CURRENT CONSIDERATIONS FOR UNDERWRITERS' COUNSEL

Chair:

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Panelists:

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Panel Description:

This session will review a number of timely topics that underwriters' counsel should consider when advising clients, including state restrictions on financial institutions due to their environmental, social and governance (ESG) positions, how underwriters can steer clear of the Municipal Advisor Rules and recent SEC enforcement actions that implicate underwriters participating in limited offerings.

1. THE MUNICIPAL ADVISOR RULE AND THE LOOP CAPITAL MARKETS, LLC SEC ENFORCEMENT ACTION

a. MA Rule (Section 15B of the Securities Exchange Act of 1934)

i. Section 975 of Title IX 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 require municipal advisors to register with the U.S. Securities and Exchange Commission ("SEC"), effective October 1, 2010. Effective January 13, 2014, the SEC adopted a series of rules (collectively, with applicable provisions of the Exchange Act, the "MA Rule") to establish a registration regime for municipal advisors and impose requirements on municipal advisors.

ii. Section 15B(a)(1)(B) of the Exchange Act provides that "[i]t shall be unlawful for a municipal advisor to provide advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, or to undertake a solicitation of a municipal entity or obligated person, unless the municipal advisor is registered [with the SEC]." *See* 15 U.S.C. 78o-4(a)(1)(B).

iii. Understanding certain terms defined and/or used in the MA Rule is essential to a proper application of the MA Rule.

A. The Dodd-Frank Act did not specifically define or otherwise provide a general standard to determine what constitutes "advice" to municipal entity or obligated person. The MA Rule does, however, provide some additional guidance on the advice standard. Rule 15Ba1-1(d)(1)(ii), provides 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. Thus it can be

assumed that advice covered by the MA Rule includes a recommendation or a call to action with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues is advice intended to be covered by the MA Rule.

Notwithstanding such guidance, the SEC has stated that the term "advice" is not subject to a bright-line definition, much like the term "material" is not able to be more accurately or specifically defined.

Without a bright-line definition, market participants must look to the SEC's adopting release for the MA Rule (Release No. 34-70462) (the "MA Adopting Release") and other interpretive resources for a more complete understanding of the scope of the term "advice." The SEC's Office of Municipal Securities' responses to frequently asked questions regarding the registration of municipal advisors (last updated September 20, 2017) (the "FAQs") is one such resource. The MA Adopting Release and the FAQs generally provide that "advice" can be interpreted to mean any recommendation, whether express or implied. This is in contrast to general information, which is not usually a recommendation and generally excluded from the definition of advice. The FAQs provide a list of specific disclosures and disclaimers the SEC believes would weigh against treatment of information as a recommendation, and therefore advice, but it should be noted that simply adding a "this is not advice" disclaimer to information that is clearly advice will not be effective.

The SEC has stated that in drawing a line between general information and recommendations, the more individually tailored the information is to a specific municipal entity or obligated person or group of municipal entities or obligated persons that share similar characteristics, the more likely the information will be considered to be a recommendation (i.e., advice).

Market participants must look at all the relevant facts and circumstances (including intent, content, context, and manner of presentation) to determine whether they are making a recommendation that could trigger the MA Rule. The general information exclusion from advice under the MA Rule allows, for example, the providing of factual information that does not contain subjective assumptions, opinions or views. The FAQs include descriptions of such factual information.

Disclosures and disclaimers may negate an intent to advise (intent being one of many factors the SEC will consider), but only to the extent they are consistent with the information provided not being a recommendation (i.e., simply adding a "this is not advice" label to information that is clearly advice will not be effective). For those interested, the FAQs provide a list of specific disclosures and disclaimers that the SEC believes would weigh against treatment of information as a recommendation that constitutes advice.

The MA Rule permits a broker-dealer to communicate with a municipal entity or obligated person as part of an effort to obtain business and to include business promotional materials that present factual information that does not involve a recommendation. In relevant part, the MA Adopting Release includes the following statement: "The [SEC] notes that not all communications with a

municipal entity or obligated person constitute municipal advisory activities. If the person has identified himself or herself as seeking to obtain business, such as serving as an underwriter on future transactions, whether such communications and analyses constitute municipal advisory activities or the provision of general information (as discussed further above) will depend on the specific facts and circumstances. For example, pursuant to the [SEC]'s interpretation of the treatment of the provision of general information, the [SEC] believes that a broker-dealer who provides information to a municipal entity regarding its underwriting capabilities and experience or general market or financial information that might indicate favorable conditions to issue or refinance debt likely would not be treated as engaging in municipal advisory activity.

The FAQs provide that business promotional materials could include current market conditions, as well as very limited info about the potential issuer (credit rating, geographic location, and market sector, plus public info about the issuer's outstanding debt) without constituting a recommendation, and even "mathematical calculations of a municipal issuer's hypothetical potential interest cost savings if it were to issue refunding bonds to refinance its outstanding municipal securities at a range of estimated current market rates, based on the assumption that the refunding bonds have the same debt structure (i.e., principal and interest is payable at the same times, in the same or proportionate amounts, and with the same final maturity date) as the issuer's outstanding bonds to be refunded."

The SEC attempted to provide additional clarity on the appropriateness of mathematical calculations of potential interest cost savings by adding an example: "For example, if a municipal entity had outstanding fixed rate municipal securities with a debt structure involving substantially level annual debt service payments and a 30-year final maturity date, the staff believes that the business promotional materials could include mathematical calculations showing hypothetical potential interest cost savings if the municipal issuer were to refund those municipal securities at a range of estimated current market rates, based on the assumption that the refunding bonds had the same debt structure involving substantially level annual debt service payments and the same final maturity date as the outstanding bonds without constituting a recommendation."

This additional SEC guidance, while beneficial to underwriters (in that it provides some flexibility), has raised questions among underwriters when they attempt to limit calculations in promotional materials to comply with the "same debt structure" standard described in the FAQs.

B. "Issuance of municipal securities" is to be construed broadly as a matter of statutory construction and policy, to include the entire life of an issuance of municipal securities, from the pre-issuance planning stage and throughout the repayment stage to the date the securities are no longer outstanding. Relevant advice given after the bonds are delivered (pertaining to, for example, amendments, covenants, continuing disclosure obligations or ratings) is within the scope of "advice with respect to the issuance of municipal securities."

C. "Municipal advisor" means a person (who is not 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.

"Municipal advisory activities" is defined generally as activities that would require registration as a municipal advisor, so the definition is rather circular and the question of whether one is engaged in municipal advisory activities is ultimately dependent on whether the activity relates to advice or solicitation.

The statutory definition of "municipal advisor" explicitly <u>excludes</u> a broker, dealer, or municipal securities dealer serving as an underwriter (as defined in Section 2(a)(11) of the Securities Act of 1933 (the "Securities Act")).

b. Application of MA Rule to Underwriters

i. Generally speaking, underwriters will not be serving as registered as municipal advisors under the MA Rule with respect to a specific issue of municipal securities given the role of the underwriter to purchase securities with a view to distribution in an arm's length commercial transaction with the municipal entity / obligated person wherein the underwriter has financial interests that differ from those of the municipal entity / obligated person and thus, no fiduciary duty to the municipal entity / obligated person. However, broker-dealer firms may be registered as municipal advisors with the SEC and will sometimes serve as municipal advisor to issuers. The MA Rule applies on a case-by-case basis such that one firm could serve as a municipal advisor in connection with an issue of municipal securities or with respect to a municipal financial product, and then (or simultaneously) as underwriter in connection with a different issue of municipal securities or with respect to a different municipal financial product, so long as no underwriter is acting as both underwriter and municipal advisor to one municipal entity or obligated person at the same time with respect to the same issue or product. Application of the MA Rule to underwriters registered and acting as municipal advisors is beyond the scope of this outline.

