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Exempt Organizations

Exempt Health Care Entities Looking for SEC To Clarify Municipal Adviser Registration Rule

A proposal by the Securities and Exchange Commission to require registration of individuals who serve as “municipal advisors” with respect to tax-exempt bonds and other financial instruments has exempt health care organizations concerned that the rule will apply onerous registration requirements to thousands of their volunteer board members, attorneys told BNA.

The proposed rule appears to apply to all employees and directors of entities that use tax-exempt financing, which would include exempt hospitals, long-term care facilities, and other exempt health care organizations that provide exempt financing “advice.” The rule does not, however, define what constitutes “advice” or explain why board members of these organizations, who already are subject to conflict of interest rules and other fiduciary duties, are not exempted from its reach.

Several attorneys told BNA that they feel confident that the SEC proposal will be corrected as a result of feedback the commission receives during the comment period that closes Feb. 22. Others, however, worry that the commission will not go far enough to provide the clarity that board members of tax-exempt health care organizations and other 501(c)(3)s covered by the current proposal need to be assured that their routine activities will not trigger liability.

They noted that registration requires, among other things, the payment of a fee, provision of a 10-year employment history, a statement of other business activities of the individual, and disclosure of all civil judicial actions involving municipal adviser violations, and bankruptcy proceedings. In addition, all such information would be made publicly available and violations could result in both civil and criminal liability.

If the SEC fails to provide clarity in the final rule, affected individuals will have to either engage in the expensive and intrusive registration process or give up their posts, the attorneys said. Exempt health care organizations can ill afford another reason for their board members—already saddled with heightened governance and oversight obligations—to conclude that the burdens of serving an exempt health care organization outweigh the benefits, they added.

Rule Raises Concerns. The proposal requires municipal advisers—those providing “advice” to both municipal entities that issue bonds and “obligated entities” such as tax-exempt hospitals that use them for financing—to register both with the SEC and the Municipal Securities Rulemaking Board. The rule, published in the *Federal Register* Jan. 6 as part of its implementation of Section 975 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, would replace a rule that expired in 2010 (76 Fed. Reg. 824).

The rule is of concern to exempt hospitals and other health care organizations that are “conduit borrowers” of municipal financial instruments because the definition of municipal adviser includes individuals who provide advice to, or on behalf of, an obligated person with respect to municipal financial products as well as those who solicit a municipal entity.

Comments received by the commission so far have come largely from the regulated municipal entity side, pointing to the lack of a definition of what constitutes “advice” that triggers a compliance obligation and asking why certain categories of board members are exempted from coverage by the rule while others are not. Their concerns, however, overlap substantially with those of obligated entities.

Although certain employees and elected board members of municipal entities are exempted, appointed board members of municipal entities are not. Most municipal entities commenting on the proposed rule suggested there is no logical reason to treat these classes

differently and recommended that all municipal entity board members be exempt under the rule.

On the obligated entity side, while no exemption applies under the rules to board members or employees of obligated entities, attorneys said board members of these entities should be exempt just like their municipal counterparts. Both are subject to fiduciary duties under state laws, which already protect against the behaviors targeted by Dodd-Frank without imposing onerous compliance obligations, they said.

“The proposal appears to inadvertently sweep in the approximately 60,000 individuals who have volunteered to serve on exempt hospital boards.”

MICHAEL ROCK,
AMERICAN HOSPITAL ASSOCIATION, WASHINGTON

Because there is no definition of “advice,” there is also a concern that routine board member actions, such as reviewing exempt financing proposals or voting thereon, could qualify as regulated advice.

Implications Wide-Reaching. Robert W. McCann, with Drinker Biddle, Washington, said the proposed rule has “implications that could be very wide-reaching in terms of finding and retaining individuals to serve as directors of charitable health care organizations,” who would have to register and comply with SEC disclosure and recordkeeping requirements.

The SEC proposal has “some real ambiguities, builds on an artificial distinction between elected and appointed board members in conferring exemption, and fails to explain why board members of obligated entities are not treated the same as those of municipal entities.”

It fails to account for the fact that obligated entity board members already are subject to conflicts disclosure requirements and do not participate in deliberations where there may be such a conflict, McCann said. The proposal also loses sight of the fact that board members for exempt health care organizations and other nonprofits affected by the rule are selected based on a range of reasons and qualifications and that finding candidates with knowledge of financial issues is not only desirable but necessary, he added.

