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Voluntary Reporting of Bank Loans – Best Practice or Sword of Damocles?

One of the hottest current topics in the world of municipal finance is the issue of the "voluntary" reporting on the Municipal Securities Rulemaking Board's ("MSRB") Electronic Municipal Marketplace Access system ("EMMA[1]") of direct bank loans to governmental entities or conduit governmental entity borrowers.

The MSRB is wholly committed to promoting this practice in the marketplace and has published a number of notices and advisories on this point over the last several years. The MSRB's expressed concern over the increasing use of bank loans is that such loans often contain terms and conditions, acceleration provisions or events of defaults that could impact the parity position, rights or collateral of existing bondholders or the liquidity of the issuer. Information regarding such loan terms, and the risks presented to bondholders, is not readily available to the secondary market, and are often disclosed only in the annual financial statements of issuers or conduit borrowers that are filed on EMMA as part of continuing disclosure obligations. The MSRB has summarized its position as follows:

> "The MSRB believes that the availability of timely information about bank loan financings is important for market transparency and promoting a fair and efficient market. Voluntary submission of information concerning bank loan financings through EMMA … would provide timely access for bondholders, potential investors and other market participants to key information useful in assessing their current holdings of municipal securities or in making investment decisions regarding potential transactions in municipal securities."[2]

Inextricably intertwined with this voluntary reporting initiative is the consideration of whether governmental entity notes issued as part of so-called bank loans constitute municipal "securities" under the federal securities laws. This is critical because characterization of bank loans as securities potentially subjects the loan/note, the issuer and various other participants in the transaction to anti-fraud and other provisions of the federal securities laws and regulation by the MSRB, the United States Securities and Exchange Commission ("SEC") and other regulators.

In Notice 2011-37 (August 2, 2011), the MSRB first warned municipal advisors that bank loans may, depending on the specific terms and conditions of the transaction, actually be placements of municipal securities. Such a result could require municipal advisors participating in the private placement of bank loans to register with the SEC as a broker-dealer and subject the municipal advisor to the rules and regulations of the MSRB, including Rule A-13, Rule G-3, Rule G-14, Rule G-17, Rule G-32, Rule G-34 and Rule G-37 with respect to the bank loan. And if a municipal advisor was required to register as a broker-dealer, it would become subject to MSRB Rule G-23, which precludes municipal advisors who are also broker-dealers from becoming underwriters or placement agents for municipal issues for which they are serving as financial advisor. The MSRB did not provide any meaningful information as to what terms and conditions may convert a bank loan to a municipal security, but deferred the determination to "guidance" provided by the SEC and the courts on this point.

The MSRB continued this drumbeat in its Notice 2011-52 (September 12, 2011) and Notice 2012-18 (April 3, 2012). In these Notices, the MSRB expresses its continuing concern over the need for secondary market transparency in the trading of issued municipal securities through provision of readily accessible information of the terms and conditions of bank loans.

Notice 2011-52 cautions that 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 true even for broker-dealers who are affiliates or separate divisions of the bank providing the loan. Further, 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.

Notice 2012-18 follows the same theme and provides further guidance on how to actually do the voluntary filing using EMMA’s existing capabilities. According to the MSRB, the EMMA posting could be done by either filing copies of the bank loan documents, or a summary of the documents containing the following information: the lender; the borrower; purpose of the loan/financing; security for repayment; third party guarantees; source of repayment; dated/closing date; par amount; interest rates, including method of computation; payment dates; maturity and loan amortization; optional, mandatory and extraordinary prepayment provisions; entity tax status; events of defaults/remedies; current borrower credit rating; governing law; CUSIP number, if applicable; and redistribution rights, if applicable.

In Notice 2012-18, the MSRB also repeats it cautionary advice to broker-dealers and municipal advisors regarding bank loans potentially constituting municipal securities, thereby subjecting them to existing securities law requirements. The MSRB did acknowledge that SEC Rule 15c2-12 (which, among other things, imposes various duties on a broker or underwriter regarding issuer or obligated person initial and continuing disclosure) would not apply to a bank loan that is negotiated and made directly by a bank since there is no underwriter or placement agent involved who is subject to the Rule.

