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Government pension plans may be wrestling with how to advise managers of private equity and hedge funds about whether proceeds of municipal securities are invested in their funds. This article attempts to shed light on the SEC Municipal Advisors Rule.

What, Me Worry? What Contributions Qualify as “Proceeds of Municipal Securities” for Purposes of the Municipal Advisors Rule

by | **Marc R. Lieberman** and **Mark E. Lasee**

You are general counsel of a government pension plan with a highly diversified investment portfolio that, on occasion, includes municipal bonds. Recently, you’ve been deluged with letters from the managers of private equity and hedge funds in which your plan has invested. The managers tell you that, unless you advise otherwise in writing, the managers will presume that the money your plan invested in their funds is not the “proceeds of municipal securities.”

The managers assure you that they “doubt” your plan’s

contributions to their funds qualify as the proceeds of municipal securities, but they put the onus on you to advise otherwise. They explain that they are asking for your advice because Subsection (m)(1) of Rule 15Ba1-1, the new Securities and Exchange Commission (SEC) Municipal Advisors Rule, says that persons receiving the “proceeds of municipal securities” must register as municipal advisors with SEC and, as a consequence of such registration, owe fiduciary duties to their advisee.

Wanting to avoid registration and new obligations, the managers imply that if you advise them that your plan's contributions to their funds *do* include "proceeds of municipal securities," they may have no choice but to redeem your plan's contributions and terminate further participation in the fund.

Given this Hobson's choice, what do you do?

SEC has not squarely answered the question of whether a government plan's contributions to private equity or hedge funds qualify as "proceeds of municipal securities" in the event the plan holds in its portfolio municipal bonds whose proceeds have the potential of being used in response to a capital call. This has caused great uncertainty (and angst) among the government plan community. This will only increase if, as we expect, fund managers insert clauses in their fund's subscription agreements requiring government plans to confirm that their contributions to the partnership do not qualify as "proceeds of municipal securities."

This article attempts to set forth a reasoned justification for the conclusion that a government plan's ownership of municipal securities does not cause its contributions to private equity or hedge funds to qualify as the "proceeds of municipal securities." The authors have requested a no-action letter from SEC confirming their analysis, but an SEC response is not expected for many months, if not longer.

The Typical Scenario

Government pension plans usually do not acquire municipal bonds except in those rare circumstances where the yield on a municipal issue is higher than comparably rated private issues or there exist other circumstances justifying the purchase.

In a typical scenario, a state or local agency will issue a municipal bond and another government plan will pay the issuer or its underwriter the face value of the bond or acquire the bond at a discount. As a holder of the bond, the plan will be entitled to receive interest from the issuer on the bond. If the plan holds the bond to maturity, the issuer will be obligated to repay the plan the principal amount of the bond. The plan may elect instead to sell the bond before maturity, at which point the plan will recover all or a portion of what it paid for the bond upon such sale.

For purposes of this article, we assume the plan purchasing the bond is never an issuer of municipal securities; instead, we have assumed that the plan is only a purchaser and holder of municipal securities or an entity that, after acquiring municipal securities, has elected to sell them.

The question presented here is whether the general partners of limited partnerships in which the government

plan invests must register as municipal advisors simply because the plan occasionally buys and trades (and derives earnings from) the municipal bonds or other securities of other state or local government issuers.

The Definition of Municipal Advisor

Section 975 of the Dodd-Frank Act states that a *municipal advisor* "means a person . . . that (i) *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 (ii) undertakes a solicitation of a municipal entity."¹

So a municipal advisor is a person who 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."²

Plans as Municipal Entities

A *municipal entity* is "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."³

In our view, the typical government pension plan qualifies as a municipal entity if it falls within any of the categories mentioned in (A) through (C).

The Plan Acquisition of Municipal Securities

According to the Municipal Security Rulemaking Board, a *municipal security* is a general term referring to "a bond, note, warrant, certificate of participation or other obligation issued by a State or local government or their agencies or authorities (such as cities, towns, villages, counties or special districts or authorities)."