If an underwriter is not registered as a municipal advisor, or if it is registered but wishes to avoid being characterized as a municipal advisor with respect to a particular issuance of municipal securities, it must answer at least one of the following four questions in the negative to avoid inadvertent municipal advisory activities that are not permitted by the underwriter or registered investment advisor exclusions under the MA Rule:

A. *Am I a municipal advisor (i.e., am I acting outside the exclusions for underwriters and registered investment advisors)?* If the underwriter is not a municipal advisor, there is no need to register as a municipal advisor with the SEC.

The Dodd Frank Act excludes from the definition of "municipal advisor" a broker, dealer, or municipal securities dealer serving as an underwriter. The term "underwriter" is defined under Section 2(a)(11) of the Securities Act, as "[a]ny person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a

direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking."

Rule 15Ba1-1(d)(2)(i) provides that the term "municipal advisor" shall not include "a broker, dealer, or municipal securities dealer serving as an underwriter of a particular issuance of municipal securities to the extent that the broker, dealer, or municipal securities dealer engages in activities that are within the scope of an underwriting of such issuance of municipal securities." Accordingly, the exclusion of a broker-dealer from the definition of municipal advisor applies only to the extent that the broker-dealer is conducting activities the SEC considers to be (1) specific to a particular issue of municipal securities and (2) integral to fulfilling the role of the underwriter.

The MA Adopting Release lists many specific activities the SEC considers to be with respect to the structure, timing, terms and other similar matters concerning an issuance of municipal securities and so within the scope of the underwriting exclusion from the definition of municipal advisor. The MA Adopting Release also identifies advice that would fall outside the scope of an underwriting, because the activities are either not specific to the particular issuance of municipal securities for which a broker, dealer or municipal securities dealer could be serving as an underwriter or the activities are not integral to fulfilling the role of an underwriter, taking the underwriter outside the protections of the underwriter exclusion from the definition of municipal advisor: (1) advice on investment strategies; (2) advice on municipal derivatives; (3) advice on method of sale (competitive or negotiated); (4) advice on approval of an issuance; (5) advice on election campaigns; (6) advice not specific to an issue being underwritten involving analysis or strategic services with respect to financing options, debt capacity, portfolio impacts, effects of debt under various economic assumptions, or other impacts of financing; (7) assisting issuers with competitive sales; (8) preparation of financial feasibility analyses; (9) budget planning; (10) advice on general (versus issue specific) rating strategy; (11) advice on general (versus issue specific) financial controls; or (12) advice regarding terms of requests for proposals or requests for qualifications.

In addition to limiting the scope of the underwriter exclusion, the SEC limited the period during which the underwriter exclusion applies. The SEC has stated that the exclusion generally (1) is not available until such time as a broker-dealer has been engaged as the underwriter with respect to a specific issue of municipal securities, and (2) terminates at the "end of the underwriting period." Advice with respect to municipal financial products or the issuance of municipal securities that is given before a specific engagement or after the end of the underwriting period would, in the SEC's view, likely constitute municipal advisory activities.

Consequently, in the MA Adopting Release, the SEC clarified that, for purposes of the underwriter exclusion, the function of serving as underwriter on a particular issuance of municipal securities is more circumscribed and limited to a narrower time frame than the types and timing of advice that may constitute municipal advisory activities.

The SEC has attempted to clarify further the boundaries of the underwriter exclusion. The FAQs address a situation in which a broker-dealer serves as an underwriter and then, after the issuance has closed and the underwriting period has terminated, discovers a material omission in the offering document and recommends to the municipal entity that a supplement be prepared. Generally, post-settlement advice is outside the scope of the underwriter exclusion. But, according to the FAQs, the underwriter in this example would still be protected by the underwriter exclusion, both because the advice (that a supplement is needed) is "integral" to the broker's underwriting responsibility and because the broker would be acting to promote compliance with the anti-fraud provisions of federal securities law. However, in the FAQs, SEC staff clarified that "a market participant [(including an underwriter)] could not assist a municipal entity with assessing whether an event is "material" under the federal securities laws and whether the municipal entity is required to file an event notice pursuant to a continuing disclosure agreement without falling within the scope of the municipal advisor definition."

Registered investment advisors (and their associates) are similarly excluded from the definition of municipal advisor when they are giving investment advice. *See* Rule 15Ba1-1(d)(2)(ii). "Investment advice" includes advice concerning the investment of proceeds in securities. "Investment advice," as contemplated by the MA Rule, 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, [or] advice concerning municipal derivatives. Registered investment advisors would need to register as municipal advisors before giving those types of advice.

B. *Am I providing "advice" or "soliciting"?* If the underwriter is not providing advice, there is no need to register as a municipal advisor with the SEC.

C. *Is my advice or solicitation provided to or on behalf of a municipal entity or obligated person?* If the underwriter is providing advice, but is not providing it to or on behalf of a municipal entity or obligated person, there is no need to register as a municipal advisor with the SEC, even if the underwriter does not qualify for the underwriter or registered investment advisor exclusion.

Where municipal financial products and municipal securities are involved, it is going to be difficult to answer this question in the negative, unless the advice is to an obligated person with respect to investments or derivatives that are not associated with municipal securities.

D. *Is my advice or solicitation with respect to municipal financial products or the issuance of municipal securities?* If an underwriter is providing advice to a municipal entity or obligated person, but the advice is not with respect to municipal financial products or the issuance of municipal securities, there is no need to register as a municipal advisor with the SEC, even if the underwriter does not qualify for the underwriter or registered investment advisor exclusion.

Where an underwriter is involved in its capacity as underwriter for a public or limited public offering, it is going to be difficult to answer this question in the

negative. The question becomes more complicated when a determination must be made as to whether an obligation or product is a security (i.e., a municipal security or municipal financial product). There are direct loan and lease products that may not themselves be municipal securities or municipal financial products subject to federal securities laws. Underwriters are unlikely to be involved with such products in the traditional role of underwriter, although many underwriters do act as placement agent for direct loans and lease products (note that the name placement agent connotes applicability of federal securities law, which may be unnecessary when not dealing with a security). Where direct loan and lease products are involved and the parties are confident that no federal securities laws apply to transaction participants, an underwriter could potentially answer this question in the negative. Note, however, that even when the product being offered to a municipal entity or obligated person is not a municipal security or a municipal financial product, it is still possible the SEC could conclude or argue that advice was being provided to a municipal entity or obligated person in violation of the MA Rule if the recommendations for the loan or lease product were to be framed as recommendations against municipal securities or municipal financial products. Suffice it to say that while an underwriter may be able to answer this question in the negative in the direct loan or lease context, underwriters working with municipal entities or obligated persons should never assume complete shelter from the requirements of the MA Rule or complete safety from the regulatory reach of the SEC. In practice, many underwriters, even when dealing with direct loans and lease products, will assume the application of federal securities laws given the complexity of the loan versus securities analysis.

