

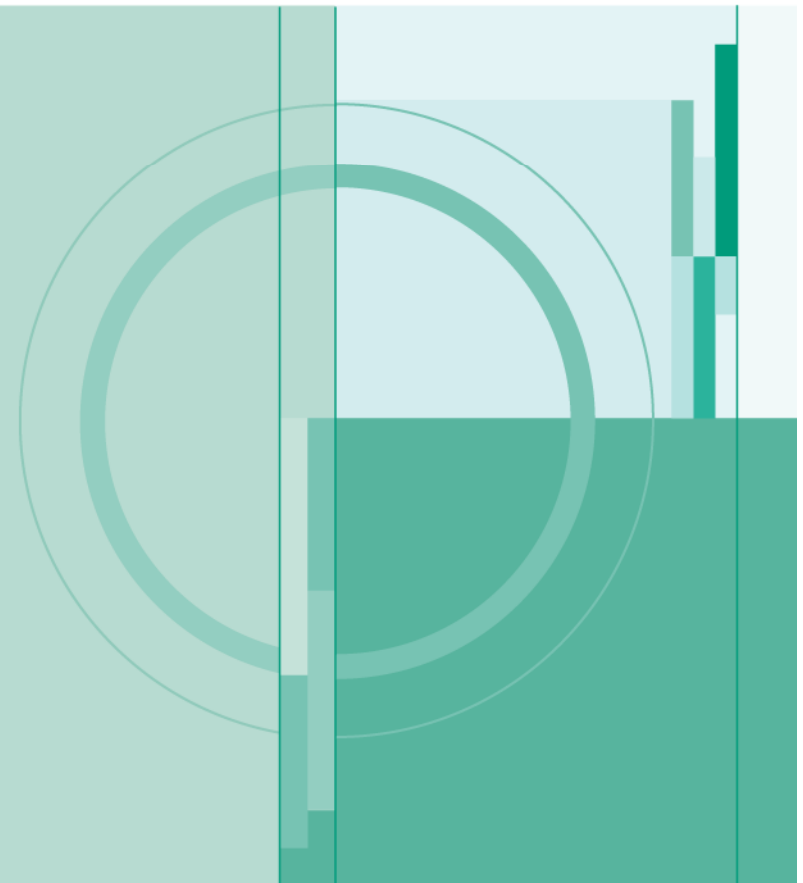
Application of MSRB Rules to Direct Purchase Transactions



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Introduction

- **There is a growing use of direct purchases in the municipal market as an alternative to traditional public offerings of bonds**
 - Prior to 2009, there were a limited number of private placements
 - Direct purchase transactions began to increase markedly in 2009
 - ✓ Favorable bank qualified treatment under ARRA
 - ✓ Financial instability in public markets
 - ✓ Concerns relating to implementation of Basel III
 - ✓ Issuer's recognition that direct purchases have a number of advantages over VRDOs, including disclosure and rating processes
 - Direct purchases continued to increase in 2011
 - ✓ According to estimates reported by The Bond Buyer in October 2011, direct purchases were roughly \$13 billion in 2011

Purpose of this Webinar

- **The MSRB issued 2 notices in 2011 relating to direct purchases:**
 - MSRB Notice 2011-37
 - MSRB Notice 2011-52
- **The MSRB's stated purposes for providing these notices were to:**
 - Alert direct purchase transaction participants, including financial advisors, of the possible application of the MSRB Broker-Dealer Rules to direct purchase transactions
 - Answer a number of questions about the application of the MSRB Broker-Dealer Rules to these transactions
- **The purpose of this webinar is to review the notices, describe how they may impact direct purchase transactions and offer practical tips on best compliance practices**

What is the MSRB?

