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Memorandum

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Municipal Securities Rulemaking Board Notice Raises Questions Whether Certain Loans to Municipal Governments are Securities

By Brian S. Fraser

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On September 12, 2011, the Municipal Securities Rulemaking Board ("MSRB") issued Notice 2011-52 titled "Potential Applicability of MSRB Rules to Certain 'Direct Purchases' and 'Bank Loans'" (the "Notice") (attached as Exhibit A). The Notice has provoked some consternation in the secondary market for commercial bank loans because the Notice suggests that certain transactions characterized as "loans" in the municipal market may in fact qualify as securities under the Federal securities laws pursuant to the Supreme Court's ruling in *Reves v. Ernst & Young, Inc.*, 494 U.S. 56 (1990).[1] The Notice states that

> 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 play a role in such financings, those parties may inadvertently violate MSRB rules, as well as other federal securities laws.

In the context of the expansion of the MSRB's role in the municipal market and the lack of transparency in municipal financial disclosure, however, the Notice is not surprising and should have no effect on the commercial loan market.[2]

Federal regulation of municipal securities is extremely modest compared to the robust regulatory scheme for other public and private securities in the United States. As enacted, the 1933 and 1934 Acts exempted (except for the antifraud provisions) municipal issuers from Federal regulation.

In 1975, Congress passed what became known as the Tower Amendment, which prohibits the SEC and the MSRB from requiring municipal securities issuer to file any type of "application, report or document" in connection with the issuance of

1 The Supreme Court's decision in *Reves* provides the analytic framework for determining whether a particular transaction involves the purchase or sale of a "security." These factors include (1) whether the instrument is motivated by investment or commercial purposes; (2) the "plan of distribution" for the instrument; (3) the reasonable expectations of the public; and (4) whether an alternative regulatory scheme or other risk-reducing factor renders application of the securities laws unnecessary. *Id.* at 66-67.

2 The lack of transparency in the muni market has been a concern among senior SEC officials and members of Congress for a long time. *See generally,* "As Municipal Securities Market Grows, Increased Regulation is Needed." Just this week reports surfaced of proposed legislation drafted by Rep. Mike Quigley (D-Ill.) that would require municipal issuers to provide more disclosure for both the primary and secondary markets.

securities. In the absence of mandatory disclosure on the part of issuers, the regulators have instead imposed obligations on municipal broker-dealers, underwriters and financial advisors to obtain contractual promises of disclosure from municipal issuers. There is no penalty, however, for issuers who fail to make timely and complete disclosure.

In 2010, Dodd-Frank imposed a number of new requirements on municipal market participants, most of which are not important here. What is significant, however, is the fact that the MSRB was expanded and made more independent of municipal broker-dealers and advisors. Under the rules presently in effect, 11 of the 21 members of the MSRB must be "independent," and at least three of the remaining slots must be filled by representatives of independent municipal advisers. The remaining members are split between broker-dealers and bank dealers.

In light of the lack of transparency on the part of municipal issuers and the greater influence and independence of the MSRB, the Notice is not surprising. The key, we believe, to the MSRB's motivation can be discerned in this paragraph of the Notice:

> 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 (emphasis added).

The MSRB appears concerned that the characterization of municipal financings as "loans" rather than securities will result in even less transparency into municipalities' financial condition and capital structure. Undisclosed loans to municipalities that are senior to or *pari passu* with public bonds are dilutive, and it appears that the MSRB wants dealers and advisors to err on the side of disclosure.

Given the already stringent financial reporting requirements for commercial entities that issue securities, there should be no such concern about transparency of commercial loans. Barring unforeseen future developments in this area, therefore, the Notice should have no effect on the market for commercial loans. *Reves* is still the key, however, and the Notice is a reminder that, especially as banks are increasingly asked to lend in markets where they have not been traditional sources of capital, naming the product a "bank loan" is not dispositive.[3] The question of whether a non-traditional financing should be characterized as a loan or security is much more nuanced. Expect more questions to arise and expect to continue to see modern regulators running the analysis of the *Reves* factors in connection with newly-evolving bank financing structures.

3 Note that the subsequent application and interpretation of the *Reves* factors by the MSRB, and the categorization by the MSRB of certain loans to municipalities as "securities" could have precedential value in cases applying the *Reves* factors to the commercial bank loan market.

QUESTIONS

If you have questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or the person listed below.

Brian S. Fraser
New York, NY
212.530.1820
bfraser@rkollp.com

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