Government plans generally are not in the business of issuing municipal securities and, while government plans do not typically acquire municipal bonds for purposes of investment, they may hold municipal securities from time to time, whether by purchasing them directly from an issuer or third party or by owning them indirectly through limited partnerships.

Importantly, one only qualifies as a municipal advisor if he or she provides advice to or on behalf of a municipal

entity with respect to (1) “municipal financial products” or (2) “the issuance of municipal securities.”⁴ Since government plans do not generally *issue* municipal securities, none of their investment managers can be characterized as municipal advisors on the basis of the investor’s “issuance of municipal securities.” However, because one can be characterized as a municipal advisor if he or she provides advice to or on behalf of a municipal entity with respect to “*municipal financial products*,” we must examine the definition of municipal financial products to determine whether this may serve as a basis for characterizing a plan’s external investment managers as municipal advisors.

What Qualifies as a Municipal Financial Product?

Municipal financial products are “municipal derivatives, guaranteed investment contracts, and investment strategies.”⁵

What Is an Investment Strategy?

Under the Exchange Act, *investment strategies* include “plans or programs for the investment of the proceeds of municipal securities that are not municipal derivatives, guaranteed investment contracts, and the recommendation of and brokerage of municipal escrow investments.”⁶

What Are “Proceeds of Municipal Securities”?

Because the Exchange Act does not address what constitutes *proceeds of municipal securities*, SEC has adopted the following definition:

[P]roceeds of municipal securities means monies derived by a municipal entity from the *sale* of municipal securities, investment income derived from the investment or reinvestment of such

monies, and any monies of a municipal entity or obligated person held in funds under legal documents for the municipal securities that are reasonably expected to be used as security or a source of payment for the payment of the debt service on the municipal securities, including reserves, sinking funds, and pledged funds created for such purpose, and the investment income derived from the investment or reinvestment of monies in such funds. When such monies are spent to carry out the authorized purposes of municipal securities, they cease to be proceeds of municipal securities.⁷

Accordingly, to the extent funds used by a governmental pension plan for investment are not (1) derived from the *sale* of municipal securities or (2) investment income therefrom or are otherwise (3) to be used as security for (or a source of repayment of) municipal obligations, they would not be “proceeds of municipal securities” for the purposes of the rule.

On its face, the SEC definition of *proceeds of municipal securities* is not limited to sale proceeds resulting from a municipal entity’s own *issuance* of municipal securities. Instead, the definition includes proceeds derived by a municipal entity from any *sale* of municipal securities. At first blush, this weighs heavily in favor of the conclusion that SEC intended “proceeds” to include funds resulting from the sale of municipal securities, regardless of source. Under this interpretation, the proceeds of municipal securities would include funds resulting from (1) a municipal entity’s issuance of its own municipal securities or (2) funds derived by a municipal entity (such as a government pension plan) from the purchase of municipal securities issued by another municipal

entity. We believe that SEC does not intend such a broad interpretation and intends only clause (1) to apply.

Commission Comments Suggest “Proceeds” Are Limited to a Municipal Entity’s Issuance of Its Own Securities

In 78 *Fed. Reg.* 67,492, SEC notes:

While the Exchange Act does not define the term “proceeds of municipal securities,” the Federal tax laws provide a longstanding, known definition of “proceeds” of tax-exempt bonds issued by State and local governments, including related definitions of various types of proceeds (including “gross proceeds,” “sale proceeds,” “investment proceeds,” and “transferred proceeds”) under Section 148 of the Internal Revenue Code of 1986, as amended, and Section 1.148-1 through 1.148-11 of the Regulations for the purpose of the arbitrage investment restrictions applicable to investments of proceeds of tax-exempt municipal securities. The arbitrage rules apply as long as the tax-exempt municipal securities are outstanding, and non-compliance with the arbitrage rules can result in the loss of the tax-exempt status of the interest on the municipal securities retroactively to the date of issuance. . . .

