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SEC Sanctions Broker for Failure to Register as Municipal Advisor and for Inadequate Procedures to Ensure Registration: A Reminder for Brokers and Fund Managers - Goodwin

On September 14, 2022, the SEC announced a settled administrative order, also dated September 14 (“Order”), imposing penalties, including a \$100,000 fine, on a registered broker (the “Broker”) for failing to (1) register as a municipal advisor, in violation of Section 15B(a)(1)(B) of the Securities Exchange Act of 1934 (“Exchange Act”), and (2) reasonably supervise its associated persons with respect to the laws and rules applicable to advising municipal entities, in violation of Rule G-27 of the Municipal Securities Rulemaking Board (“MSRB”), and consequently, Exchange Act Section 15B(c)(1). The Order is a reminder that persons that come into contact with municipal entities, including brokers and fund managers, should have written policies and procedures to ensure that they know what activities would cause them to be municipal advisors and whether they need to register or have an available exemption or exclusion.

SEC Findings

Broker provides institutional brokerage services to certain municipal entities, including a Midwest city described in the Order as “Municipal Entity.”[1] Broker was temporarily registered as a municipal advisor prior to July 1, 2014 but ceased to be registered as a municipal advisor thereafter.[2] Between 2017 and 2019, a registered representative (“Registered Representative”) of Broker provided advice to Municipal Entity regarding securities that were purchased with municipal bond proceeds (generally, proceeds of a municipal bond offering that have not yet been spent or applied to their intended use). The SEC found that Registered Representative recommended that Municipal Entity purchase specific financial products, which were ultimately acquired by the Municipal Entity with municipal bond proceeds. Furthermore, the SEC found that “the communications from [Broker] and Registered Representative included subjective opinions or views, conveying more than mere general information.” These communications were sufficient to make Broker a municipal advisor, required to register.

The SEC also found that Broker did not maintain a system to supervise the municipal securities activities of its associate persons that was reasonably designed to achieve compliance with applicable securities laws, regulations, and MSRB rules. During the relevant period, Broker had written supervisory procedures (“WSPs”) that required it to “conduct its public finance and municipal securities-related business in a manner so as to not subject the firm to registration and regulation as a Municipal Advisor.”[3] However, the SEC found that Broker’s supervisory system was inadequate to (1) enable registered representatives to know when communications could require registration as a municipal advisor, (2) train personnel with respect to the municipal advisor training requirements, and (3) conduct electronic communication surveillance to identify potential violations of the municipal advisor registration rules. As a result, Broker failed to reasonably detect or prevent unregistered municipal advisor activities.

Violations

The Order held that the failure to register as a municipal advisor was a violation of Section 15B(a)(1)(B) of the Exchange Act. In addition, it held that Broker's failure to establish and maintain an adequate system to supervise the municipal securities activities of its associated persons reasonably designed to achieve compliance with applicable securities laws, regulations, and MSRB rules was a violation of MSRB Rule G-27(e), which requires appropriate supervisory procedures, and, therefore, of Section 15B(c)(1) of the Exchange Act. Section 15B(c)(1) provides, in part, that "no broker, dealer, municipal securities dealer or municipal advisor shall make use of the mails or any means or instrumentality of interstate commerce to provide advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products, the issuance of municipal securities, or to undertake a solicitation of a municipal entity or obligated person, in contravention of any rule of the [MSRB]."

There was no finding that Broker was a member of the MSRB. The SEC found Broker to be in "willful" violation of MSRB Rule G-27 even though Broker was not a member and without regard to whether it realized that the rule applied to its activities.[4]

Who Needs to Have Supervisory Procedures Required by Rule G-27?

It may come as a surprise to some readers that they can be in violation with an MSRB rule even if they are not members of the MSRB. If you are a municipal advisor and not registered, you can be in violation not only of the registration requirement but of the MSRB rule requiring you to have adequate supervisory procedures to make sure you are registered. If you are not a municipal advisor, you are not in violation of either the registration requirement or the supervisory procedures rule.

Section 15B(c)(1) says that "brokers" that act as municipal advisors (or municipal securities brokers) are subject to MSRB rules and, therefore, must have supervisory procedures in place to, among other things, ensure that they are registered if they are required to be. However, Section 15B(c)(1) and Rule G-27 do not make it unlawful not to have supervisory procedures to make sure you are registered if you are not actually acting as a municipal advisor or municipal securities broker. If your municipal advisor supervisory procedures are inadequate or even non-existent, but, by good fortune, you never act as a municipal advisor or municipal securities broker, you won't be in violation of G-27. But that's no way to go through life if you do business with municipal entities.

