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Direct Purchases and Bank Loans as Alternatives to Public Financing in the Municipal Securities Market

Introduction

The Municipal Securities Rulemaking Board (MSRB) and the Financial Industry Regulatory Authority (FINRA)[1] are providing guidance to remind firms of their obligations in connection with privately placing municipal securities directly with a single purchaser and of the use of bank loans in the municipal securities market.

The MSRB and FINRA are aware of the increasing practice of privately placing municipal securities directly with a single purchaser (sometimes referred to as "direct purchases") and of the use of bank loans[2] as alternatives to traditional public offerings in the municipal securities market.[3] Although it can be beneficial for potential issuers of municipal securities to consider such alternatives and the means of financing used is the issuer's choice, this development raises a number of concerns with respect to firms' conduct in connection with such alternative financings. First, FINRA has observed and the MSRB is aware that firms may not be conducting sufficient due diligence and analysis to determine whether the

[1] *See* FINRA Regulatory Notice 16-10.

[2] A "bank loan" refers to a loan directly to a municipal entity evidenced by a loan agreement or other type of financing agreement between a bank and a municipal entity. A "municipal entity" is defined as "any State, political subdivision of a State or municipal corporate instrumentality of a State, including (A) any agency authority, or instrumentality of the State, political subdivision, or municipal corporate instrumentality; (B) any plan, program, or pool of assets sponsored or established by the State, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof; and (C) any other issuer of municipal securities." Section 15B(e)(8) of the Securities Exchange Act of 1934 ("Exchange Act"). *See also* 17 C.F.R. §240.15Ba1-1(g) (defining "municipal entity" for purposes of municipal advisor registration with the Securities and Exchange Commission (SEC)).

[3] *See e.g.*, "California Private Placement Market May be Pivoting," The Bond Buyer (November 5, 2015) reporting that, based on data provided by Thomson Reuters, the private placement of municipal securities totaled about $24 billion in 2014.

financing instruments are municipal securities or bank loans even where the financing instrument is described as a "loan." Second, firms may be engaging in placements of these instruments without fully understanding the nature of their roles in the transactions, such as whether the firm is engaging in conduct that makes it a broker-dealer or municipal advisor. Finally, some firms may not have fully considered the applicability of the federal securities laws and the rules and regulations thereunder, including FINRA and MSRB rules, to these transactions.

The MSRB previously issued notices advising brokers, dealers and municipal securities dealers (collectively "dealers") that their obligations under certain MSRB rules are equally applicable to public offerings and private placements of municipal securities.[4] In addition, the MSRB cautioned that a private placement of municipal debt with a single purchaser, including a bank, even if described as a "loan," could be a municipal securities transaction and, as a result, require the dealer to comply with the applicable MSRB rules.[5] FINRA and the MSRB are issuing this notice to remind firms of these prior notices and firms' obligations under the applicable federal securities laws and rules and regulations thereunder, as well as FINRA and MSRB rules.

Discussion

Security or Loan Analysis

A threshold analysis a firm must undertake is to determine whether the nature of the municipal entity's financing instrument is a security or a loan. Exchange Act Section 3(a)(10) includes "notes" within the definition of "security" and labeling an alternative financing for a municipal entity a "loan," which is often evidenced by a note, does not obviate the need to fully assess the particular facts and circumstances of the financing transaction.

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.,* which held that a note is presumed to be a security unless it is of a type specifically identified as a non-security.[6] The types of non-security

[4] *See* MSRB Notice 2011-37 "Financial Advisors, Private Placements, and Bank Loans" (August 3, 2011) and MSRB Notice 2011-52 "Potential Applicability of MSRB Rules to Certain 'Direct Purchases' and 'Bank Loans'" (September 12, 2011).

[5] *Id.*

[6] 494 U.S. 56 (1990). While the *Reves* case is the leading case on whether a note is a loan or a security, other court decisions and SEC guidance have also addressed the question.

notes identified in *Reves* include notes delivered in a consumer financing transaction, 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]

An instrument that is not among the list of non-security notes identified in *Reves* is deemed to be 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 for determining whether a note is a security 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. Under the Supreme Court's decision, if a note fails the family resemblance analysis, it is deemed to be a security.[9]

Simply labeling a financing as a "loan" is not dispositive of whether it is a loan or a security. For example, firms should review the transaction documentation in considering whether a particular financing instrument is a municipal security or a loan. FINRA has found instances of financing arrangements that firms have concluded are loans even though the *Reves* factors indicated otherwise. In some instances, the transaction documentation described the instruments as "bonds," or contained language consistent with bond offerings, such as: (i) references to "purchasers" or "sellers"; (ii) the debt instruments were to be sold in separate denominations; (iii) the purchasers made representations regarding their knowledge and experience in investments and willingness to take on risk; and (iv) the debt instruments could have been resold. Contrary to the firms' views, in many instances the banks and municipal issuers involved in the transactions considered the instruments as municipal securities. FINRA has also found instances where firms failed to evaluate whether interim financing instruments (*i.e.*, a two-tier financing arrangement) should have been treated as a municipal security or a loan. The consequences of failing to analyze such financings properly may be significant. Firms should also

[7] *Id.* at 65.