Because the arbitrage rules governing the investment of bond proceeds are central to an issue of tax-exempt municipal securities and well-known in the municipal market, *the Commission has determined to define proceeds of municipal securities in a similar manner* and to apply the

term to tax-exempt municipal securities and also to taxable municipal securities.⁸

In application of SEC intent to use the arbitrage rules relating to the definition of *proceeds of municipal securities*, the applicable regulations promulgated under Section 148 of the Internal Revenue Code suggest that the term *proceeds* was intended to mean amounts derived from a municipal entity's issuance of its own securities and not to apply to revenues received by municipal entities that merely purchase the bonds of (and thereby derive revenue from bonds of) other agencies.

For example, the applicable arbitrage rule defines *proceeds* as "any sale proceeds, investment proceeds, and transferred proceeds of an issue." In turn, *sale proceeds* are defined, in relevant part, as "any amounts actually or constructively received from the sale of the issue."⁹ This implies sale proceeds are revenues derived by the issuer from its sale of municipal securities and do not include income derived by a holder or purchaser of such securities. This conclusion is strengthened by the fact that *sale proceeds* are specifically defined to include "amounts used to pay underwriters' discount or

compensation and accrued interest other than pre-issuance accrued interest."¹⁰ Only the issuer of municipal securities *pays* the underwriters and accrued interest on an issue; in contrast, a holder or purchaser of the issue is *paid* interest and certainly does not *pay* underwriters anything.

The conclusion that *proceeds* was intended to mean amounts derived from a municipal entity's issuance of its own securities and not to apply to municipal entities that merely purchase the municipal securities of other agencies is also supported by the definitions of *investment proceeds* and *transferred proceeds*, the two other components of "proceeds" (along with "sale proceeds") as that term is defined by the arbitrage rules. *Investment proceeds* are "amounts actually or constructively received from investing proceeds of an issue."¹¹ The issuer of municipal securities receives the proceeds of an issue, which can then be invested for purposes of paying the holder or purchaser of an issue, not vice versa. Similarly, *transferred proceeds* are revenues derived by an issuer from the sale of a subsequent issue to replace an existing issue.¹² The holders or purchasers of the issue do not receive transferred proceeds.

Importantly, the arbitrage rules make a distinction between "gross proceeds" and "proceeds." Whereas *proceeds* are "any sale proceeds, investment proceeds, and transferred proceeds of an issue,"¹³ *gross proceeds* consists of a larger category of revenues: "Gross proceeds of an issue include (i) amounts received (including repayments of principal) as a result of investing the original proceeds of the issue and (ii) amounts to be used to pay debt service on the issue."¹⁴ In specifying that *investment strategies* includes "plans or programs for the investment of the proceeds of municipal securities," SEC use of the more limited term *proceeds* instead of the broader term *gross proceeds* (which includes amounts to be used to pay debt service on an issue) indicates SEC intent to exclude as investment strategies revenue derived from a holder's receipt of debt service payments. And, apart from this analysis but apropos to our earlier comments, since the definition of *gross proceeds* makes clear that gross proceeds include "amounts to be used to pay debt service on the issue," such amounts apply to the issuer, not holder of an issue, since only the issuer is obligated to *pay* debt service.

We also believe the commission's intent was to limit the term *proceeds of municipal securities* to monies received by the issuer (or for its benefit) from the issuance of its own securities, and not monies received by holders of municipal securities, because SEC notes:

[T]he Commission is adopting a definition of "proceeds of municipal securities" for purposes of the term "investment strategies," which is consistent with the Fed-

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eral tax laws and regulations related to the definition of proceeds. *This definition provides that when monies are spent to carry out the authorized purposes of the municipal securities, they cease to be proceeds of municipal securities.* Under this definition and except as otherwise noted below, the mere fact that proceeds are commingled with other funds generally does not cause such monies to lose their character as proceeds. However, *once the proceeds are spent to carry out an authorized purpose of the issuance of municipal securities, and the applicable legal documents or any other agreement pertaining to the investment of proceeds of municipal securities are no longer in effect, such funds will no longer constitute proceeds of municipal securities.*¹⁵

