MSRB NOTICE 2011-52 (SEPTEMBER 12, 2011)

POTENTIAL APPLICABILITY OF MSRB RULES TO CERTAIN "DIRECT PURCHASES" AND "BANK LOANS"

Introduction

The Municipal Securities Rulemaking Board ("MSRB") is aware that many state and local governments have turned to private placements of their municipal securities with banks (sometimes referred to as "direct purchases") and bank loans as an alternative to public offerings of municipal securities. In many cases, this shift is attributable to the pending expirations of letters of credits and standby bond purchase agreements providing liquidity for variable rate demand obligations ("VRDOs"). In other cases, these private placements and bank loans have taken the place of temporary cash flow borrowings previously accomplished with revenue anticipation notes ("RANs").

The MSRB has received a number of inquiries regarding the potential applicability of MSRB rules or other federal securities laws or regulations to direct purchases of municipal securities or bank loans placed in these contexts. As the MSRB has previously observed, private placements of municipal securities are subject to MSRB rules and other federal securities laws applicable to transactions in municipal securities.[1] In response to these recent inquiries, the MSRB is publishing this notice to alert municipal market participants that, under existing legal principles described below, certain financings that are called "bank loans" may, in fact, be municipal securities. If that is the case, and parties regulated by the MSRB[2] play a role in such financings, those parties may inadvertently violate MSRB rules, as well as other federal securities laws.

Securities Regulation of "Direct Purchases" and "Bank Loans"

If a broker-dealer serves as a placement agent for a "direct purchase" by a bank of municipal securities or as a placement agent for a "bank loan" that is, in fact, a municipal security, the broker-dealer is subject to all MSRB rules, as well as other federal securities laws. This is the case even if the broker-dealer is an affiliate of such bank or a separately identifiable department or division of the bank.[3] For example, as agent, a broker-dealer may effect a direct purchase of VRDOs by its bank affiliate followed by a restructuring of such VRDOs. In some cases, that restructuring may be so significant that it amounts to a primary offering of municipal securities.[4] In such a case, depending upon the broker-dealer's involvement in the purchase and restructuring, the broker-dealer may be obligated under MSRB Rule G-32 to report the restructured transaction to the MSRB. The same would be true of a broker-dealer that places a "bank loan" that is, in substance, a municipal security.

This obligation to report such a primary offering exists even though Rule G-32 does not require that copies of private placement memoranda be delivered to the MSRB. The reporting of such primary offerings serves important investor protection and market efficiency functions by ensuring that market information systems are able to properly record and disseminate to the marketplace information regarding any subsequent trading in such municipal securities or any continuing disclosures relating to such securities (including disclosures provided voluntarily for securities not subject to the continuing disclosure provisions of Exchange Act Rule 15c2-12). It also provides the enforcement agencies with an audit trail for purposes of their enforcement of MSRB rules and other federal securities laws. Furthermore, the

reporting of the baseline Rule G-32 information for such transactions alerts investors in other securities of the issuer to the existence of issuer debt that might be on a parity with, or senior to, their own holdings.

Among the other MSRB rules that might apply to a broker-dealer placing a bank financing that is a municipal security are: Rule A-13 (requiring broker-dealers to pay assessments on underwritings and placements of municipal securities), Rule G-3 (requiring broker-dealers engaged in municipal securities activities to pass qualifying examinations), Rule G-14 (requiring broker-dealers to report purchases and sales of municipal securities, including agency trades), Rule G-17 (imposing a duty of fair dealing on broker-dealers and municipal advisors in the conduct of their municipal securities and municipal advisory activities), Rule G-34 (requiring broker-dealers to obtain CUSIP numbers for municipal securities issues), and Rule G-37 (banning broker-dealers from engaging in municipal securities business for two years following non-*de minimis* political contributions to certain "issuer officials").

A municipal advisor that advises a state or local government issuer on whether to enter into a "bank loan" that is, in fact, a municipal security, or on a "direct purchase" by a bank of the issuer's securities followed by a restructuring of the securities that is considered a primary offering, is subject to the rules of the MSRB concerning municipal advisors. For example, a municipal advisor to a state or local government on a direct purchase and restructuring of VRDOs could be considered to provide advice on the issuance of municipal securities if such restructuring amounts to a primary offering. Such a municipal advisor would be subject to a federal fiduciary duty to the issuer under Section 15(c)(1) of the Exchange Act. The municipal advisor would, therefore, be required to act in the best interests of the issuer and advise the issuer of any risks associated with the transaction. The same would be true of a municipal advisor that advised a state or local government issuer on whether to enter into a transaction that, while called a "bank loan," is, in fact, a municipal security. The MSRB notes that Standard & Poor's has issued a report that highlights the risks such financings may pose for state and local governments, including repayment risks and the risk of cross-default on other obligations.[5]

"Bank Loans;" the *Reves* Case

Municipal securities that are purchased by banks and subsequently restructured do not lose their character as municipal securities. However, when banks make "loans" to state and local governments, even if only to provide a source of funds for those governments to purchase their own securities, whether such "loans" will be considered securities can be a difficult question.