If any one of these questions can be answered in the negative, even if the other three are answered in the positive, an underwriter would not be considered to be acting as a municipal advisor.

ii. Alternatively, underwriters can avoid violating the MA Rule by qualifying for an exemption from the MA Rule. Exemptions to the MA Rule are distinguishable from the underwriter and investment advisor exclusions from the definition of municipal advisor described above. Two exemptions for which underwriters may qualify are described below:

A. <u>IRMA Exemption</u>: The MA Rule provides an exemption for underwriters (and other participants) where another entity is registered as a municipal advisor and engaged on the same transaction. Any person engaging in municipal advisory activities in a circumstance in which a municipal entity or obligated person is otherwise represented by an independent registered municipal advisor ("IRMA") is exempt from the MA Rule upon satisfaction of certain requirements.

B. <u>RFP Exemption</u>: Anyone responding to a request for proposal (RFP) or request for qualifications (RFQ) is also exempt from registration as a municipal advisor under the MA Rule. The RFP / RFQ exemption does not apply if the person seeking the exemption receives separate compensation (whether direct or indirect) for the advice included in the response to the subject RFP / RFQ.

c. Loop Capital Markets, LLC SEC Enforcement Action

i. On September 14, 2022, the SEC charged Chicago-based Loop Capital Markets, LLC ("Loop") for allegedly providing advice to a municipal entity without registering as a municipal advisor under the MA Rule. The action is the first time the SEC has charged a broker-dealer for violating the MA Rule.

ii. Loop agreed to settle with the SEC and consented, without admitting or denying any findings, to the entry of an SEC order finding that it violated the MA Rule and its municipal advisor registration and supervision requirements, censuring it, and ordering it to pay disgorgement and prejudgment interest of $5,456.73 and a civil penalty of $100,000. The following findings are as presented in the order, although Loop has not admitted or denied any of them:

   A. From September 2017 through February 2019, a Loop broker provided advice to a midwestern city regarding the investment of municipal securities proceeds.

   B. The communications from Loop and the broker "included subjective opinions or views, conveying more than mere general information," and, in one instance, the broker recommended that the midwestern city purchase specific fixed income products from Loop as an investment of municipal securities proceeds.

   C. Loop does not appear to have been an underwriter of the particular municipal securities at issue, but, according to the SEC, Loop knew that proceeds of municipal securities were being invested (and, in any event, Loop did not investigate further or determine that was not the case).

iii. Loop has been registered with the SEC as a broker-dealer since 1997. Prior to July 1, 2014, Loop was temporarily registered as a municipal advisor, but that registration lapsed.

iv. Loop's written supervisory procedures ("WSPs") required it to "conduct its public finance and municipal securities-related business in a manner so as not to subject the firm to registration and regulation as a Municipal Advisor." But, according to the SEC, Loop failed to maintain adequate systems to ensure compliance with the WSPs. Specifically, according to the SEC, Loop fell short by providing inadequate employee training and insufficient surveillance of electronic communications.

v. According to the Loop order, Loop's alleged failure to maintain adequate supervisory procedures and employee training was a willful violation of MSRB Rules G-27(a), (b), and (e), which require adequate supervisory and review procedures. Note that "willfully," for purposes of imposing relief under Section 15(b) of the Exchange Act, "means no more than that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965). Therefore, based on the findings in the order, the SEC found that Loop's conduct was willful.

d. Underwriter Lessons from the Loop Capital Markets, LLC SEC Enforcement Action

i. Underwriters who, whether upon introduction of the MA Rule in 2014 or at any point after, registered as a municipal advisor with the SEC likely had one or more reasons to register. Initial registration under the MA Rule indicates to the SEC that the person

was acting as, or expected to act as, a municipal advisor and provide municipal entities and obligated persons advice with respect to municipal financial products or the issuance of municipal securities. The SEC may view the initial registration as an indication of intent to engage in some form of municipal advisory activity. Where an entity is no longer registered as a municipal advisor, the entity should be prepared to demonstrate and/or explain to the SEC that (A) the entity's activities have materially changed and municipal advisory activity is no longer any part of the business model; or (B) the initial registration was not necessary.

ii. Having written supervisory procedures ("WSPs") is not enough. Underwriters must have adequate systems in place to enforce WSPs for all employees at all times. Policies and procedures, training protocols and other systems should both (A) attempt to prevent violations from occurring (e.g., training employees so they understand the boundaries of the MA Rule) and (B) help the underwriter identify and address potential violations of the MA Rule as soon as possible (e.g., reviewing electronic communications with municipal entities or obligated persons). Underwriters must provide training to all employees. All employees should understand the boundaries of the MA Rule and the importance of not crossing those boundaries, or, alternatively, employee roles should be very clearly delineated to ensure employees not trained on the MA Rule do not inadvertently cross a line. WSPs should go beyond listing desired outcomes. Loop's WSPs were outcome-based. They stated that Loop would "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." Instead, WSPs should be process-based and include detailed procedures for supervision, training, and surveillance. The SEC focused on Loop's allegedly insufficient methods to identify potential violations of the MA Rule. If an underwriter's WSPs do not identify and address conduct that should be avoided, they are arguably inadequate.

iii. Underwriters should avoid giving advice on municipal financial products by limiting their discussions to general, factual information, unless they take steps to qualify for an exclusion or exemption (e.g., those afforded to registered investment advisors or transactions involving IRMAs).

e. Drawing the Boundaries of the MA Rule

i. *How can an underwriter have confidence they have met an exclusion or exemption in any particular set of facts and circumstances, given varied practices nationwide and sector-wide?*

Where relying on an exclusion, underwriters should be engaged early in a transaction, even though some aspects of the underwriting may be identified as preliminary or subject to conditions at that point. Examples of "reasonable conditions or limitations under the circumstances" provided in the FAQs include: (A) a statement that the engagement is preliminary; (B) a statement that engagement is subject to conditions; (C) a statement that the engagement is non-binding and can be terminated by either party; and (D) a term that limits liability of a party to the engagement letter. Engagement letters should clearly state the role of the broker-dealer in the transaction, relate clearly to a particular issuance of municipal securities (rather than being structured as a general engagement for underwriting services), and disclose conflicts of

interest (actual and potential). Where an engagement is for underwriting services for a period of time, or as part of a pool of potential underwriters, and there is no readily identifiable project or issuance of municipal securities, to the extent the underwriter advises the municipal entity or obligated person without another exclusion or exemption, the underwriter may doing so outside the scope of the underwriter exclusion. It is likely the SEC would argue that such activities, even if integral to fulfilling the role of the underwriter, are not specific enough to a particular issuance of municipal securities. Engagement letters for a period of time or a pool may be sufficient if, prior to relying on the underwriter exclusion, the engagement is tied to (in a subsequent written communication) a particular issuance.

Underwriters should be acutely aware of the limits of their engagements and the scope of their roles, and underwriter's counsel should alert an underwriter client when it believes the underwriter may be stepping outside its role as underwriter. *See* paragraph 14 of SIFMA Model Memorandum to Underwriter's Counsel For New Issues of Municipal Securities (September 26, 2018).

Where relying on an exemption (IRMA or RFP / RFQ), policies and procedures to establish the exemption should be clearly established and the same should be strictly and timely followed.

ii. *When may an underwriter provide guidance on investments in the context of a municipal bond engagement if not registered as an investment advisor, or is this purely municipal advisory activity?*

The SEC clearly states in the MA Adopting Release that advice on investment strategies falls outside the scope of an underwriting. The Loop action supports a clarification that advice on investment decisions related to municipal securities is also outside the scope of an underwriting.

