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A Closer Look at Rule 15c2-12 Exemptions Following Unprecedented SEC Enforcement Actions: Frost Brown Todd

In September of 2022, the Securities and Exchange Commission (SEC) took enforcement actions against four municipal security underwriting firms for failing to comply with Rule 15c2-12 disclosure requirements. The firms believed that they were exempt from such requirements under the "limited offering exemption," yet they allegedly failed to satisfy the "reasonable belief" requirements necessary for the disclosure exemption.

Three of the firms have since elected to settle with the SEC, agreeing to disgorgement, ranging from $40,000 to $656,000, and financial penalties, ranging from $100,000 to $300,000, while the fourth firm is proceeding with litigation. These enforcement measures are noteworthy as this is the first time that the SEC has taken action against an underwriter for failing to meet the legal requirements of Rule 15c2-12's disclosure exemption.

What You Need to Know About SEC Enforcement

These recent, unprecedented actions and statements made by the SEC regarding the use of the limited offering exemption by municipal underwriters indicate that compliance with the requirements of the exemption, specifically the reasonable belief component, has become an enforcement priority. The SEC appears to be setting the tone, with four major underwriting firms facing penalties and SEC staff having already begun investigations into other firms' reliance on the limited offering exemption. Gurbir S. Grewal, the director of the SEC's Division of Enforcement, has encouraged underwriters to examine their practices and self-report any failures "before we identify them ourselves."

Accordingly, now is the time for underwriters that utilize the limited offering exemption to strengthen or establish measures, whether through revised investment letters or written supervisory procedures, that ensure compliance with any Rule 15c2-12 exemptions they utilize.

Rule 15c-12's Disclosure Requirements and Exemption

In primary offerings of municipal securities, Rule 15c2-12 requires that an underwriter provide certain disclosures to investors in an effort to prevent fraudulent, deceptive, or manipulative acts or practices. However, Rule 15c2-12 also provides a limited offering exemption which discharges underwriters from their typical disclosure obligation in qualified transactions. To qualify for the limited offering exemption, the offering must be sold in denominations of $100,000 or more and sold to no more than 35 investors that the underwriter reasonably believes (1) have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and the risks of the prospective investment, and (2) are not purchasing for more than one account or with a view to distributing the securities.

According to the SEC, the four underwriting firms sold newly issued municipal bonds without providing the required Rule 15c2-12 disclosures, citing the limited offering exemption as their justification. The issue arises from the SEC alleging that the underwriting firms failed to

demonstrate compliance with the previously mentioned reasonable belief requirements to qualify for the exemption. Specifically, in the SEC's view, the firms allegedly sold securities intending to meet the limited offering exemption without a reasonable belief that the purchasers were buying for their own account. The SEC observed that some of the broker-dealers who purchased the primary offering from one of the underwriters resold the securities to multiple customers. The SEC reasoned that therefore the underwriter in question "did not reasonably believe the broker-dealers were buying for their own accounts because the broker-dealers were in the business of servicing brokerage customer accounts." Further, since the firms failed to determine if the securities were being purchased for more than one account or for distribution, the SEC then reasoned that the firms were therefore also unable to have a reasonable belief whether the ultimate purchasers of the security had the requisite financial knowledge and experience to evaluate the investment.

SEC Comments and Guidance

The SEC's complaint against the firm that did not settle provides additional information as to the nature of the alleged violations, as well as guidance as to what the SEC views as the proper diligence required of an underwriter claiming the limited offering exemption. First, the SEC claims that in violation of Rule 15c2-12, the underwriting firms allegedly "made no inquiry to determine if those entities were buying on behalf of their customers and/or clients and, if so, whether such investors met the exemption criteria." The complaint provides a list of information that, at a minimum, an underwriter asserting the limited offering exemption must obtain about potential investors: (1) the size of each investor's investment, (2) the number of investors, (3) whether each investor is buying the securities for a single account, and (4) each investor's level of financial experience and/or sophistication.

Notably, however, the SEC does not provide guidance or suggestions as to the proper way this information should be obtained by underwriting firms from potential investors. One suggestion currently circulating the municipal securities industry is the modification of traditional investment letters to better and more specifically obtain the information that the SEC has outlined. Investment letters, sometimes referred to as "big boy letters," are an SEC-approved method often used by underwriters to confirm the investment intent of potential investors—the thought being that such letters could be modified going forward and used to confirm whether the securities being purchased are for a single account or, if for multiple accounts, the number of investors and the size of their investments. Similarly, revised letters could more thoroughly address the investor's level of financial experience and sophistication. Unfortunately, the SEC has neither confirmed nor denied whether an investment letter used in this manner is sufficient for the purpose of the limited offering exemption.

MSRB Rule Violations

In addition to Rule 15c2-12 violations, the SEC alleges that all four underwriting firms also violated the Municipal Securities Rulemaking Board (MSRB) Rule G-27, and that the firm that opted not to settle violated MSRB Rule G-17. MSRB Rule G-27 requires that municipal underwriters have written supervisory procedures (WSPs) in place to ensure compliance with federal security laws. MSRB Rule G-17 prohibits deceptive, dishonest, or unfair practices by an underwriter, and as the SEC contends, this rule was violated by making assurances to issuers that, as the underwriter, the limited offering would be conducted in accordance with federal law.

If the SEC is indeed ramping up enforcement activities for Rule 15c2-12 violations in the municipal securities market, underwriters would be advised to review their existing procedures or establish new measures before claiming the limited offering exemption. It also might be wise to create or modify investment letters to solicit the kind of information cited in the SEC complaint.

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