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Bank Loan Disclosure Fraught With Uncertainty.

WASHINGTON – As regulators increasingly push for more disclosure of bank loans, some of these "loans" may actually be securities that are already subject to federal securities laws and rules, including municipal disclosure requirements, lawyers said this week.

The Municipal Securities Regulatory Board, rating agencies, and other groups have recently stepped up efforts to promote voluntary disclosure of bank loans, pointing out that the interests of bond investors could be at risk if bank loans and private placements of debt draw on government resources also used to back securities.

But their plea for voluntary disclosure is running up against a tangled web of legal issues involving issuers, broker-dealers and municipal advisors.

In general, issuers are not required to disclose information about their bank deals. While certain information about a loan, such as its size will eventually turn up in the city's financial documents, detailed information about its terms may remain hidden.

The MSRB and rating agencies have urged issuers to put detailed information about their bank loans on EMMA, raising legal concerns for muni analysts who want to be able to consider the impact of the perhaps $60 billion muni bank loan market on the bond market.

But some transactions that are structured as, and classified by, banks as "loans," can be municipal securities that are subject to federal securities laws and MSRB rules.

In September 2011, the MSRB published a warning that loans and direct purchases could be subject to these laws and rules. The warning acknowledged the difficult legal issues.

"Municipal securities that are purchased by banks and subsequently restructured do not lose their character as municipal securities," the MSRB warned. "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."

The Financial Industry Regulatory Authority chimed in the following February, telling dealers that "these financings may be municipal securities and thus subject to all MSRB rules."

There is widespread agreement that the question of whether a transaction is a security or a loan is problematic. The Securities Act of 1933 defines a "security" to include most notes, evidence of indebtedness, and certificates of participation. Many muni bank loans are evidenced by notes.

The most concrete guidance available comes from a Supreme Court ruling in 1990, in Reves v. Ernst & Young that provides a four-part test for determining whether such notes are securities.

The court ruled that notes are presumably securities unless they fall into a limited category decided by the court to be outside the securities realm, or if the instrument in question bears a "family resemblance" to an excluded category. The test involves: whether the instrument is motivated by

investment or commercial purposes; the plan of its distribution; the expectations of the public; and whether the notes fall under other federal regulations which make applying the securities laws unnecessary.

The MSRB explained the test in its September 2011 notice, pointing out the court said an instrument is likely a security if it was sold to finance substantial investments and the buyer expected a profit or if there were trading for speculation or investment. The court also opined that it might consider instruments to be "securities" on the basis of public expectations, even if other factors pointed to a loan, the board said.

While the so-called "Reves Test" provides guidance suggesting that debt instruments structured as closely as possible to traditional bank loans might not fall under Securities and Exchange Commission oversight or be subject to any MSRB rules, bond lawyers and disclosure experts said the question of whether something is a loan or a security is still very hard to answer.

"That is not an easy determination to make," said Dave Sanchez, who runs his own law firm in California. "Not with legal certainty."

Ernesto Lanza, a shareholder in Greenberg Traurig's Washington office, said the status of the debt can wind up being "pretty amorphous."

"It's almost a gut feel," he said.

"There's no telltale sign that something is a bank loan or is a security," said Jessica Giroux, Bond Dealers of America senior counsel and managing director for federal regulatory policy.

If a security is being mischaracterized as a loan that is not subject to securities laws, and regulators discover it, the implications could be severe. Dealers acting as placement agents between issuers and banks could potentially violate a host of MSRB rules, including those requiring dealers to obtain CUSIP numbers and report trades, as well as comply with the pay-to-play rule and restrictions on gifts and gratuities to municipal officials.

Bank loans have already been a source of tension between non-dealer municipal advisors and dealer firms. BDA has accused non-dealer MAs of acting as broker-dealers, even though they are not registered as such, when they serve as go-betweens for loans that are really securities.

The National Association of Municipal Advisors has countered by claiming that negotiating the terms of an issuer's loan with a bank constitutes an MA activity and asking the SEC to clarify this by providing an exemption from broker-dealer registration for MAs acting in this capacity.

Larry Kidwell, president of Brentwood, Tenn.-based MA Kidwell & Company, however, continues to caution non-dealer MAs about such activities. "I would recommend in the strongest possible terms that registered independent municipal advisors avoid activities which may be deemed to be those of a dealer firm by the SEC," Kidwell said.

Sanchez described a flip side of that coin, saying broker-dealers have to be worried about pitching bank loans as alternatives to bond financings, because this would make them subject to the municipal advisor registration regime. The Dodd-Frank Act places a fiduciary duty on MA firms that offer advice "with respect to" an issuance of munis that is considered by regulators to be inconsistent with the relationship between an underwriter and an issuer. The duty requires an MA to put the issuer's interests first before its own. Any dealer actively recommending a loan needs to be sure they are complying with MA rules and G-23, Sanchez said.

While the growing popularity of bank loans and direct purchases has thrust these issues to the forefront, the lack of clarity about how to categorize them may not be resolved any time soon. Bond lawyers said the SEC would be hard-pressed to provide useful guidance on such a facts and circumstances-based standard. Lanza said it's likely only a major SEC enforcement action would provide much for the market to go on.

"People would love to have the SEC say 'here's the definition,' Lanza said. "The only guidance you'll get is if there's a really meaty case."

Sanchez said it remains a question whether bank loans that are not securities should become subject to continuing disclosure obligations. The SEC would have to amend its Rule 15c2-12 on disclosure to require that they be included as financial information relevant to bondholders.

The Government Finance Officers Association has recommended voluntary disclosure of bank loans. But issuers who release this information voluntarily are still under antifraud obligations to ensure the information is not misleading.

Giroux said disclosure would generally be helpful to the market, and help alleviate regulators' primary anxiety that investors could be harmed by undisclosed debt that draws on the same tax flows as outstanding bonds.

"Nobody can really point fingers if it's all disclosed," Giroux said.

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