Unless they qualify for an exclusion, underwriters should strictly limit any guidance provided with respect to investments. In practice, underwriters should feel comfortable informing issuers of permissible investments under applicable state law (even this, however, could be deferred to bond counsel and municipal advisors), and where applicable, informing issuers of the availability and efficiency of investments as they relate to the requirements of refunding escrows (e.g., describing the availability and efficiency of using open-market securities versus SLGS as escrow investments). In an attempt to clarify the boundaries of underwriter activating with respect to refunding escrow investments, the SEC has stated that the "structuring of refunding escrow cash flow requirements necessary to provide for the refunding and defeasance of an issue of municipal securities is qualifying underwriting activity; however, the recommendation of and brokerage of particular municipal escrow investments is outside the scope of the underwriting exclusion." Even with this added clarity, an underwriter may at some point question the exact limits of the underwriter exclusion when advising with respect to refunding escrows. In such an instance, underwriters should consider refocusing their attention on the advice standard generally rather than on the nuanced limits of the underwriter exclusion. Underwriters should avoid recommending any particular securities, unless they qualify for a registered investment advisor exclusion or IRMA exemption. Any advice concerning the investment of debt proceeds is investment

advice under the MA Rule. Notwithstanding the cautions provided above, a broker-dealer may serve as underwriter and investment advisor with appropriately licensed individuals providing investment advice and with disclosure of the potential conflict of interest.

Where the scope of the underwriting role (i.e., the reach of the underwriter exclusion) is unclear, underwriters should consider the value in documenting an IRMA exemption. Provided the registered municipal advisor's scope of engagement is broad enough, the IRMA exemption applies and protects the underwriter even if the IRMA is not present for a particular conversation, for example, regarding investments. SEC staff have reasoned that the IRMA can subsequently meet with the municipal entity and help evaluate the advice provided by the underwriter. There are limitations on the investment advice a municipal advisor may provide without being separately registered as an investment advisor. *See* https://www.sec.gov/interps/legal/slbim11.htm.

Underwriters and their counsel should consider the need for or the advisability of an IRMA exemption at the time of engagement. To document the exemption requires additional time and energy (above and beyond MSRB Rule G-17 procedures), so it may not be necessary or prudent for an underwriter to seek an IRMA exemption as a matter of course. All the facts and circumstances should be evaluated.

2. STATE LIMITATIONS ON UNDERWRITER ENGAGEMENTS AND INVESTMENTS

a. Different Types of State Action and Triggering Policies / Conduct

i. There are various types of state action intended to encourage or discourage certain environmental, social and governance ("ESG")-motivated conduct or policies by companies.

Some states directly outlaw the conduct, e.g., Ga. Code Ann. §§ 10-1-439 *et seq.*:

". . . it shall be an unlawful discriminatory practice for any person to refuse to provide financial services of any kind to, . . . or to otherwise discriminate in the provision of financial services against a person or trade association solely because such person or trade association is engaged in the lawful commerce of firearms or ammunition products . . ."

Other states limit state and municipal procurements to companies that follow or eschew ESG-motivated conduct or policies, e.g., Tex. Gov't Code § 2274.002(b):

". . . a governmental entity may not enter into a contract with a company for the purchase of goods or services unless the contract contains a written verification from the company that it:

(1) does not have a practice, policy, guidance, or directive that discriminates against a firearm entity or firearm trade association; and

(2) will not discriminate during the term of the contract against a firearm entity or firearm trade association."

Still other states prohibit political subdivisions from taking ESG-motivated conduct or policies into account in contracting.

ii. To date, policies and conduct that trigger governmental restrictions include:

A. "Boycotting" Israel, e.g., Mo. Rev. Stat. § 34.600.3:

". . . engaging in refusals to deal, terminating business activities, or other actions to discriminate against, inflict economic harm, or otherwise limit commercial relations specifically with the State of Israel; companies doing business in or with Israel or authorized by, licensed by, or organized under the laws of the State of Israel; or persons or entities doing business in the State of Israel, that are all intended to support a boycott of the State of Israel."

B. "Boycotting" fossil fuel companies, e.g., Tex. Gov't Code § 809.001(1):

". . . without an ordinary business purpose, refusing to deal with, terminating business activities with, or otherwise taking any action that is intended to penalize, inflict economic harm on, or limit commercial relations with a company because the company: (A) engages in the exploration, production, utilization, transportation, sale, or manufacturing of fossil fuel-based energy and does not commit or pledge to meet environmental standards beyond applicable federal and state law; or (B) does business with a company described by . . . (A)."

C. Discriminating against firearm companies, e.g., Tex. Gov't Code § 2274.001(3):

". . .(i) refuse to engage in the trade of any goods or services . . .;(ii) refrain from continuing an existing business relationship . . .; or (iii)terminate an existing business relationship with the entity or association based solely on its status as a firearm entity or firearm trade association;"

D. Other trigger policies and conduct are being considered, e.g., assisting abortions.

iii. What contracts are covered? Are bond purchase agreements covered?

A. Mo. Rev. Stat. § 34.600.2:

"a contract with a company to acquire or dispose of services, supplies, information technology, or construction"

B. Tex. Gov't Code § 2274.002:

"a contract [for the purchase of goods or services] that: (1) is between a governmental entity and a company with at least 10 full-time employees; and (2) has a value of at least $100,000 that is paid wholly or partly from public funds of the governmental entity."

Note that the Texas Attorney General has concluded that bond purchase agreements are covered by this statute even though (a) the governmental unit sells, rather than purchases, securities, rather than goods; (b) the underwriter does not contract to provide any service; and (c) compensation flows to, rather than from, public funds.

iv. There are various means by which such state actions are enforced:

A. Civil or criminal actions against financial service companies, e.g., Ga. Code Ann. § 10-1-439.3 (State Attorney General "shall" seek to enjoin violations and recover civil penalties).

B. Restricting procurements and investments.

1) Required by legislation, e.g., Tex. Gov't Code § 2274.002(b).

2) Voluntary purchasing and investment policies or decisions, e.g., Florida State Treasury termination of asset management by BlackRock.

v. The following tables list, and where known to have been litigated, summarize existing laws that are known to the authors as of the date hereof and may limit contracts with underwriters, organized by trigger policies / conduct:

BOYCOTTING ISRAEL	
Cite	Provision
Alabama Act No. 2016-312	Not known to be adjudicated.
Az. Rev. Stat. § 35-393.01	A public entity may not enter into a contract with a value of $100,000 or more with a company to acquire or dispose of services, supplies, information technology or construction unless the contract includes a written certification that the company is not currently engaged in, and agrees for the duration of the contract to not engage in, a boycott of goods or services from Israel.
Ark. Code § 25-1-503	A public entity may not enter into a contract with a company to acquire or dispose of services, supplies, information technology, or construction unless the contract includes a written certification that the company does not and for the duration of the contract will not refuse to deal, terminate business activities, or take other actions that are intended to limit commercial relations with Israel, or persons or entities doing business in Israel or in Israeli-controlled territories, in a discriminatory manner
Cal. Gov't Code § 11135	Not known to be adjudicated.
Col. Rev. Stats §§ 24-54.8-201 et seq.	Not known to be adjudicated.
Fla. Stats § 287.135	Not known to be adjudicated.
Ga. Code § 50-5-85	State may not contract for construction, services, supplies, or IT for $100,000 or more unless vendor certifies that it does not, and for the life of the contract will not, refuse to deal with, terminate business activities with, or engage in other actions that are intended to limit commercial relations with Israel or companies doing business in Israel , with Israel, organized under the laws of the State of Israel, or licensed by Israel to do business in Israel, when such actions are taken in furtherance of a boycott of Israel or for an unreasonable basis without a valid business reason.
Iowa Code §§ 12J.1 et seq.	Not known to be adjudicated.
Kan. Stat. § 75-3740f	State may not enter into a contract with a company, unless such company submits a written certification that such company does not refuse to deal with, terminate business activities with, or perform other actions that are intended to limit commercial relations with companies