Many loans are evidenced by notes. Section 3(a)(10) of the Exchange Act includes "notes" within the definition of "security." The principal legal authority on the distinction between a note that is a security from one that is not is the U.S. Supreme Court case of *Reves v. Ernst & Young, Inc.*[6] A note is presumed to be a security under the Supreme Court's opinion in *Reves* unless it is of a type specifically identified as a non-security.

The types of non-security notes identified in *Reves* include notes delivered in a consumer financing, notes secured by a mortgage on a home; short-term notes secured by a lien on a small business or its assets, short-term notes evidenced by accounts receivable, notes evidencing "character" loans to bank customers, notes formalizing open account debts incurred in the ordinary course of business, and notes evidencing loans from commercial banks for ordinary operations.[7]

A note that is not among the list identified in *Reves* is a security unless it bears a "strong family resemblance" to the non-security notes identified in the opinion.[8] *Reves* established a four-part family

resemblance test to determine whether a note is a security, which is composed of the following factors: (i) the motivations of the buyer and seller; (ii) the plan of distribution; (iii) the reasonable expectations of the investing public; and (iv) the existence of an alternate regulatory regime.[9] If a note fails the family resemblance test, it is deemed a security.

As to the first factor -- the motivations of the buyer and the seller -- the Supreme Court said that, if the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." On the other hand, if the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, the note is less sensibly described as a "security."[10]

As to the second factor -- the plan of distribution -- the Supreme Court said the question is whether the note is an instrument in which there is "common trading for speculation or investment."[11]

As to the third factor -- the reasonable expectations of the investing public -- the Supreme Court said that it might consider instruments to be "securities" on the basis of public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction.[12]

As to the fourth factor -- the existence of another regulatory scheme that significantly reduces the risk of the instrument, thereby rendering application of the securities laws unnecessary -- the Supreme Court said it would consider whether the notes would escape federal regulation entirely if the securities laws were held not to apply.[13]

Application of the *Reves* Factors to "Bank Loans"

Certain characteristics of some bank financings evidenced by notes may be indicative of securities, using the factors enumerated by the Supreme Court in *Reves*. An analysis of different bank financings may produce different results, depending upon the facts and circumstances. While the *Reves* case is the leading case on whether a note is a loan or a security, other court decisions and Securities and Exchange Commission ("SEC") guidance have also addressed the question. Dealers and municipal advisors that play a role in bank financings evidenced by notes should consult with their counsel on whether the financings are securities or loans, because whether the financing is called a "loan" is not necessarily dispositive of whether the financing is a loan or a security, and the consequences of failing to analyze such financings properly may be significant.

The SEC and the courts, and not the MSRB, ultimately have the authority to interpret the meaning of the term "security" for purposes of the federal securities laws. Because this notice is only an advisory, the MSRB has not filed it with the SEC for approval, and no inference should be drawn that the SEC or its staff has approved its publication. In issuing this notice, the MSRB intends to make dealers and municipal advisors aware that some financing instruments might be municipal securities. While the MSRB's intent is to draw attention to the factors to consider in determining whether an instrument is a security, the MSRB draws no legal conclusions regarding any individual instrument. Dealers and municipal advisors should consult with their legal counsel about the analysis of whether an individual instrument is a security.

The MSRB will continue to monitor evolving market practices and to consider the securities law implications of such changing practices. Although market participants must take primary responsibility for

understanding the specific legal consequences of any transaction in which they participate, the MSRB will seek to provide further educational alerts as appropriate and to discuss with other regulatory authorities potential clarifications of their applicable rules and regulations in the context of such new market practices.

September 12, 2011

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[1] *See* MSRB Notice 2011-37 (August 3, 2011).

[2] Pursuant to Section 15B of the Securities Exchange Act of 1934 (the "Exchange Act"), the MSRB regulates brokers, dealers, and municipal securities dealers ("broker-dealers") engaged in municipal securities activities and municipal advisors engaged in municipal advisory activities.

[3] As defined in MSRB Rule G-1.

[4] Under MSRB Rule G-32(d)(viii), the term "primary offering" means "an offering defined in Securities Exchange Act Rule 15c2-12(f)(7), including but not limited to any remarketing of municipal securities that constitutes a primary offering as such subsection (f)(7) may be interpreted from time to time by the Commission." Exchange Act Rule 15c2-12(f)(7) provides that:

The term "primary offering" means an offering of municipal securities directly or indirectly by or on behalf of an issuer of such securities, including any remarketing of municipal securities

(i) That is accompanied by a change in the authorized denomination of such securities from $100,000 or more to less than $100,000, or

(ii) That is accompanied by a change in the period during which such securities may be tendered to an issuer of such securities or its designated agent for redemption or purchase from a period of nine months or less to a period of more than nine months.

[5] Standard & Poor's, "The Appeal of Alternative Financing Is Not Without Risk for Municipal Issuers," (May 17, 2011).

[6] 494 U.S. 56 (1990).

[7] *Id.* at 65.

[8] *Id.* at 64-65.

[9] *Id.* at 66-67.

[10] *Id*. at 66.

[11] *Id*.

[12] *Id*. at 66-67.

[13] *Id*. at 67.