The Municipal Advisor Rule:

Changing Rules for Professionals Who Assist Local Governments (and some understanding for local units of government)

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One of the many products of the 2008 housing crash and resulting recession was the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010. While other provisions of the Act garnered headlines, a less well-known part contained a change to existing statutes and regulations to provide new duties for "municipal advisors". The changed rule was proposed to prevent harm to investors due to the risky investment strategies pursued by some large municipalities. Sometimes, local governments may have invested the proceeds of bonds into lucrative and complex investments instead of using the funds to build infrastructure. This was aided by third party investment managers whose actions were fraught with conflict of interest issues and political patronage concerns. To address this, the Act added new legal duties for municipal advisors along with a registration requirement. After passage of the Act, municipal advisors would be fiduciaries of their client municipalities, would be subject to registration with the Securities and Exchange Commission (SEC), and would have to submit reports to the government. While regulation of small municipalities and government-sponsored lending were not considerations in the passage of the new law, these provisions will have an effect on how small communities, lawyers and engineers approach these transactions. Managers, officers, council members and board members should be aware of these rules, as the regulation will change what information can be provided to a municipality and the parties who will provide it.

Section 15B(a)(1) of the Act makes it unlawful for a municipal advisor to provide advice to, or on behalf of, a municipal entity with respect to municipal financial products or the issuance of municipal securities, or to undertake a solicitation of a municipal entity, unless the municipal advisor is registered with the SEC. This is a broad and general rule that not only would control the actions of an investment advisor for a large city, but could also apply to anyone providing advice to a municipality about loans or bond issues for construction of improvements. It is certainly recognized by the SEC that this new law implicates independent accountants, lawyers and engineers consulting with municipalities. Instead of creating a narrow and strict rule for a few investment specialists, the focus of the regulations and comments has been to limit the reach of certain terms in the law to allow actions that do not undermine the purpose of regulating municipal securities in the current market. As a result, there are very few bright-line rules established by the regulations. So, those parties who assist municipalities in the planning and funding of infrastructure projects will need to understand the rules and how to apply them in each situation they encounter.

> **Essentially, a municipal advisor is a qualified financial professional (such as a banker or financial consultant) who counsels municipalities on financial deals like bond offerings.[1]**

The first question is whether someone is providing "advice" to a municipality. The SEC has refused to state a clear rule, but instead has outlined some general standards to determine if advice has been given. First, a person can provide general information that does not involve a recommendation, more particularly:

- Information of a factual nature without subjective assumptions, opinions or views;
- Information that is not particularized to a specific municipal entity or type of municipal entity;
- Information that is widely disseminated for use by the public, clients, or market participants other than municipal entities or obligated persons; or General information in the nature of educational materials.

This gives several indications of what "advice" entails. General information, without opinions or direction on picking one option over another, would not be prohibited advice. But comparing funding options, giving opinions on those options, or applying the general information specifically to the municipality being served is likely to be considered "advice" subject to regulation. The regulations and rules attempt to focus on providing opinions or recommendations regarding municipal funding options. The SEC believes that a recommendation is advice that is particularized to the specific needs, objectives, or circumstances of a municipal entity, including with respect to the structure, timing and terms of the security, based upon all the facts and circumstances. This standard considers the specific facts on a case-by-case basis, but at the same time it is considered an objective inquiry. So, the intent of the person providing the information is irrelevant. Also note that it is irrelevant whether the advisor is paid for his or her services. The regulations will look to the facts in each case to see if, to the neutral observer, a recommendation has been given.