Different exemptions and exclusions apply to different categories of persons, and the need to have procedures to test whether you are a municipal advisor will depend on the nature of your business and whether it could change in the future to include municipal advisory activities. Here are some examples:

- **Brokers.** A broker that executes transactions in securities for a municipal entity investing the proceeds of a municipal securities offering is not a municipal advisor if it does not provide advice or recommendations 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 financial products or issues. "Municipal financial product" is a defined term that includes investment strategies – plans or programs for the investment of the proceeds of municipal securities. Every broker that executes transactions in securities for municipal entities should have policies and procedures to educate associated persons about what activities will require registration as a municipal advisor and a system to test and monitor the communications of associated persons to ensure that they are not providing municipal advisory services.
- **Placement agents.** The definition of "municipal advisor" includes a person who "undertakes a solicitation of a municipal entity." "Solicitation of a municipal entity" is defined, in substance, as communications with a municipal entity, for compensation, on behalf of a broker, dealer, municipal securities dealer, municipal advisor, or investment adviser with whom the solicitor is not affiliated,

for the purpose of obtaining or retaining an engagement of such person. In the case of an investment adviser, the definition specifies that the engagement is to provide investment advisory services to or on behalf of a municipal entity [emphasis supplied]. In response to proposed rules interpreting, among other things, the phrase “solicitation of a municipal entity,” the SEC received comments that the phrase should not be interpreted to include a placement agent soliciting a municipal entity to invest in a collective fund, even if advised by an investment adviser. The SEC agreed, stating that a placement agent soliciting an investment by a municipal entity on behalf of a fund is not soliciting on behalf of the investment adviser in order for the municipal entity to retain the services of the investment adviser.[5] However, if a placement agent solicits a municipal entity to open a separate account with an investment adviser so that the investment adviser can advise the municipal entity on the investment of proceeds of a municipal offering (and the placement agent is not affiliated with the investment adviser), the placement agent could be required to register as a municipal adviser to engage in that type of solicitation. Placement agents should have policies and procedures to educate associated persons about the difference between the two types of solicitation and to monitor for and prevent direct solicitation on behalf of investment advisers if the placement agent is not registered as a municipal advisor.

- **Investment advisers.** Exchange Act Section 15B(e)(4)(C) excludes from the definition of municipal advisor “any investment adviser registered under the Investment Advisers Act of 1940, or persons associated with such investment advisers who are providing investment advice.” Mere registration as an investment adviser is not sufficient to qualify for the exemption. The investment adviser must be providing investment advice, and the SEC makes clear in Rule 15B1-1(d)(2)(ii) that, for purposes of the investment adviser exclusion, investment advice does not include “advice concerning whether and how to issue municipal securities, advice concerning the structure, timing, and terms of an issuance of municipal securities and other similar matters, advice concerning municipal derivatives, or a solicitation of a municipal entity or obligated person.”[6] An investment adviser that provides advice to municipal entities should have policies and procedures to educate associated persons about the difference between investment advice and the other kinds of advice and services that do not provide an exclusion from registration as a municipal advisor, and to test for and prevent the investment adviser from being compensated for providing the other kinds of advice and services without registration as a municipal advisor.
- **Fund managers.** In the Adopting Release, the SEC stated that it would interpret a pooled investment vehicle (e.g., a hedge fund, private equity fund, real estate fund, or commodity pool) “to be an investment strategy and an advisor to such a pool to be a municipal advisor, when the pooled investment vehicle contains proceeds of an issuance of municipal securities, regardless of whether all funds invested in the vehicle are funds of municipal entities.”[7] An advisor to a pooled investment vehicle that has at least one municipal entity participant that has invested the proceeds of an issuance of municipal securities must be registered as a municipal advisor, unless it is excluded as a registered investment adviser or registered commodity trading adviser. Some real estate fund advisors are not required to be registered as investment advisers because the funds own real property rather than real estate securities. Whether a real estate fund advisor is required to be registered as a municipal advisor may come down to whether municipal entity investors are investing the proceeds of an issuance of municipal securities or, instead, funds that either were not proceeds of an issuance of municipal securities or have been “spent,” i.e., put to the use for which the proceeds were intended.[8] An example of the latter would be proceeds of an issuance of municipal securities that have been used to fund an employee retirement system, and have become the property of the retirement system to use for its purposes. A fund manager may rely on representations in writing made by a knowledgeable official of the municipal entity or obligated person whose funds are to be invested regarding the nature of such funds, provided that the manager has a reasonable basis for such reliance.[9] A fund manager’s policies and procedures concerning municipal advisor registration should include, among other things, procedures for obtaining a representation by a knowledgeable official of the municipal entity with respect to the

nature of the funds invested, which can be part of the subscription agreement or a separate document.

Having reasonably designed supervisory procedures with respect to activities with municipal entities can prevent a broker or advisor from inadvertently acting as an unregistered municipal advisor and, if a good faith mistake is still made, can reduce the level of sanctions the SEC may seek.

[1] Merely providing brokerage services to municipal entities does not require a broker to register as a municipal advisor unless the broker otherwise provides services or advice that would make it a municipal advisor.

[2] Municipal advisors were permitted to register on the temporary form until the permanent rules applicable to registration as a municipal advisor went into effect on July 1, 2014. As a result of new exemptions and exclusions added by the SEC in the permanent rule and related FAQs, some persons temporarily registered as municipal advisors withdrew their registrations.

[3] Apparently verbatim quotation by the SEC from the text of the WSPs.

[4] The SEC cited case law in support of its interpretation of “willfully” in this context to mean “no more than that the person charged with the duty knows what he is doing.”

[5] SEC Release No. 34-70462 (Sept. 20, 2013)(“Adopting Release”), text preceding n. 461.

[6] This is discussed in the Adopting Release in the text preceding n. 655.

[7] Adopting Release, text preceding n. 398.

[8] Rule 15Ba1-1(m), definition of proceeds of municipal securities.

[9] Rule 15Ba1-1(m)(3); see also Adopting Release, text preceding n. 340.

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