

# **Bond Case Briefs**

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## **Potential Risks in Voluntary Reporting of Bank Loans.**

A current hot topic in the world of municipal finance is the issue of voluntary reporting of information regarding direct bank loans to governmental entities or conduit governmental entity borrowers. The Municipal Securities Rulemaking Board (MSRB) has strongly encouraged municipal issuers to voluntarily report this information, through its Electronic Municipal Marketplace Access system (EMMA).

The MSRB has published a number of notices and advisories over the last few years in support of its position that this information should be voluntarily provided. The MSRB's expressed concern is that such loans often contain terms that may adversely affect the parity position, rights or collateral of existing bondholders or the liquidity of the issuer, and that information regarding such loan terms, and the risks presented to bondholders, is not readily available to the secondary market.

Inextricably intertwined with this voluntary reporting initiative is the consideration of whether governmental notes issued as part of these loans constitute municipal securities under federal securities laws. Characterization of bank loans as securities potentially subjects the issuer and other participants in the transaction to anti-fraud and other provisions of federal securities laws and regulations enforced by MSRB, the U.S. Securities and Exchange Commission (SEC) and other regulators.

The MSRB first raised the issue of the potential application of the federal securities laws to bank loans when it published Notice 2011-37 on Aug. 3, 2011, aimed generally at municipal advisers involved in such loans. The MSRB stated that if such loans were properly characterized as a municipal security, a municipal adviser participating in the private placement of a loan would be required to register with the SEC as a broker-dealer, thereby subjecting the adviser to the rules and regulations of the MSRB. Among other things, the municipal adviser would become subject to MSRB Rule G-23, which precludes municipal advisers who are also broker-dealers from becoming underwriters or placement agents for municipal issues for which they are serving as financial advisor.

Later that year the MSRB provided additional guidance to professionals involved in bank loans that might be characterized as municipal securities. In Notice 2011-52 (Sept. 12, 2011), the MSRB cautioned 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. Further, the MSRB explained that a municipal adviser becomes subject to the rules and regulations governing municipal advisers if it advises a 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.

The MSRB followed up on Notice 2011-52 with Notice 2012-18 on April 3, 2012, in which it provided guidance on how to actually do the voluntary filing through EMMA of information regarding a bank loan. According to the MSRB, the EMMA posting may 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.

The MSRB also restated in Notice 2012-18 its prior cautionary advice to broker-dealers and municipal advisers regarding bank loans potentially constituting municipal securities, thereby subjecting them to existing securities law requirements. However, 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 this rule. While a bank loan made with the participation of an underwriter or placement agent may also be exempt from Rule 15c2-12 under certain circumstances, the participating broker would be required to report the loan to the MSRB under Rule G-32. And, in any event, the MSRB has signaled that the greater transparency and disclosure needs of the secondary market overshadow these “technicalities.”

The MSRB’s statements on voluntary reporting and the classification of bank loans as municipal securities culminated in its Jan. 29 publication of Notice 2015-03. In this notice, the MSRB incorporated the substance of the prior notices and set forth its “best practices” for voluntary reporting of bank loans. However, and perhaps as a harbinger of things to come, the MSRB includes two important cautionary notes regarding information that is voluntarily filed for bank loans under its 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.

These comments from the MSRB present the obvious and important question of whether an issuer that voluntarily files a report regarding its bank loan activity is subjecting itself to MSRB jurisdiction and potential securities fraud exposure where none may otherwise exist. So far, there is no clear answer.

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 such bank loans.

However, significant legal and jurisdictional questions remain unresolved, including when and under what circumstances bank loans may constitute municipal securities and the scope of a disclosing party’s potential liability. 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.

Of course, there is also a concern that based on the MSRB’s rather clear trajectory, the SEC may in the future take the position that an issuer’s failure to do a voluntary bank loan posting, where the issuer has outstanding municipal securities, constitutes a basis for a securities fraud proceeding, on a theory that the failure to file caused the information then available to the secondary market to be materially inaccurate or misleading.

Such a concern may not be as untenable as it may initially appear, particularly in light of a prior enforcement proceeding brought by the SEC against the city of Harrisburg, where it took a

substantially similar position. In the consent order entered in that proceeding, 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 undertaken by the SEC in 2014 clearly demonstrates that regulators are actively seeking out new, innovative and aggressive enforcement techniques regarding municipal securities.

There likely will be additional developments in this area, as the signals from the MSRB and the SEC are clear as to their position on the issues. Issuers, obligated persons, banks, broker-dealers and municipal advisers would be well advised to pay close attention to future developments.

**Daniel J. Malpezzi and Timothy J. Horstmann, The Legal Intelligencer**

July 28, 2015

**Daniel J. Malpezzi** and **Timothy J. Horstmann** are attorneys with the law firm of McNees Wallace & Nurick in Harrisburg, and practice in the firm's financial services and public finance groups. The firm represents state and local governments and agencies as issuers of revenue bonds and general obligation bonds. The firm also routinely serves as underwriter's counsel and counsel to conduit borrowers, banks and trustees. Malpezzi can be reached at [dmalpezzi@mwn.com](mailto:dmalpezzi@mwn.com) and Horstmann at [thorstmann@mwn.com](mailto:thorstmann@mwn.com).

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