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

[9] *See* MSRB Notice 2011-52 for a more detailed review of *Reves*.

consider consulting with counsel on whether a particular financing instrument is a municipal security or a loan.

Overview of Applicable FINRA and MSRB Rules

FINRA member firms engaged in alternative financings that involve securities must consider their obligations under all applicable FINRA rules.[10] Moreover, certain FINRA rules apply to member firms' conduct involving non-securities products, including FINRA Rules 2010 (Standards of Commercial Honor and Principles of Trade), 2210 (Communications with the Public), 3310 (Anti-Money Laundering Compliance Program) and 4530 (Reporting Requirements).[11] In addition, firms have broad supervisory obligations under FINRA Rule 3110, including supervisory obligations with respect to compliance with such rules.

MSRB rules that may be applicable to firms engaged in alternative financings that involve municipal securities include, but are not limited to, MSRB Rule A-12 (requiring registration), MSRB Rule A-13 (requiring broker-dealers to pay assessments on underwritings and placements of municipal securities), MSRB Rule G-2 (standards of professional qualification), MSRB Rule G-3 (professional qualification requirements), MSRB Rule G-8 (recordkeeping requirements), MSRB Rule G-9 (preservation of records), MSRB Rule G-14 (reports of sales or purchases of municipal securities, including agency trades), MSRB Rule G-15 (confirmation, clearance, settlement and other uniform practice requirements with respect to transactions with customers), MSRB Rule G-17 (fair dealing in the conduct of municipal securities activities), MSRB Rule G-23 (activities of financial advisors), MSRB Rule G-32 (disclosures in connection with primary offerings), MSRB Rule G-34 (CUSIP numbers, new issue and market information requirements) and MSRB Rule G-37 (political contributions and prohibitions on municipal securities business). Firms also have broad supervisory obligations under MSRB Rule G-27, including supervisory obligations with respect to compliance with these rules. In

[10] We note that FINRA rules are not intended to be, and shall not be construed as, rules concerning transactions in municipal securities. *See* FINRA Rule 0150.

[11] *See, e.g.*, *Iallegio v. SEC*, No. 98-70854, 1999 U.S. App. LEXIS 10362, at *4-5 (9th Cir. May 20, 1999) (holding that Rule 2010 applies to all unethical business conduct, regardless of whether the conduct involves securities); *Vail v. SEC*, 101 F.3d 37, 39 (5th Cir. 1996) (same); *In re Wallace*, Admin. Proc. File No. 3-9549, 1998 SEC LEXIS 2437, at *13 (November 10, 1998) (emphasizing that Rule 2210 is "not limited to advertisements for securities, but provide[s] standards applicable to all [broker-dealer] communications with the public").

addition, if a firm is engaged in advising the municipal entity, the firm may be subject to a federal fiduciary duty under Exchange Act Section 15B(c)(1), and subject to SEC and MSRB rules applicable to municipal advisors.[12]

In addition, firms are reminded that timely disclosure by or on behalf of the municipal entity of additional debt or debt-like obligations that are outstanding is beneficial to foster market transparency and to ensure a fair and efficient municipal market. Municipal market participants are encouraged to voluntarily disclose the existence and terms of bank loans in a timely manner.[13]

Conclusion

The increasing use of direct purchases of municipal securities and bank loans as alternatives to publicly-offered municipal securities gives rise to a number of compliance risks for firms engaging in this activity and may erode market transparency that serves the interests of investors and promotes fair and efficient markets. This notice reminds firms seeking to engage in these alternative financings with municipal entities of their obligations to conduct adequate due diligence to ascertain the nature of the transaction and financing instrument to ensure compliance with FINRA and MSRB rules, as well as the federal securities laws and other rules and regulations thereunder applicable to the activity.

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[12] For example, a firm that provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products, as defined in the Exchange Act, 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, may be engaged in municipal advisory activity and be required to register as a municipal advisor with the SEC and MSRB. *See* Registration of Municipal Advisors, Securities Exchange Act Release No. 70462 (Sept. 20, 2019), 78 FR 67467 (Nov. 12, 2013). *See also* MSRB Rules A-12 (Registration) and G-42 (Duties of Non-Solicitor Municipal Advisors) (effective June 23, 2016); and MSRB Notice 2011-52 (discussing, among other things, the applicability of MSRB rules to a municipal advisor that advises a state or local government issuer on whether to enter into a bank loan that is, as a legal matter, a municipal security).

[13] *See* MSRB Notice 2015-03 for guidance on best practices in order to facilitate the timely voluntary disclosure of bank loans and information related to bank loans that supports market transparency and enhances market efficiency.