	doing business in Israel or territories controlled by Israel, when such actions are taken in furtherance of a boycott of Israel or for an unreasonable basis without a valid business reason and the contract constitutes an integral part of business conducted or sought to be conducted with the state.
Ky Rev. Stats ch. 45A	Not known to be adjudicated.
La. Rev. Stats § 1602.1	Not known to be adjudicated.
Mich. 1984 PA 431, § 241c, 1984 PA 431, § 261	Not known to be adjudicated.
Minn. Stats ch. 3, § 16C3.226 et seq.	Not known to be adjudicated.
Rev. Stats Mo. § 34.600	Not known to be adjudicated.
Nev. Rev. Stats ch. 332	Not known to be adjudicated.
NC Gen. Stats §§ 147.86.80 et seq.	Not known to be adjudicated.
Ohio Rev. Code § 9.75	Not known to be adjudicated.
Okl. Stats Tit. 74, § 582	Not known to be adjudicated.
Penn. Cons. Stats Tit. 62, ch. 36	Not known to be adjudicated.
RI Gen Laws Tit. 37, ch 2.6	Not known to be adjudicated.
SC Code Tit. 11, ch. 35, art. 23	Not known to be adjudicated.
Tex. Gov't Code § 2274	Governmental entity may not enter into a contract for goods or services with a value of $100,000 or more payable from public funds unless the contract contains a written verification from the vendor that it does not and for the contract term will not refuse to deal with, terminate business activities with, or otherwise take any action that is intended to penalize, inflict economic harm on, or limit commercial relations with Israel, or with a person or entity doing business in Israel or in an Israeli-controlled territory, unless for ordinary business purpose.
Utah Code § 63G-27-101	Not known to be adjudicated.
Wisc. Stats §§ 16.75, 16.75 (10p)	Not known to be adjudicated.

Boycotting Fossil Fuel Companies	
State	Notes
Ken Rev. Stat. § 41.480	State government may not enter into contract for goods or services with a value of $100,000 or more payable from public funds with company with 10 or more employees unless the company verifies that it does not and will not (during the term of the contract) discriminate against energy companies.
Okla. Stat. tit. 74, § 12005	Similar to Kentucky, except that it applies to political subdivisions, too.
Tex. Gov't Code § 2274.002	Similar to Oklahoma
W. Va. Code §§ 12-1C-1 et. seq.	Similar to Kentucky

Discriminating Against Firearm Companies	
State	Notes
Ga. Code Ann. §§ 10-1-439 et seq.	Outlaws discrimination against firearm companies in providing financial services
Tex. Gov't Code §§ 2274.001 et seq.	Limits government contracts to companies that do not discriminate against firearm companies
Wyo. Stat. §§ 13-10-301 et seq.	Similar to Georgia

Note that state legislation limiting only investments (but not underwriting agreements) has not been summarized here, nor has introduced legislation which has not yet become law.

Bills similar to laws listed in one or more of the above tables are pending in a number of states, including Arkansas, California, North Dakota, Oklahoma and Wyoming.

b. Is State Action Constitutional or a Violation of the First Amendment (as incorporated by the Fourteenth Amendment) of the U.S. Constitution or State Constitutions?

i. The First Amendment to the U.S. Constitution limits state and local government action through the incorporation doctrine of the Fourteenth Amendment. *Rosenberger v. Rector & Visitors of the Univ. of Va.*, 515 U.S. 819 (1995).

ii. Corporations are "persons" and enjoy First Amendment rights. *Citizens United v. Fed. Election Comm'n,* 558 U.S. 310 (2010).

iii. The First Amendment protects independent contractors from governmental retaliation against exercise of their free speech rights.

A. In *Board of Comm'rs, Wabaunsee Cty. v. Umbehr*, 518 U.S. 668 (1996), a county allegedly failed to renew a contract with its independent trash hauler after he criticized the board of commissioners. It was held that the First Amendment protects independent contractors from retaliation for their speech on a matter of public concern, unless the speech is related to and outweighed by the government's interest as a contractor.

B. In *O'Hare Truck Service, Inc. v. City of Northlake,* 518 U.S. 712 (1996), a city allegedly excluded a company from its list of approved towing companies in retaliation for the owner's support of the mayor's opponent. It was held that the government may not retaliate against a contractor, or regular provider of services, for the exercise of rights of political association or the expression of political allegiance.

iv. Does state action to encourage or discourage ESG-motivated policies or action punish expressive or non-expressive conduct?

A. In *Texas v. Johnson*, 491 U.S. 397 (1989), the burning of a U.S. flag at a protest rally was held to be expressive conduct protected by the First Amendment, preventing state criminal prosecution.

B. In *NAACP v. Claiborne Hardware Co.*, 458 U.S. 886 (1982), black residents of a county organized a boycott of white merchants, seeking racial equality and integration, then were sued by the merchants for lost earnings. It was held that the state may not impose liability for the exercise of rights of speech and association guaranteed by the First Amendment.

C. In *Rumsfeld v. Forum for Academic and Institutional Rights*, 547 U.S. 47 (2006), an association of law schools sought to bar military recruiters because of the military's policies on homosexuality and to enjoin the Solomon Amendment, which conditions federal funding on equal on-campus access for military recruiters. It was held that the Solomon Amendment is constitutional, since it effectively regulates non-expressive conduct, not speech, and does not compel school speech.

D. Cases regarding legislation discouraging the "boycotting" of Israel:

1) Upholding:

In *Arkansas Times LP v. Mark Waldrip*, No. 19-12378 (8 Cir. 2022) (en banc), cert. requested, a newspaper sued to enjoin the Arkansas Israel boycott statute because it conditions the paper's contract with a state college (to publish notices) on the paper certifying that it will not boycott Israel, i.e., "engag[e] in refusals to deal, terminating business activities, or other actions that are intended to limit commercial relations with Israel, or persons or entities doing business in Israel or in Israeli-controlled territories, in a discriminatory manner," in order. It was held that the statute discourages only "purely commercial, non-expressive conduct," and required speech is only a statement of fact, so the statute not unconstitutional.

2) Striking or enjoining:

Koontz v. Watson, 283 F.Supp.3d 1007 (D. Kan. 2018).

Jordahl v. Brnovich, 336 F.Supp.3d 1016 (D. Ariz. 2018).

Amawi v. Pflugerville Indep. Sch. Dist., 373 F.Supp.3d 717 (W.D. Tex 2019), *vacated as moot, Amawi v. Paxton*, 956 F.3d 816 (5th Cir. 2020).

Martin v. Wrigley, 540 F.Supp.3d 1220 (N.D. Ga. 2021).

A & R Engineering and Testing, Inc., 2022 WL 256990 (S.D. Tex. 2022).

E. The following features of state statutes may be relevant to whether they unconstitutionally abridge freedom of speech: (1) whether the statute compels speech (e.g., a verification), (2) whether the statute discourages action that could be expressive (e.g., by references to "other action" or policies, directives, or guidance), (3) whether the statute singles out action intended to be expressive (e.g., by excusing action for an ordinary business purpose), and (4) whether the statute discourages collective action (e.g., by penalizing adherence to the Net Zero Banking Alliance).

c. If the State Action is Unconstitutional, What Are the Consequences?

i. If depriving a person of a contract is found to be unconstitutional, there could be governmental liability under 42 U.S.C. 1983:

"Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory or the District of Columbia, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress . . ."