Apart from the repeated references to "recommendations" and "advice," the SEC emphasizes that the advice must be about the structure, timing and terms of the municipal security. This would require there to be some specific details about the municipal security proposed – that the interest rates, length of the loan and procedures for the funding would have to be

Day-To-Day Examples Concerning the SEC Municipal Advisor Rule

Because of the refusal by the regulatory authorities to establish any bright line rules, it is difficult to tell exactly what information would be considered to be "advice" in these circumstances. As a general matter, boards or municipal employees will not need to be concerned about compliance with the rule, but to understand that the information that they may be used to receiving from engineers and others may no longer be available, or may be in a different form. In order to understand these limitations, and due to the fact-based nature of the issues, the best way to discuss the rule is to deal with real-world examples:

1. KRWA provides an educational program open to public water suppliers where staff explains funding options available to water suppliers through State of Kansas revolving water or wastewater fund loans, GDBG grants, USDA Rural Development loans, bonds or other financing options.

This would not be a violation of the Municipal Advisor Rule as KRWA is giving general advice to these suppliers that is neither specific to their individual needs, nor a subjective opinion on what option to choose based upon those needs.

2. A city obtains a USDA Rural Development loan to replace aging water lines, and obtains assistance from KRWA assist with the loan application.

This also would not be a violation as KRWA is providing clerical and technical assistance in regards to matters involving municipal debt, but is not providing advice or a recommendation between different types of debts.

3. At the invitation of a city in southwest Kansas, an engineering firm provides a preliminary report on a new well replacement project. In the preliminary report, the firm studies historical water use, the present water system and the ability of the new source to supply the necessary water. The engineering firm gives some general cost estimates of the well replacement project in the preliminary report. The city is interested in pursuing the project further, and asks for additional information on the financing of such a project. A subsequent report includes the same information as the preliminary report, but also includes a summary of the estimated debt service using a KDHE revolving fund loan compared to a Rural Development loan, and creates projections on likely water rate increases needed to service the debt under each option. The engineers present the supplemented report and stating that the choice is up to city on how they wish to proceed.

The preliminary report would be considered traditional engineering advice, and would not be a violation. However, the supplemented report contains advice regarding municipal securities (KDHE loans and USDA loans) that could be considered an opinion regarding the structure, timing and terms of the issuance of a municipal security. Since the report has financial details specific to the city, the engineers have met many of the factors that the SEC looks for in determining whether advice has been given. This leaves only one question, whether the information, under all the facts and circumstances, makes a recommendation on which funding to use. Since no court has ruled on the issue, it may be to just present the alternatives to the city without endorsing a specific option does not violate the rule. However, it is possible that providing this information, even though not actually pushing one option, or by affirmatively stating that "no recommendation is being made," may be determined to violate the rule.

4. Before construction of a new wastewater lagoon, KRWA performs a rate study for a city to determine how much rates would need to increase in order to have a surplus of at least $22,000 per year that could be used to service debt.

This is not a violation. While the study is tailored to a specific municipality, it does not contain an opinion, recommendation or information on the issuance of a municipal security, as it merely determines an amount of surplus income for debt service.

5. A city attorney is asked to negotiate on behalf of a city for a lease-purchase agreement with a local bank for construction of a new water storage tank. The bank provides the documents for the attorney to review, but the city wishes the attorney to push the bank for better terms.

This is not a violation. Providing a review of a loan document is traditionally considered legal advice, and it is not prohibited for the attorney to attempt to obtain better terms for a client as this is within the attorney exception.

6. A city attorney helps with a new project to create a nitrate removal system. In the process the attorney looks over legal titles to properties and deals with the permits and requirements of the state to construct the new plant. At the same time, several funding options are presented to the city. The attorney discusses the funding options with the city council and pushes for a USDA loan over KDHE revolving fund loan; arguing that the interest rate and terms are better for the city.

This is a violation. It is acceptable for the attorney to help with the legal titles and permits, but the attorney cannot give an opinion or advice on which municipal security to choose based upon economic advantages for the client.

7. A certified public accountant is at a city council meeting presenting the annual audit to the city and explaining the results. The council begins discussing the need for capital improvements for the coming year, but remains concerned about existing debt. Knowing that current interest rates are much lower than the long term bonds being paid by the city, the accountant tells the city that they may be able to refinance their bonds and reduce their debt payments, opening up more funds for improvements.