Thus, once the proceeds of municipal securities are received by the issuer (and spent for their designated purpose), such proceeds no longer qualify as *proceeds of municipal securities*. To illustrate this point, the Office of Municipal Securities issued FAQs concerning the registration of municipal advisors wherein it explained that contributions by a municipal entity to a public pension plan that were derived from the issuance of a pension obligation bond cease to be proceeds of municipal securities:

Question 11.2: Proceeds of Pension Obligation

Bonds: Suppose a municipal entity issues pension obligation bonds to finance an unfunded actuarial liability for a municipal entity's public pension plan and contributes those proceeds to such public pension fund where they are commingled with other pension funds for collective investment and treated as spent to carry out their authorized purposes to fund the public pension plan under applicable state law upon their contribution to the public pension plan. Funds in these public pension plans are required to be used for the exclusive benefit of the pension beneficiaries. *In these circumstances, do such proceeds of pension obligation bonds cease to be considered "proceeds of municipal securities" under the Final Rules upon their contribution to the public pension plan?*

Answer: Yes, in the staff's view, under the circumstances described in Question 11.2, such proceeds of pension obligation bonds lose their character as proceeds of municipal securities under the Final Rules upon their contribution to the public pension plan. Exchange Act Rule 15Ba1-1(m)(1) provides that proceeds of municipal securities cease to be treated as proceeds of municipal securities when they are spent to carry out the authorized purposes of municipal securities. The staff notes that, under existing accounting practices,

municipal entities commonly treat proceeds of taxable pension obligation bonds as spent for their authorized purposes under applicable state law upon contribution to public pension funds and thereafter they no longer segregate, account for, or track such funds as proceeds of municipal securities. By contrast, however, in the staff's further view, if a municipal entity segregates proceeds of pension obligation bonds and continues to account for them separately as proceeds of the pension obligation bonds or retains control over the ability to use such funds for any purpose other than the exclusive benefit of pension beneficiaries, such proceeds continue to constitute proceeds of municipal securities under the Final Rules until used ultimately to pay pension benefits to pension fund beneficiaries or to carry out other authorized purposes of the pension obligation bonds.¹⁶

If revenue derived by a municipal entity from the issuance of its own pension obligation bonds ceases to be "proceeds of municipal securities" once such revenue is paid to the entity's own public pension plan, it makes even more sense that revenues received by a public pension plan from bonds issued by *another* municipal entity should not qualify as "proceeds of municipal securities." After all, such revenues are the product of the monies spent to carry out the purpose of the issue. Such a result is further supported by SEC's comment: "In general, *public pension plans do not include proceeds of municipal securities because proceeds of tax-exempt municipal securities generally cannot be spent to fund investments for pension liabilities.*"¹⁷ Given the foregoing, we believe that principal and/or interest or other revenue received by a public pension system from municipal securities it purchased from the issuer or a third party are not intended to be "proceeds of municipal securities" such that the plan's investment of such revenue in a partnership constitutes an investment strategy requiring the partnership's general partner or manager to register as a municipal advisor.

Reliance on Municipality Representations

Under the Municipal Advisors Rule, advisors are provided some leeway in making a determination as to whether they must register as a municipal advisor, in that they can rely on a statement from the municipal entity that proceeds from municipal sales are not being used in making the investment: "[A] person 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 the funds, provided that the person seeking to rely on such representation has a reasonable basis for such reliance."¹⁸

If a government pension plan, as an investor in a partnership, provides a statement to the general partner of such partnership that the plan is not investing proceeds from the sale of municipal securities and it is later determined that the plan's statement was in error, this would have significant repercussions, not only to the advisor, which may be required to register as a municipal advisor, but also to the plan.¹⁹ In order to invest in a partnership, the plan is required to be bound by a subscription agreement. The subscription agreement normally contains extensive warranties and representations made by the plan to the partnership, and the plan will be required to indemnify the general partner for its costs arising from a breach of such warranty or representation. It is common for such warranties and representations to provide that the investor is in compliance with all applicable securities laws and, further, that any certification it provides to the general partner is true and accurate. In the event the general partner requests the certification suggested by Rule 15Ba1-1(m)(3), and the plan provides the certification that eventually proves untrue, the plan's exposure might be substantial.

