

Solicitors as Municipal Advisors Subject to Registration and New Fiduciary Standards

While SEC-registered investment advisers may not be covered by the new municipal advisor requirements, solicitors may be caught up and subjected to new fiduciary duties when soliciting municipal entity clients.

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The regulatory framework for investment adviser solicitors (especially third-party solicitors) and possibly hedge fund placement agents has recently become more complicated, at least for those solicitors who solicit municipal entities. Specifically, solicitors may find themselves subject to fiduciary duties to municipal entities that they solicit on behalf of investment advisers, which may involve a radical change in the roles and responsibilities of these solicitors.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) requires registration of municipal advisors and subjects them to rules that will be written by the MSRB and enforced by the SEC. The SEC recently issued rules, in furtherance of the Act, to mandate the registration of municipal advisors.¹ **The deadline for registration is October 1, 2010.** The Act's provisions relating to municipal advisors and the related SEC rules raise a large number of interpretive questions, including questions on the treatment of solicitors for investment advisers, which is disconcerting given the October 1 deadline.

Broad Definition

While the term municipal advisor was defined in part to address concerns surrounding advisers to municipalities who, although in many cases not regulated, provided public finance advice to municipalities on the security types, maturity structures, and terms of municipal debt, the term picks up solicitors to investment advisers. Specifically, the term "municipal advisor" is defined in the Act (in a somewhat circular fashion) to include any "person . . . that . . . undertakes a solicitation of a municipal entity,"² and the term "includes financial advisors, guaranteed investment contract brokers, *third-party marketers*, *placement agents*, *solicitors*, *finders*, and swap advisors, if such persons," among other things, undertake solicitation of a municipal entity. (Emphasis added.)

Solicitors and placement agents that might be caught in the broad definition of municipal advisor may, depending on the facts, be able to take advantage of definitional exclusions from the term or the further definition of the term "solicitation of a municipal entity."

Narrow Exclusions

The municipal advisor definition has exclusions for broker-dealers and investment advisers and their associated persons, but these exclusions are limited, vague, and currently lacking interpretive guidance from the SEC or its staff. The exclusion for broker-dealers is limited to broker-dealers when serving as "underwriters." The exclusion for investment advisers and their associated persons is limited to investment advisers registered with the SEC

¹ See Temporary Registration of Municipal Advisors, Securities Exchange Act Release No. 62824 (Sept. 1, 2010).

² "Municipal entity" is, in turn, defined to mean "any State, political subdivision of a State, or municipal corporate instrumentality of a State, including: any agency, authority, or instrumentality of the State, political subdivision, or municipal corporate instrumentality; 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 any other issuer of municipal securities." See Section 15B(e) of the Exchange Act, as amended by Section 975(e) of the Act.

and “persons associated with such investment advisers who are providing investment advice.”

In the release issuing the registration rules, the SEC stated that it interprets the exclusion of SEC-registered investment advisers and their associated persons as applying only where the adviser or the associated persons provide services that are investment advice for purposes of the Investment Advisers Act of 1940 (Advisers Act). Conversely, a registered adviser or associated person must register as a municipal advisor “if the adviser or associated person . . . provides any municipal advisory services other than investment advice within the meaning of the Investment Advisers Act.”

As a result:

- An SEC-registered investment adviser’s *internal* wholesalers and solicitors may be excluded if they provide advice on behalf of the investment adviser in connection with their solicitation activities.
- Third-party solicitors that are themselves SEC-registered investment advisers may be excluded if they are acting as investment advisers when engaging in solicitation activities, and their associated persons will be excluded if they provide advice on behalf of the investment adviser in connection with the solicitation activities.

Whether an adviser or its associated persons are providing investment advice when engaging in solicitation activities depends on the facts and circumstances. While the SEC staff has taken the position that a person providing advice on the selection of an investment adviser may be deemed to be providing investment advice,³ the SEC has also noted that, in the case of third-party solicitors, “solicitation of clients may not involve providing investment advice on behalf of the adviser” for whom the solicitor conducts solicitation activities.⁴ If firms seek to characterize solicitation activities as involving the provision of investment advice, that characterization should ideally be reflected in the adviser’s policies and procedures and related disclosures, including the newly revised Form ADV Part 2A and 2B (for individual supervised persons) when they go into effect. However, even if an investment adviser and its personnel seek to avoid municipal advisor status by characterizing solicitation activities as investment advice, that may still trigger fiduciary duties to the municipal entity—fiduciary duties that may be comparable to the (as-of-yet undefined) fiduciary duties of municipal advisors.

Concept of Solicitation and “Purpose” Test

The Act also defines “solicitation of a municipal entity” in a way that may narrow its applicability to investment adviser solicitors and possibly hedge fund placement agents. First, in the case of solicitations for an investment adviser, the term does not include solicitation by any persons in a control relationship with the investment adviser. This is so without regard to whether they provide investment advice on behalf of the investment adviser, which appears inconsistent with the exclusion of associated persons of SEC-registered investment advisers, discussed above, that the SEC interprets as being available only when they provide investment advice for purposes of the Advisers Act. This point will need to be addressed through interpretive guidance.

Second, the Act establishes a “purpose test” under which communications with a municipal entity are only deemed a solicitation if they are made “*for the purpose of obtaining or retaining an engagement by a municipal entity . . . of a broker, dealer, municipal securities dealer, or municipal advisor for or in connection with the municipal financial products, the issuance of the municipal securities, or of an investment adviser to provide investment advisory services to or on behalf of a municipal entity.*” (Emphasis added.) As a result, a third-party solicitor’s communications with a municipal entity are covered where made for the purpose of retaining an investment adviser to provide investment advisory services to a municipal entity.

By contrast, a placement agent’s communications made for the purpose of promoting interests in a hedge fund to a municipal entity might arguably not be covered unless the solicitation of the hedge fund was somehow viewed as akin to solicitation of the investment advisory services provided by the hedge fund’s investment adviser, a view that seems inconsistent at least with the tenor of the D.C. Circuit’s decision in *Goldstein v. SEC*⁵ and the SEC

³ See Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. 1092 (Oct. 16, 1987), text at note 5.

⁴ See Rules Implementing Amendments to the Investment Advisers Act of 1940, Advisers Act Release 1633 (May 15, 1997), text at note 123.

⁵ *Goldstein v. SEC*, 451 F.3d 873, (D.C. Cir. 2006) (Striking down Advisers Act Rule 203(b)(3)-2, which had required most advisers to private funds to register by redefining “client” of an adviser to include the investors in a private fund managed by the adviser, and holding that the SEC’s attempt to treat fund investors as clients of an adviser “falls outside the bounds of reasonableness” in light of the purposes of the Advisers Act and the language of Section 203(b)(3).).

staff's position that the Advisers Act cash solicitation rule (Rule 206(4)-3) does not apply to placement agents or solicitors to hedge funds.⁶ Given the specific mention of placement agents in the definition of municipal advisor, this point, however, is an uncertain matter for which we have found no clearly applicable legislative history and on which the SEC staff has not provided written guidance.

The implications of investment adviser solicitors and hedge fund placement agents being deemed to be municipal advisors goes beyond having to register with the SEC (and do so quickly). Municipal advisors will, as noted above, be subject to rules written by the MSRB and enforced by the SEC as well as a statutorily mandated fiduciary duty.

Further Questions

If you have any questions or would like more information on the issues discussed in this FYI, please contact any of the following Morgan Lewis attorneys:

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⁶ Mayer Brown LLP, SEC Staff Interpretive Letter (July 28, 2008).