Governmental entities and officials that deny an underwriting assignment to retaliate against an underwriter's exercise of rights of speech or association could be liable for damages, since, (A) whether pursuant to statute or the exercise of discretion, the action would appear to be under color of law, (B) financial institutions are persons; and (C) free speech is a right secured by the U.S. Constitution.

In *Martin v. Wrigley*, 540 F.Supp.3d 1220 (N.D. Ga. 2021), the court declined to dismiss a Section 1983 action brought by a proposed speaker against a state university for requiring an Israel boycott certification as a condition to a contract.

ii. What effect do these issues have on competitive bidding statutes? Is an award of sale valid if, without statutory compulsion, the issuer declines to accept the best bid because it was submitted by a bidder with whose ESG policies it disagrees? Is a statutory disqualification of the best bid unconstitutional and therefore ineffective?

d. Exposure of Underwriters for Representations, if False or Misleading.

i. Would an inaccurate or misleading no boycott or discrimination certification violate Section 10(b) of the Exchange Act and Rule 10b-5? Consider *In the Matter of Town of Sterlington, Louisiana*, Securities Exchange Act of 1934 Release No. 95024 (June 2, 2022), wherein an issuer was alleged to have violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by intentionally overstating projected customers and revenue to a state commission to secure its required approval of bonds, then representing in private placement closing documents that the bonds had been validly issued in accordance with state law.

The SEC made an inquiry of underwriters who certified compliance with Texas fossil fuel and firearm contracting laws. The inquiry was made for unknown reasons and with unknown results.

ii. MSRB Rule G-17:

"In the conduct of its municipal securities or municipal advisory activities, each broker, dealer, municipal securities dealer, and municipal advisor shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice."

"*All representations made by underwriters to issuers in connection with municipal securities underwritings, whether written or oral, must be truthful and accurate and must not misrepresent or omit material facts*." MSRB Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities (March 31, 2021).

iii. Common law action for breach of warranty or misrepresentation?

iv. State securities or deceptive trade practices acts?

v. State crimes for obtaining property by misrepresentation with *mens rea*?

vi. Recission of transactions?

e. State ESG Limitations on Contracts in Practice

i. The following is an example of the certification required by (Texas) law:

"To the extent this Agreement constitutes a contract for goods or services for which a written verification is required under Section 2271.002 or 2274.002, Texas Government Code, as amended, the Underwriter hereby verifies that it and its parent company, wholly- or majority-owned subsidiaries, and other affiliates, if any, do not and will not during the term of this Agreement (a) boycott Israel, (b) boycott energy companies, or (c) discriminate against firearm entities. The foregoing verification is made solely to enable the Issuer to comply with such Sections and to the extent such Sections do not contravene applicable Federal or Texas law."

"As used in the foregoing verification,

"(a) "boycott Israel" . . . means refusing to deal with, terminating business activities with, or otherwise taking any action that is intended to penalize, inflict economic harm on, or limit commercial relations specifically with Israel, or with a person or entity doing business in Israel or in an Israeli-controlled territory, but does not include an action made for ordinary business purposes;

"(b) "boycott energy companies" . . . means, without an ordinary business purpose, refusing to deal with, terminating business activities with, or otherwise taking any action that is intended to penalize, inflict economic harm on, or limit commercial relations with a company because the company engages in the exploration, production, utilization, transportation, sale, or manufacturing of fossil fuel-based energy and does not commit or pledge to meet environmental standards beyond applicable federal and state law or does business with such a company;

"(c) "discriminate against a firearm entity or firearm trade association" . . . (A) means, with respect to the firearm entity or firearm trade association, to (i) refuse to engage in the trade of any goods or services with the firearm entity or firearm trade association based solely on its status as a firearm entity or firearm trade association, (ii) refrain from continuing an existing business relationship with the firearm entity or firearm trade association based solely on its status as a firearm entity or firearm trade

association, or (iii) terminate an existing business relationship with the firearm entity or firearm trade association based solely on its status as a firearm entity or firearm trade association and (B) does not include (i) the established policies of a merchant, retail seller, or platform that restrict or prohibit the listing or selling of ammunition, firearms, or firearm accessories and (ii) a company's refusal to engage in the trade of any goods or services, decision to refrain from continuing an existing business relationship, or decision to terminate an existing business relationship (aa) to comply with federal, state, or local law, policy, or regulations or a directive by a regulatory agency or (bb) for any traditional business reason that is specific to the customer or potential customer and not based solely on an entity's or association's status as a firearm entity or firearm trade association;

"(d) "firearm entity" . . . means a manufacturer, distributor, wholesaler, supplier, or retailer of firearms . . . , firearm accessories . . . , or ammunition . . . or a sport shooting range . . . ; and

"(e) "firearm trade association" . . . means any person, corporation, unincorporated association, federation, business league, or business organization that (i) is not organized or operated for profit (and none of the net earnings of which inures to the benefit of any private shareholder or individual), (ii) has two or more firearm entities as members, and (iii) is exempt from federal income taxation under Section 501(a), Internal Revenue Code of 1986, as an organization described by Section 501(c) of that code.

"The Underwriter understands "affiliate" to mean any entity that controls, is controlled by, or is under common control with the Underwriter within the meaning of SEC Rule 405, 17. C.F.R. § 230.405, and exists to make a profit."

ii. What is the role of the underwriter's counsel in regards to ESG-motivated and similar statutory limitations on contracts?

It is important for underwriter's counsel to establish at the beginning of an engagement who will advise the underwriter regarding required ESG and similar certifications. Certifications are typically included in the bond purchase agreement, which is traditionally drafted by underwriter's counsel, and other certifications may be required by the issuer or its state. Per the SIFMA model memorandum to underwriter' counsel: "It is expected that you draft and assist [Underwriter] bankers in negotiating the Bond Purchase Agreement (the "BPA")." "Representations of the [Underwriter], if any, should be limited and not go beyond those in the SIFMA Model BPA." "[Underwriter] generally requires 10b-5 assurance from . . . underwriter's counsel," "subject only to standard exclusions." "This memorandum is not intended to limit your current standard of practice to the issues listed herein. Instead, this memorandum is to be read and used in conjunction with your current standard of practice which is traditionally given in your capacity as Underwriter's Counsel."

Underwriter's counsel can interpret, explain, and negotiate the ESG or related certifications, but generally is not in a position to weigh in on whether an underwriter can make the requested or required certifications without an untrue or misleading statement of fact. Final decisions must come from the underwriter. Each underwriter likely has a different internal approval or signoff process, and counsel may not have a

direct line of communication to all internal stakeholders of the underwriter. Underwriter's counsel will likely need to rely on the relationship banker or other primary contact with whom counsel works to take these issues up the chain of command at the underwriter's offices, but counsel should communicate directly with, or at a minimum, encourage the banker to communicate directly with, internal counsel for the underwriter. Unless specifically engaged to assist an underwriter in determining whether any required certifications can actually be made, and unless counsel is competent and adequately informed of all the facts and circumstances, underwriter's counsel should avoid advising an underwriter regarding the appropriateness of any certifications. Reviewing underwriter's internal ESG and related policies designed to ensure compliance with state laws such as those described in this outline is likely outside the scope of the traditional underwriter's counsel engagement.