Further, as a result of the rule coming into effect, plans should anticipate that all future subscription agreements will require municipal entity investors to avow their contributions to the investment are not "proceeds from the sale of municipal securities." If plans decline to make the representation, they may be forced to forgo private equity or hedge investment opportunities.

In apparent recognition of this hardship, SEC indicated: "The Commission recognizes commenter's concerns that requiring advisors to pooled investment vehicles that include funds of municipal entities to register as municipal advisors could have the effect of limiting investment choices for municipal entities, including investment choices for municipal entities, including investment choices for public pension funds."²⁰ Accordingly, SEC stressed that it was exempting from the definition of *municipal advisor* those "persons that provide advice with respect to investment strategies that are not plans or programs for the investment of the proceeds of municipal securities."²¹

Most government pension plans are not plans or programs for the investment of the proceeds of municipal securities. Instead, their stated purpose is to generate funds sufficient for them to pay retirement, disability and survivor benefits to their members, beneficiaries and survivors. For this reason alone, cash received by these plans from the municipal securities of another agency should not qualify as the "proceeds of municipal securities" sufficient to require the general partners of investments in which such cash is contributed to register as municipal advisors.²²

Conclusion

For the reasons stated, revenue received by a government pension plan from municipal bonds it has purchased that is then contributed to various investment partnerships for the benefit of the plan should not qualify as "proceeds of municipal securities" for the purposes of Rule 15Ba1-1(m)(1). Nevertheless, until SEC better clarifies its position on the matter, public pension plans may incorrectly (albeit in good faith) report that amounts they have earned from the municipal bonds of other agencies, which are then invested in limited partnerships, do not constitute *proceeds of municipal securities* as that term is defined in the rule.

We hope that SEC will act swiftly to address the issue so plans will not continue to be forced to weigh the risk of making an incorrect declaration about the character of their contributions against the potential for compulsory redemption of their existing investments (or the unwillingness of general partners to accept new subscriptions).

Endnotes

1. Exchange Act §15B(e)(4)(A) (emphasis added).
2. For the purposes of this article, we assume that the advisor in each instance would be providing advice to the government plan.
3. Exchange Act §15B(e)(8).
4. Exchange Act §15B(e)(4)(A).
5. Exchange Act §15B(e)(5) (emphasis added).
6. Exchange Act §15B(e)(3) (emphasis added).
7. Rule 15Ba1-1(m)(1) (emphasis added). The definition excludes Section 529 College Savings Plans.
8. 78 Fed. Reg. 67,492 (emphasis added).
9. 26 C.F.R. §1.148-1(b) (emphasis added).
10. Id.
11. Id.
12. Id.; 26 C.F.R. §1.148-9(b).
13. 26 C.F.R. §1.148-1(b).
14. Id.; 26 U.S.C. §148(f)(6)(B).
15. 78 Fed. Reg. 67,494 (emphasis added).
16. Section 11, Frequently Asked Questions (FAQs), Office of Municipal Securities (May 19, 2014), www.sec.gov/info/municipal/mun-advisors-faqs.pdf (emphasis added).
17. 78 Fed. Reg. 67,497 (emphasis added). Contrary to the commission's comment, there is generally no prohibition on a public pension plan's acquisition of municipal securities. However, since public pension systems are tax-exempt and yields on municipal securities are generally lower than taxable issues to account for the fact that, generally, the proceeds of many municipal issues are also tax-exempt, public pension systems typically refrain from purchasing municipal securities except when the yields on such securities exceed comparably rated private issues or other extraordinary factors are applicable.
18. Rule 15Ba1-1(m)(3).
19. Such certifications are regularly being demanded by the managers of plan investment partnerships. Many plans are declining to provide the requested certifications, but in our view, fund management will start demanding such certifications in their subscription agreements as conditions for participation in fund investment.
20. 78 Fed. Reg. 67,498.
21. Id.
22. However, if managers were completely comfortable with taking this position, they would not be requiring a certification from the municipal entity that proceeds from municipal sales are not being used in making the investment provided in Rule 15Ba1-1(m)(3).