Providing audit services does not make the accountant a municipal advisor. Just making general statements about refinancing would not be a violation of the rule. However, if the accountant also provides a spreadsheet showing savings that would result from refinancing at current rates, even without a specific recommendation it could be considered advice and a violation.

outlined in some respect. Giving advice about matters beyond these terms would not be covered by the new rule. This leads to the question of what "municipal securities" are included within the rule. At present, this provision is also read broadly, and would not only include general obligation bonds and revenue bonds, but also revolving fund loans and Federal loans backed by municipal bonds. Thus, most funding methods for large projects would be considered to be within the Rule.

The Municipal Advisor Rule has certain exceptions for some professionals. Accountants, engineers and attorneys all are granted exceptions, but these are limited to providing advice that involves their specialty, and not advice on municipal securities. The engineering exception is one of the more significant exceptions due to the duties of the engineer. In the context of municipal borrowing for infrastructure, engineering has gone beyond the mere nuts and bolts planning of improvements, and may include assistance on funding options, including obtaining federal and state funding through loans or grants. These usually require not only up-front traditional engineering planning, but also details on financing terms, cost projections and proposed rate structures to show the ability to pay for the improvements proposed. In many ways, the engineer is in the best position of the group of professionals hired by a municipality to assist in determining a course of action based upon the costs of municipal funding options. At the same time, this kind of advice will often present options and make recommendations that would require registration as a municipal advisor.

In general, the SEC states that activities within the scope of the exemption could include feasibility studies, cash flow analyses, and similar activities; provided that the exception would not cover these actions if they amount to "advice." While this seems at first to give engineers a specific list of things they can do, they are still forbidden to give advice or to make recommendations regarding municipal securities. As such, a feasibility study that ended with recommendations for certain financing options would still be prohibited. Still, the SEC has attempted to give additional assistance in interpreting the regulations. Specifically, the SEC states that an engineer could provide a project schedule and anticipated funding requirements. In addition, engineering feasibility studies that include output capacity projections, potential utility rates, future market demand or projected revenues that are based upon consideration of engineering aspects of a project are within the scope of the exception. Since most Federal government financing options require feasibility studies to be submitted to the financing agency, it makes sense that reports regarding technical feasibility of a project, without reference to funding options, would be excluded from the rule. Also, the engineer can establish a proposed schedule for construction, noting the times when funding would need to be available to pursue the project, and when certain revenue would be available due to the ability to hook up customers to the improved system. These kinds of activities are strongly based in engineering concepts, and are not directly related to determining the structure, timing and terms of a municipal security. If the municipality provides certain financial information, such as interest rates for existing debt or current utility rates, analysis of these in light of planned improvements would also be considered engineering advice, and outside of the rule. In regards to "cash flow analysis" the use of information on municipal cash flows and relating them to the project schedule and available funding sources would not be engaging in municipal advisory activity.

But quick reliance on buzzwords such as "cash flow analysis" and "feasibility studies" can be misleading, as the rule is clear that these activities can cross over into improper "advice". While simply providing projected revenue or debt service information can be protected by the exception, if these are used in connection with a presentation on different funding options for a municipality, the rule has been violated. An engineer who does so is likely to be considered to be giving a recommendation on the issue of municipal bonds and would not be within the exception. Similarly, a feasibility study that contained the usual engineering information and proposed financing options would suggest municipal advisory activity.

The new rules regarding municipal advisors are untested and subject to interpretation. Since the questions involved are based upon each individual circumstance, it is impossible to list any clear rules that would guide municipalities and others. However, municipalities should know that these limitations exist, and should seek out a registered municipal advisor if it does need help with issues involving municipal securities. Since another exception to the municipal advisor rule exists for other professionals when the municipality is represented by a registered municipal advisor, be aware that this help may be requested in larger projects involving municipal securities.

[1] Farmer, Liz. "Why's the SEC's New Municipal Advisor Rule So Confusing?" *Governing*. Web. July 2014.

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