If advising the underwriter regarding required certifications, underwriter's counsel may wish to consider the following:

1) Is the meaning of the certification clear and, if not, can it be clarified?
2) Can the certification be qualified so that, if not needed, it is ineffective?
3) Is an explanation of the certification advisable to avoid a claim of misrepresentation?

iii. Challenges for underwriters (and when consulted, their counsel) include:

A. One deal binds the underwriter and potentially all its affiliates.

B. Choosing states to do business in, recognizing that doing business in one state may at some point in the future potentially preclude business in another state.

C. Coordinating the approach of public finance, commercial banking, and asset management divisions.

D. Ascertaining the continued veracity of certifications.

E. Managing compliance with agreements included in certifications.

3. RULE 15c2-12 LIMITED OFFERING EXEMPTION AND RECENT SEC ENFORCEMENT ACTIONS / LITIGATION

a. The Rule, the Limited Offering Exemption and SEC Intent

Rule 15c2-12, promulgated under the Exchange Act (the "Rule"), includes an exemption for limited offerings of municipal securities placed with a small number of sophisticated investors with investment intent.

Underwriters participating in offerings of municipal securities issued in denominations of $100,000 or more that are sold to no more than thirty-five persons are exempt from the Rule's requirements if the underwriters have a **reasonable belief** that each purchaser: (1) has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the investment; and (2) is not purchasing the securities for more than one account or with a view to distributing the securities.

In its 1989 adopting release for the Rule (the "1989 Adopting Release"), the SEC stated, "the exemptions contained in the Rule are designed to facilitate certain of those offerings

where the SEC believes that, given the sophistication of the investors and the alternative mechanisms developed by the industry to facilitate disclosure in connection with such offerings, the specific requirements of the Rule are not necessary to prevent fraud and encourage the dissemination of disclosure into the secondary market," and "the primary intent of the [Rule is] to focus on those offerings that involve the general public and are likely to be actively traded in the secondary market. The absence of a limited placement exemption in the proposed rule reflected the [SEC]'s concern that, without transfer restrictions, municipal securities initially sold on a limited basis to sophisticated investors could be resold to numerous secondary market investors, who lacked the sophistication of the initial purchasers."

The plain language of Section 15c2-12(d) of the Rule (the "Limited Offering Exemption"), in addition to the language found in the 1989 Adopting Release which addresses the intent and purpose of the Rule and the Limited Offering Exemption, is key to understanding the recent actions and settlements. The SEC originally recognized that an exemption may be appropriate when dealing with larger denominations of municipal securities for a smaller group of investors if those investors (1) have an appropriate amount of knowledge and experience as to evaluate the merits and risks of the investment to avoid being defrauded without typical secondary market disclosure(s) and (2) have an intent to hold the securities for investment to avoid being "resold to numerous secondary market investors, who lacked the sophistication of the initial purchasers" and who would subsequently not have received appropriate disclosure.

Regarding the formation of a reasonable basis, the 1989 Adopting Release states: "the [SEC] believes that an underwriter will satisfy its obligation … if it obtains a statement indicating that the investor has purchased the securities with investment intent. Furthermore … in order to maintain the integrity of the 35 person limit, the Rule requires that each of the purchasers acquire securities for only one account. Finally, the Rule requires that the underwriter make a subjective determination that each investor have the knowledge and experience required to evaluate the merits and risks of the prospective investment." Footnote 74 in the 1989 Adopting Release noted with respect to the last sentence in the foregoing statement as follows: "This differs from Regulation D under the Securities Act [of 1933], which provides that the issuer in private placements may presume that accredited investors meet the purchaser qualifications."

b. A Growing List?

On September 13, 2022, the SEC filed a litigated action against Oppenheimer & Co. Inc. ("Oppenheimer") and announced settlements with BNY Mellon Capital Markets LLC ("BNY Mellon"), TD Securities (USA) LLC ("TD"), and Jefferies LLC ("Jefferies"). Each was charged with failing to comply with the Limited Offering Exemption. On December 21, 2022, the SEC announced that PNC Capital Markets LLC ("PNC") had agreed to settle charges that it failed to comply with the Limited Offering Exemption.

i. *Oppenheimer & Co.*

The SEC alleged that "Oppenheimer acted as underwriter in 354 municipal offerings of $1 million or more and purported to comply with the Limited Offering Exemption. Yet, Oppenheimer allegedly neither sought nor received any of the information necessary to determine whether the investors met the criteria of the Limited Offering

Exemption." For example, the SEC alleged that in a specific municipal offering that "Oppenheimer did not reasonably believe the investment advisers were buying the securities for their own accounts because these investment advisers were in the business of managing accounts for their advisory clients."

Thus, the SEC concluded that Oppenheimer failed the second prong of the Limited Offering Exemption, because, the SEC alleged, "Oppenheimer made no inquiry to determine whether the investment adviser was purchasing on behalf of advisory client(s), and if so, whether such advisory client(s) met the Limited Offering Exemption criteria. In particular, to the extent the investment advisers were purchasing on behalf of their clients, Oppenheimer neither requested nor received information from the investment adviser about how many clients would receive the securities; how much each client was investing; each client's level of financial experience; or whether each client was buying for a single account."

Based on Oppenheimer's alleged inaction to request or receive that information, the SEC concluded that "[w]ithout this information, Oppenheimer could not have formed the requisite reasonable belief that the investment advisers or the clients on whose behalf they may have been buying, were sufficiently sophisticated and buying for their own account, as the Limited Offering Exemption requires."

ii. *BNY Mellon Capital Markets*

Similarly, in its settlement with BNY Mellon, the SEC alleged that BNY Mellon participated in 245 limited offerings where it sold securities to broker-dealers and investment advisers and did not have "a reasonable belief that the broker-dealers and investment advisers were purchasing the securities for investment" per the requirements of the Limited Offering Exemption. Additionally (and consistently throughout these actions), the SEC specifically alleged that BNY Mellon "did not inquire, or otherwise determine, if the broker-dealers and investment advisers were purchasing the securities for more than one account or for distribution. It also failed to ascertain for whom the broker-dealers and investment advisers were purchasing the securities. It therefore was unable to form a reasonable belief that the broker-dealers and investment advisers were purchasing the securities for investors who possessed the necessary knowledge and experience to evaluate the investments."

iii. *TD Securities*

Again, the SEC, in its settlement with TD, alleged that TD participated in 35 limited offerings where it "sold … municipal securities to … broker-dealers and investment advisers … and … did not have a reasonable belief that the broker-dealers and investment advisers were purchasing the securities for investment" per the requirements of the Limited Offering Exemption. And again, the SEC alleged that "TD Securities did not inquire, or otherwise determine, if the broker-dealers and investment advisers were purchasing the securities for more than one account or for distribution. It also failed to ascertain for whom the broker-dealers and investment advisers were purchasing the securities. It therefore was unable to form a reasonable belief that the broker-dealers and investment advisers were purchasing the securities for investors who possessed the necessary knowledge and experience to evaluate the investments."

iv. *Jefferies*

Consistently, in its settlement with Jefferies, the SEC alleged that in 18 limited offerings "Jefferies did not have a reasonable belief that the broker-dealers and investment advisers were purchasing the securities for investment" because "[it] did not inquire, or otherwise determine, if the broker-dealers and investment advisers were purchasing the securities for more than one account or for distribution. It also failed to ascertain for whom the broker-dealers and investment advisers were purchasing the securities. Jefferies therefore was unable to form a reasonable belief that the broker-dealers and investment advisers were purchasing the securities for investors who possessed the necessary knowledge and experience to evaluate the investments."

v. *PNC Capital Markets LLC*

On December 21, 2022, the SEC settled with PNC and alleged that, in 18 limited offerings, "PNC did not have a reasonable belief that the broker-dealers and investment advisers were purchasing the securities for investment" because "[it] did not inquire, or otherwise determine, if the broker-dealers and investment advisers were purchasing the securities for more than one account or for distribution. It also failed to ascertain for whom the broker-dealers and investment advisers were purchasing the securities. PNC therefore was unable to form a reasonable belief that the broker-dealers and investment advisers were purchasing the securities for investors who possessed the necessary knowledge and experience to evaluate the investments."