Further, a bank loan made with the participation of an underwriter or placement agent may also be exempt from Rule 15c2-12 requirements under a limited offering exemption set forth in the Rule, but the participating broker would be required to report the loan to the MSRB under Rule G-32. However, the greater transparency and disclosure needs of the secondary market overshadow these technicalities in the view of the MSRB. The Notice also attempted to provide additional guidance as to the features and attributes that would cause a bank loan to constitute a “security” by citing to the U.S. Supreme Court decision in Reves v. Ernst & Young, Inc., 494 U.S. 56 (1990).

All of this culminated in the publication by the MSRB earlier this year of its Notice 2015-03 (January 29, 2015). In this Notice, the MSRB incorporates the substance of the prior Notices and sets forth what it believes to be the best practices for voluntary reporting of bank loans. However, and perhaps as a harbinger of things to come, the MSRB works into the Notice two very important cautionary notes regarding information that is voluntarily filed for bank loans under its best practices guidelines: all voluntary disclosure information “may” be held to the same standards of materiality and timeliness of information disclosed under SEC Rule 15c2-12; and bank loan disclosure information provided should be consistent with the requirements of SEC Rule 10b-5 such that the information is not false or misleading in the context in which it is provided. Is the MSRB inviting issuers to subject themselves, by voluntary disclosure, to MSRB jurisdiction and potential securities fraud exposure where none may otherwise exist?

There is little doubt that the policy behind the MSRB's voluntary disclosure initiative is sound or that the secondary market for municipal securities would benefit from greater access to information regarding bank loans undertaken by issuers of municipal bonds and conduit borrowers of municipal bond proceeds. However, there are significant legal and jurisdictional questions still unresolved, including when and under what circumstances bank loans may constitute municipal securities and the scope of a disclosing party's party potential liability, that should be considered before undertaking voluntary disclosure of a bank loans. Not the least of these concerns is the possibility that by posting voluntary information on EMMA, the issuer or borrower is subjecting itself to potential securities law regulation and Rule 10b-5 liability if that information is later determined by a regulator or a court to have been materially inaccurate or incomplete. This is particularly true where the regulators have not provided any safe harbors or other firm guidance that can be relied upon with legal certainty.

On the flip side, would the regulators at some point take the position that failure to do a voluntary bank loan posting by an issuer that has outstanding municipal securities constitutes a basis for a securities fraud proceeding on a theory that such failure to file caused the information then available to the secondary market to be materially inaccurate or misleading? Sounds a bit far-fetched, perhaps, but it is noteworthy that the SEC, in its 2013 enforcement proceeding against the City of Harrisburg, took a substantially similar position. In the consent order entered in that proceeding,[3] the SEC found that, when considered against the total mix of information available to investors and potential investors, the City's failure to make its required continuing disclosure filings constituted actionable securities fraud. In addition, the Municipalities Continuing Disclosure Cooperation Initiative ("MCDC") undertaken by the SEC in 2014 clearly demonstrates that the regulators are actively seeking out new, innovative and aggressive enforcement techniques regarding municipal securities.

There will very likely be future developments in this evolving area of municipal finance law as the signals being provided by the MSRB and the SEC are clear as to their direction on these issues. The only thing missing at this point is reliable guidance from the regulators or the courts on the key legal points, but it is reasonable to expect new rules or regulations from the SEC and the MSRB further addressing disclosure of bank loans. Issuers, obligated persons, banks, broker-dealers and municipal advisors would be well advised to pay close attention to future developments as the federal regulators continue to take aim at the municipal marketplace and its participants.

[1] EMMA is a registered trademark of the MSRB

[2] MSRB Notice 2012-18 (April 3, 2012)

[3] United States Securities and Exchange Commission, In the Matter of the City of Harrisburg, Pennsylvania, Respondent, Administrative Proceeding File No. 3-15316, entered May 6, 2013, Release No. 6915

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