transactions.
  - **Definition of Advice.** The Dodd-Frank Act does not specifically define or otherwise provide a general standard to determine what constitutes “advice” to a municipal entity or obligated person, instead suggesting a general evaluation of the relevant “facts and circumstances.” However, the Commission did state in the adopting release for the Final Rules that advice excludes, among other things, “the provision of general information that does not involve a recommendation regarding municipal financial products or the issuance of municipal securities (including with respect to the structure, timing, terms and other similar matters concerning such financial products or issues).” The Commission continued to state that “While the determination of whether a person provides advice depends on all the relevant facts and circumstances, the more individually tailored the information to a specific municipal entity or obligated person or a targeted group of municipal entities or obligated persons that share common characteristics, such as school districts or hospitals, with respect to municipal financial products or the issuance of municipal securities, the more likely it will be a recommendation that constitutes advice under the municipal advisor definition, which would require registration as a municipal advisor, absent the application of an exemption or

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exclusion from registration.”

- **Definition of Recommendation.** According to the Commission, “Whether a “recommendation” has taken place is not susceptible to a bright line definition, but turns on the facts and circumstances of the particular situation. . . factors considered in determining whether a recommendation has taken place include whether the communication ‘reasonably could be viewed as a ‘call to action’ and ‘reasonably would influence an investor to trade . . . The more individually tailored the communication to a specific customer or a targeted group of customers about a security or group of securities, the greater the likelihood that the communication may be viewed as a ‘recommendation.’”

### ***Summary of Registration Requirement***

Most of our Bank clients offer customized, specific trading strategies to their customers (for example, an interest rate swap with a specific notional amount, amortization, fixed and variable rates for a specific customer). We believe that these traditional derivatives activities would be viewed by the Commission as a recommendation which constitutes “advice” under The Dodd-Frank Act. Accordingly, most Banks who are not registered swap dealers may not offer swaps to municipal entities or obligated persons without registering as a municipal advisor unless:

- As to obligated persons only, the swap does not relate to the person’s capacity as an obligated person;
- The municipal entity or obligated person retains an independent registered municipal advisor (and the Bank adheres to the other requirements of the exception for independent registered municipal advisors described above); or
- A registered swap dealer advises the customer and executes the trade – we do believe that a Bank who is neither registered as a swap dealer or an independent municipal advisor could purchase a risk participation in the swap sold by a swap dealer without a requirement to register as a municipal advisor.

### ***Registration and Compliance***

To register as a municipal advisor, a Bank would file Form MA with the Commission via EDGAR, the Commission’s electronic filing system. The forms and instructions are located on the Commission’s website at <http://www.sec.gov/info/municipal.shtml>, and information about EDGAR is available at <http://www.sec.gov/info/edgar.shtml>. Once filed, Form MA must be renewed each year by filing an annual update within 90 days after the end of the Bank’s fiscal year. The Form must be amended promptly whenever a material event has occurred that changes the information provided in the form. There are no filing fees in connection with Form MA, amendments or annual updates.

### ***Additional Requirements and Pending MSRB Rules***

In addition to registering with the Commission, every municipal advisor is required to comply with additional requirements under Section 15B of the Exchange Act (for example, Section 15B(a)(5), which prohibits a municipal advisor from engaging in any fraudulent, deceptive, or manipulative acts or practices when providing advice to or on behalf of a municipal entity or obligated person with

respect to municipal financial products).

Finally, the Municipal Securities Rulemaking Board (“MSRB”) has been delegated rulemaking authority over municipal advisors by the Commission. On January 9, 2014, the MSRB issued Proposed Rule G-42 which, if adopted in its current form, dramatically curtails the ability of Banks to interact with municipal entities (and obligated persons), including a complete ban on “principal transactions” which would prohibit Banks from trading derivatives with municipal entities or obligated persons. The American Bankers’ Association, among many others, vehemently objected to the Proposed Rule in comment letters which were accepted by the MSRB until March 10, 2014. The MSRB has not yet adopted a final rule, but as recently as May 6, 2014, the MSRB stated that it will “continue to consider the comments received and announce next steps soon.” Whatever the final MSRB rules contain, they will likely further limit the ability of Banks to trade municipal derivatives with clients.

## Conclusion

The adopting release for the Final Rules and associated regulatory guidance is extensive, and this update provides only a brief summary of those materials.

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