“But I think the more significant concerns are that the SEC could in the future make rules that would, de facto, establish standards or qualifications for directors of charitable organizations that borrow in the tax-exempt bond market and that directors would be subject to potential civil and criminal penalties in the event something goes awry with a bond issue,” McCann said.

“This, generally, is not what people sign up for when they agree to serve as voluntary directors of a public charity,” he added.

Michael W. Peregrine, with McDermott Will & Emery LLP, Chicago, said the proposed rule “is consistent with a growing policy push-back against directors of any stripe having business relationships with the companies for whom they serve as directors.” The proposal seems to be an “over reaction” because existing regulatory oversight mechanisms in the not-for-profit sector should be sufficient, he said.

“The SEC’s effort is useful to the extent it illuminates the need for board members of charitable health care organizations to pay attention to the obligations this proposal aims to enforce,” Peregrine continued. “And while I do not think the SEC’s interpretation is one that I would reasonably expect to survive the comment process, exempt health care organizations need to keep running this ground ball out.”

Resolution Uncertain. Anastasia Khokhryakova, with Hogan Lovells US LLP, in Denver, said she, too, is optimistic that the commission will respond favorably to the comments that it receives and clarify that all board members of both municipal and obligated entities are exempted from the rule.

“The proposal makes a distinction between elected and appointed board members of municipal entities—exempting the former, but not the latter—but that distinction is unreasonable and superfluous because both are subject to fiduciary duty standards under state law regardless of how the individual comes to serve on a board,” Khokhryakova said.

“The commission should exempt all municipal entity board members and should do the same for board members of obligated entities as well because there is really no basis in this context for treating board members of obligated entities different from those who serve municipal entities,” she added.

Khokhryakova said there is some concern, however, that the SEC will decide to sidestep the exemption issue and focus instead on clarifying that certain routine board member actions do not constitute “advice” covered by the rule.

“Under the current proposal, the term ‘advice’ is not defined and could conceivably include a board member’s participation in a meeting about alternative structures or timing of a bond transaction or execution of a swap or guaranteed investment contract,” she said. “The term could possibly be interpreted so broadly that it would encompass action taken by a governing board to approve such a bond transaction or financial product even if there is no further discussion,” Khokhryakova added.

“The SEC could clarify in a final rule that voting, deliberating, or other routine action by a board member on a proposed exempt financial product does not qualify as ‘advice,’” she noted. “This, however, would not be an ideal resolution of the issue because board members, if they are not exempted altogether, will be concerned about what statements might be categorized as ‘advice,’ thereby requiring their registration as municipal advisers,” she concluded.

Other Comments. Michael Rock, senior associate director with the American Hospital Association in Washington, said his organization supports a registration requirement for professionals who make their livelihood advising on financial investments. “AHA does not, however, believe individuals who merely sit on an exempt hospital board, who are not finance professionals, and who are themselves acting on the information they receive from paid financial advisers should have to register with the commission,” Rock said.

Although the SEC appears concerned about transparency and conflicts of interest, AHA believes the state and federal laws that already are in place are sufficient and that additional protections are not needed, Rock said.

“The proposal appears to inadvertently sweep in the approximately 60,000 individuals who have volunteered to serve on exempt hospital boards,” Rock said. “In light of all the rules currently in place, we don’t see added protection, but added disincentive to community service,” he added.

AHA hopes to work with the SEC to craft a clear and workable exemption for board members and executives of obligated health care entities who are not finance professionals, Rock said. “The association does not believe a clarification by the SEC concerning what constitutes ‘advice’ triggering a registration obligation will provide sufficient comfort to board members considering voluntary service.”

Charles A. Samuels, with Mintz Levin in Washington, said the SEC needs to adopt a bright-line rule that clarifies that board members and executives of both obli-

gated and municipal entities who are not financial professionals are exempt under the regulations.

“The SEC made this proposal, without much consideration of the consequences for board members and employees of exempt health care organizations, and needs to adopt a clear exemption that will allow board members and executives to engage in full deliberation,” Samuels said. He said he is preparing comments on behalf of the National Association of Health and Educational Facilities Finance Authorities.

BY PEYTON M. STURGES

The proposed rule is available at <http://www.sec.gov/rules/proposed/2010/34-63576.pdf> on the SEC’s website. The comment letters are at <http://www.sec.gov/comments/s7-45-10/s74510.shtml>.