MSRB and FINRA issue joint notice cautioning broker-dealers and municipal advisors about bank loans

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Abstract

Purpose – *To alert lenders, broker-dealers and municipal advisors to a joint regulatory notice from the Municipal Securities Rulemaking Board ("MSRB") and the Financial Industry Regulatory Authority ("FINRA") regarding direct purchase or "bank loan" transactions.*

Design/methodology/approach – *Explains the MSRB and FINRA notice, why the notice was issued, what lenders should know about the notice, what broker-dealers and municipal advisors should know about the notice, and what MSRB rules could apply to bank loans.*

Findings – *Firms should determine whether state and local government obligations acquired through bank loan transactions constitute municipal securities for federal securities law purposes.*

Originality/value – *Review of a recently issued regulatory notice by experienced municipal securities lawyers.*

Keywords *Financial Industry Regulatory Authority (FINRA), Municipal Securities Rulemaking Board (MSRB), Broker-dealer, Bank loan, Municipal advisor, Municipal security*

Paper type *Technical paper*

On April 4, the Municipal Securities Rulemaking Board ("MSRB") and the Financial Industry Regulatory Authority ("FINRA") issued a joint regulatory notice reminding firms they regulate of their obligation to determine whether state and local government obligations (including conduit obligations) ("municipal obligations") acquired through direct purchase or "bank loan" transactions constitute municipal securities for federal securities law purposes. MSRB Notice 2016-12 and FINRA Regulatory Notice 16-10 emphasize that although a financing may be described as a "bank loan," firms still must consider the applicability of federal securities laws and MSRB and FINRA rules with respect to their activities.

Why did the MSRB and FINRA issue this notice now?

The two regulatory agencies are concerned that firms involved in bank loan transactions may simply be relying on "loan" terminology in the transaction instead of undertaking the detailed analysis necessary to determine whether a municipal obligation constitutes a "security" for federal securities law purposes. Without this detailed analysis, firms may be operating under mistaken assumptions that the "loan" features of the transaction are sufficient to establish that the transaction does not involve the issuance of a municipal security and they are not required to comply with federal securities laws and regulations applicable to broker-dealers and municipal advisors.

What should lenders know about the notice?

Whether a particular municipal obligation constitutes a loan or security may differ depending on whether the inquiry is for securities law, state law or accounting purposes.

While many lenders in the direct purchase market classify their purchase of municipal obligations as a loan instead of a security for accounting purposes, the other transaction participants still need to undertake separate diligence to determine whether the municipal obligation is a security for securities law purposes. Regardless of the structure of the transaction, lenders should avoid certifying or representing to the other transaction participants that the municipal obligation being purchased is a loan and not a security for securities law purposes. Additionally, lenders that have employees from a broker-dealer arm or affiliate involved in the structuring of the transaction should consult with counsel on potential implications and regulatory compliance considerations for the lender and its broker-dealer arm or affiliate.

What should broker-dealers know about the notice?

Firms serving as placement agents, brokers or finders in a direct purchase transaction will need to assess whether the municipal obligation is a security for securities law purposes[1], even if the transaction is structured or described as a "bank loan." Such firms must consider the applicability of MSRB and FINRA rules and other federal securities laws with respect to their activities.

The joint notice highlights that certain FINRA rules apply to member firms' conduct involving non-securities products, including FINRA Rules 2010 (Standards of Commercial Honor and Principles of Trade), 2210 (Communications with the Public), 3310 (Anti-Money Laundering Compliance Program) and 4530 (Reporting Requirements). In addition, firms have broad supervisory obligations under FINRA Rule 3110, including supervisory obligations with respect to compliance with such rules.

What should municipal advisors know about the notice?

In previous regulatory notices, the MSRB has cautioned municipal advisors that their activities in placing or assisting their clients with bank loans may constitute broker-dealer activity under federal securities law[2]. The National Association of Municipal Advisors and the Securities Industry and Financial Markets Association have submitted competing position papers to the SEC on whether a municipal advisor placing or assisting with a bank loan transaction is required to be registered as a broker-dealer. To date, no guidance has been provided by the SEC on the questions raised in these position papers.

The absence of guidance from the SEC and the challenges associated with determining whether a particular transaction involves a loan or a security under the complex, fact-sensitive analysis required by the *Reves* case place municipal advisors in a difficult position. Due to the absence of clear guidance, it is often not possible for firms to obtain clean legal opinions on whether a bank loan transaction involves a loan or a security. As a result, many municipal advisor firms operate under a default assumption that bank loan transactions could be considered to involve a municipal security, and require their borrower clients to engage broker-dealer firms to serve as placement agents on these transactions and/or take other steps intended to ensure that they will not be considered to be engaged in broker-dealer activities.

MSRB rules that may apply to bank loans

MSRB rules that may be applicable to firms acting as placement agents in bank loan transactions that may involve a municipal security include, but are not limited to, MSRB Rule A-12 (requiring registration), MSRB Rule A-13 (requiring broker-dealers to pay assessments on underwritings and placements of municipal securities), MSRB Rule G-2 (standards of professional qualification), MSRB Rule G-3 (professional qualification requirements), MSRB Rule G-8 (recordkeeping requirements), MSRB Rule G-9 (preservation of records), MSRB Rule G-14 (reports of sales or purchases of municipal securities, including agency trades), MSRB Rule G-15 (confirmation, clearance, settlement and other uniform practice requirements with respect to transactions with customers),

MSRB Rule G-17 (fair dealing in the conduct of municipal securities activities), MSRB Rule G-23 (activities of financial advisors), MSRB Rule G-32 (disclosures in connection with primary offerings), MSRB Rule G-34 (CUSIP numbers, new issue and market information requirements) and MSRB Rule G-37 (political contributions and prohibitions on municipal securities business). Firms also have broad supervisory obligations under MSRB Rule G-27, including supervisory obligations with respect to compliance with these rules.

Notes

1. This analysis involves application of the "family resemblance" test established in *Reves v. Ernst & Young,* 494 US 56 (1990) and other court decisions and SEC guidance.

2. See MSRB Notice 2011-37 "Financial Advisors, Private Placements, and Bank Loans" (August 3, 2011) and MSRB Notice 2011-52 "Potential Applicability of MSRB Rules to Certain 'Direct Purchases' and 'Bank Loans'" (September 12, 2011).

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