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A Teachable Moment: Latest SEC Enforcement Actions Remind Underwriters of Limited Offering Exemption's "Reasonable Belief" Requirements - Orrick

In an unprecedented move, the Securities and Exchange Commission (the "SEC") recently filed litigation against one underwriter of municipal securities and announced settlements with three others. The litigation and settlements concern transactions treated by the underwriters as exempted from the requirements of Rule 15c2-12 under the so called "Limited Offering Exemption." The SEC alleges that the underwriters did not take the steps necessary to satisfy the exemption's criteria. According to the SEC, these are the first actions the agency has taken addressing underwriters who fail to meet the legal requirements that would exempt them from Rule 15c2-12's requirements to obtain disclosures for investors.

Rule 15c2-12: What's Typically Required and Related Exemptions

Generally speaking, Rule 15c2-12 requires underwriters (as defined in Rule 15c2-12) in most primary offerings of municipal securities to obtain disclosure documents from issuers and to reasonably determine that there is an appropriate undertaking to provide certain continuing disclosures. Rule 15c2-12, however, provides two complete exemptions from its requirements: (1) a short-term security exemption, and (2) the "Limited Offering Exemption." Each of these exemptions require that the security be in large denominations of $100,000 or more.

For the Limited Offering Exemption to apply, the securities must also be sold to no more than 35 persons each of whom the "Participating Underwriter" **reasonably believes**: (A) has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the prospective investment; and (B) is not purchasing for more than one account or with a view to distributing the securities. The Limited Offering Exemption can be the more difficult exemption to establish in that it imposes "reasonable belief" requirements on underwriters. The SEC's recent actions focus on these requirements and the alleged deficiencies of the underwriters in forming the requisite reasonable beliefs.

The Scope of an "Underwriter" in Rule 15c2-12: Broader Than Expected

It is important to note that the term "underwriter" within Rule 15c2-12 is broader than it suggests at face value. Within Rule 15c2-12, the term "underwriter" includes not only those purchasing securities with a view to reselling them to investors. Of particular importance to the Limited Offering Exemption, this term also includes those serving as placement agent in a limited offering.

What the SEC's Actions Mean for Underwriters

Within the SEC's Complaint in the litigated action (the "Complaint") and the agreed orders in the settled actions (the "Settlement Orders"), the SEC sheds light upon its view of the Limited Offering Exemption and, in particular, the reasonable belief requirements of the exemption.

In addition to the actions alleging that the underwriters failed to comply with the Limited Offering Exemption, the SEC also alleges that the underwriters violated MSRB Rule G-27 in that they failed to adopt, maintain and enforce written supervisory procedures ("WSPs"). In the litigated action, the SEC also alleges that the underwriter violated MSRB Rule G-17 by breaching assurances made to issuers that the underwriter would conduct the limited offerings in compliance with federal law.

As an initial matter, the Complaint states that underwriters relying on the Limited Offering Exemption must obtain certain information about investors in the securities. This key information includes, at a minimum, the following:

- the size of each investor's investment,
- the number of investors,
- each investor's level of financial experience and/or sophistication, and
- whether each investor is buying the securities for a single account.

A recurring theme throughout the actions is that the underwriter must determine the identity of the actual investors when the underwriter knows or should know that the securities are being purchased for another's account. If an underwriter fails to determine the identity of the actual investors, the underwriter obviously cannot obtain the key information concerning those investors.

Most or possibly all of this key information could presumably be obtained through statements of investors in a "big boy letter" or similar document. The SEC's prior guidance indicates that an underwriter may confirm investment intent (i.e., whether securities are purchased for one's own account and without a view to distributing the securities) through an investor's statements. Underwriters could also use the same document to determine the total number of investors and the amount invested by each.

The final and perhaps the most difficult piece of key information to obtain relates to the investor's sophistication. The SEC's guidance is clear that the underwriter must make a subjective determination in this regard. In practice, many issuer agreements with placement agents or underwriters contain language confirming that each investor is an "accredited investor" or a "qualified institutional buyer." These terms are undefined (and have no direct significance) in Rule 15c2-12. Still, industry practice has been to use these terms to refer to a readily identifiable investor group in order to confirm that an investor is sufficiently sophisticated and knowledgeable. Underwriters should, at a minimum, obtain these confirmations in limited offerings. If a "big boy letter" or similar document is unable to be obtained, underwriters could consider otherwise documenting through a memo to file the diligence process undertaken to support why it has a reasonable belief that the investor satisfies the requirements of the Limited Offering Exemption.

The recent actions make it clear that underwriters must adopt, maintain and enforce WSPs reasonably designed to enable them to comply with the Limited Offering Exemption. To align with the SEC's positions, underwriters who do not currently have WSPs addressing the Limited Offering Exemption should consider adopting them as soon as is reasonably possible. WSPs should contain procedures regarding the exemption's reasonable belief requirements and should instruct personnel on how to obtain the key investor information. WSPs should also contain guidance as to how the underwriter will comply with the Limited Offering Exemption when an entity may be or actually is purchasing securities on behalf of another party.

Looking Around the Corner: Additional Investigations Into Other Firms and Potential Actions Appear Likely

The SEC's press release regarding these actions telegraphs that more actions regarding the Limited Offering Exemption may follow. The SEC indicates that its staff has begun investigations of other

firms’ reliance on the Limited Offering Exemption. The press release also encourages firms that may have wrongfully relied upon the Limited Offering Exemption to email the SEC at LimitedOfferingExemption@sec.gov. Underwriters should consider whether self-reporting to the SEC is appropriate.

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