In several of the settlements, the SEC alleged that the underwriters charged "did not provide investors in these securities with copies of any preliminary official statement or final official statement for the securities, or determine that a continuing disclosure undertaking had been entered into…" and that all the underwriters failed to either comply with or adopt appropriate policies and procedures related to the Limited Offering Exemption. Additionally, the SEC found several instances of underwriters relying on the Limited Offering Exemption and selling to broker-dealers and investment advisers who in turn resold the municipal securities, a clear violation of the plain language and intent of the exemption. While these additional points are important to note, the actions and settlements generally focus on why the SEC believes the underwriters failed to form the "reasonable belief" required to conform to the plain language and intent of the Limited Offering Exemption.

All of the settlements hone in on one consistent theme. The underwriters allegedly "did not have a reasonable belief" that the purchasers of the municipal securities "were purchasing the securities for investment" because each underwriter allegedly "did not inquire, or otherwise determine" if the purchasers "were purchasing the securities for more than one account or for distribution." Further, the underwriters allegedly "failed to ascertain" for whom the purchasers were purchasing the municipal securities. The underwriters were therefore allegedly "unable to form a reasonable belief" that the purchasers were "purchasing the securities for investors who possessed the necessary knowledge and experience to evaluate the investments." Lastly, some of the offerings identified in the SEC actions were no longer outstanding at the time of the action, and there was no apparent investigation into investor loss or harm.

c. Establishing the Underwriter's Reasonable Basis

In its press release announcing the actions and first three settlements, the SEC stated: "As a result of its findings in these investigations, the SEC staff has begun investigations of other firms' reliance on the limited offering exemption. Firms that believe their practices do not comply with the securities laws are encouraged to contact the SEC at LimitedOfferingExemption@sec.gov."

Consequently, the SEC's limited offering exemption enforcement initiative is expected to continue and underwriters should prepare themselves for investigation. To the extent the SEC identifies measurable abuse or noncompliance with the Rule, this enforcement trend could grow into a regulatory or rulemaking effort. It is in the interests of underwriters and their counsel to undertake a thorough self-policing and re-education effort to ensure future compliance with the Rule, and in particular, the Limited Offering Exemption.

Drawing conclusions from the SEC's enforcement efforts, it can be argued that a reasonable effort is required to establish the reasonableness of an underwriter's belief that the requirements of the Limited Offering Exemption have been satisfied. In the actions and settlements discussed above, each underwriter allegedly did not "inquire, or otherwise determine" as to who was purchasing the municipal securities and for whom they were being purchased. The SEC has signaled in these actions that this lack of effort evidenced the failure to form a reasonable belief.

In each of the settlements, the SEC states that the underwriters failed to either comply with or adopt appropriate policies and procedures related to the Limited Offering Exemption. Creating and following an appropriate process to diligence the satisfaction of the required elements of the Limited Offering Exemption will evidence effort, which may be sufficient to establish a reasonable belief.

An underwriter's process (i.e., effort) to establish and memorialize a reasonable belief in compliance with the Rule could include, for example: (i) identifying accounts (e.g., looking through non-institutional investors such as broker-dealers and investment advisers to the ultimate purchasers); (ii) investigating sophistication through representations of each ultimate purchaser or someone acting on their behalf (e.g., using objective criteria and defined terms such as "qualified institutional buyers" (note that representations regarding "accredited investor" status may be insufficient for this purpose)), or, if necessary, a short documented questionnaire / interview; (iii) investigating investment intent; (iv) developing a form investor letter to be obtained to address (i), (ii) and/or (iii) above; (v) making a written record supporting the reasonableness of each determination; (vi) post-sale spot reviews (e.g., routine reviews of public trade data to identify sales inconsistent with representations); (vii) a process to challenge or avoid investors known to have provided unreliable representations in the past; (viii) regular review of Rule G-27 supervision requirements as they relate to the Limited Offering Exemption (this being a key violation highlighted in each of the settlements and actions); and (ix) regular review of the underwriter's use of the Limited Offering Exemption to ensure there is no systemic use to avoid disclosure or continuing disclosure responsibilities.

d. Questions to Consider

i. *Is an investor letter required?* No. An underwriter may establish its reasonable belief in any number of ways, including by receipt of an investor letter. Alternatives to investor letters may include email representations, independent confirmation by telephone or other electronic means, course of dealing, etc. Receiving an investor letter is no doubt the gold standard; however, nothing in the Rule or the recent enforcement actions requires or even suggests a letter signed in writing by the investor. In many cases, an investor letter may be called a best practice, but in some cases (e.g., if selling to investment advisers), requiring an investor letter may be impractical and create unnecessary expense, such that a letter is not a best practice.

ii. *Is an investor letter sufficient?* Maybe. The 1989 Adopting Release provides that a statement from the investor will satisfy the obligation, so if the letter is signed by the actual investor and no red flags exist, a letter should be sufficient (e.g., when selling to an institutional investor known to hold securities for investment). However, if the purchaser is a broker-dealer or an investment adviser, the purchaser is unlikely to be buying with investment intent, and an investor letter from such purchaser is likely not sufficient to establish reasonable belief, as the SEC guidance is clear that an underwriter cannot rely on certificates or representations without independent investigation where inconsistencies and inaccuracies may exist (e.g., when a broker-dealer or investment adviser is making representations as if it were the actual investor). A letter from a broker-dealer or an investment advisor would likely be sufficient if the letter states the number of beneficial investors and that the purchaser is familiar with the beneficial investors' financial acumen and investment intent.

iii. *Does an investor letter need to come from the individual investor, or is a letter from the broker-dealer or investment adviser sufficient?* If a broker-dealer or investment adviser is buying for discretionary accounts, then the broker-dealer or investment adviser should have enough knowledge to make a reliable representation regarding the sophistication and intent of the individual investor. Note, however, that in its statement of facts in the settlement orders, the SEC stated that the underwriters couldn't satisfy the conditions of the Limited Offering Exemption because they did not know the identity of the ultimate investors, and the orders made no mention of whether their accounts were discretionary. If the underwriter has reason to question any representations, additional effort should be used to establish a reasonable belief.

iv. *Should an underwriter self-report violations of the Limited Offering Exemption to the SEC as requested in the actions and the settlements?* Maybe. The SEC has created a dedicated email address to receive correspondence regarding self-reporting. Historically, the SEC has valued cooperation. Underwriters should review their historical use of the Limited Offering Exemption and their internal processes and procedures and compare them to the efforts of the underwriters named in the recent enforcement actions. If similar fact patterns and pitfalls are discovered, self-reporting may be appropriate, and should be discussed internally by the underwriters' compliance professionals.

January 27, 2023