- **The MSRB was created in 1975 under the Securities Exchange Act of 1934 (the “Exchange Act”) to regulate the municipal securities market for the purposes of (among others):**
 - Preventing fraudulent and manipulative acts and practices
 - Promoting just and equitable principles of trade
- **The MSRB’s market regulation activities include rulemaking, regulatory support and qualification of municipal market professionals**
- **The MSRB Rules are required to be approved by the Securities and Exchange Commission (the “SEC”) and have the force of federal law**
- **The MSRB Rules are enforced by:**
 - Financial Industry Regulatory Authority (FINRA) for securities firms
 - Bank regulatory agencies for banks
 - The SEC for municipal advisors, all securities firms and banks

Who is Subject to the MSRB Rules?

- **Brokers, Dealers and Municipal Securities Dealers**
 - Section 15B of the Exchange Act provides that the MSRB shall propose and adopt rules to effect the purposes of this title with respect to transactions in *municipal securities* effected by *brokers, dealers and municipal securities dealers*
- **Municipal Advisors (as of October 1, 2010 when Dodd-Frank broadened the mission of the MSRB to include the regulation of Municipal Advisors)**
 - The focus of this webinar is on the MSRB Broker-Dealer Rules, not the MSRB Municipal Advisor Rules

“Brokers,” “Dealers” and “Municipal Securities Dealers”

- **Brokers**

- A “broker” is any person engaged in the business of effecting transactions in securities ***for the account of others***
- Brokers, among other things, find investors for issuers of securities and act as placement agents in connection with private placements of securities, but are not engaged in purchasing securities for their own account

- **Dealers and Municipal Securities Dealers (“Dealers”)**

- Any person engaged in the business of buying and selling municipal securities for such person's own account through a broker or otherwise, ***but exclude***:
 - ✓ Any person insofar as he buys or sells such securities for his own account, but not as a part of a regular business; and
 - ✓ Banks, unless the bank (including a department of a bank) is engaged in the business of buying and selling municipal securities for its own account other than in a fiduciary capacity, through a broker or otherwise
- Dealers, among other things, hold themselves out as willing to buy and sell securities

MSRB Notice 2011-52: Direct Purchases and Bank Loans

- **MSRB Notice 2011-52 (September 12, 2011):**
 - Alerted municipal market participants that, under existing legal principles, certain direct purchases that are called “bank loans” may in fact be municipal securities
 - Reviewed *Reves v. Ernst & Young, Inc.* (1990), the principal U.S. Supreme Court case on whether a note constitutes a security and therefore is subject to federal securities laws
- **If a direct purchase involves municipal securities and if parties regulated by the MSRB play a role in such financing, those parties may inadvertently violate MSRB Rules as well as other federal securities laws**
 - Purchasers are not subject to the MSRB Rules unless they are acting as Brokers or Dealers

Reves Analysis – Rebuttable Presumption

- **Rebuttable Presumption:** Every “note” is presumed to be a “security,” except for a judicially created list of instruments commonly called “notes” that nonetheless fall outside of the security category
- **The types of “notes” that are not “securities” include:**
 - Note delivered in a consumer financing
 - Note secured by a mortgage on a home
 - Short-term note secured by a lien on a small business or some of its assets
 - Note evidencing a “character” loan to a bank customer
 - Short-term notes secured by an assignment of accounts receivable
 - Note which simply formalizes an open-account debt incurred in the ordinary course of business
 - Note evidencing a loan from a commercial bank for current operations

Reves Analysis – Family Resemblance Test

- **The presumption can be rebutted only if it can be shown that the note in question bears a strong “family resemblance” to one of the judicially enumerated “non-security” notes (listed on slide 7) by applying four factors**
 1. Examine the transaction to assess the motivations that would prompt a reasonable buyer and seller to enter into it
 2. Examine the plan of distribution to determine whether the note is an instrument in which there is common trading for speculation or investment
 3. Examine the reasonable expectations of the investing public
 4. Examine the existence of an alternate regulatory scheme
- **Possibility that other instruments fall outside the security category: “If an instrument is not sufficiently similar to an item on the list, the decision whether another category should be added is to be made by examining the same factors.”**

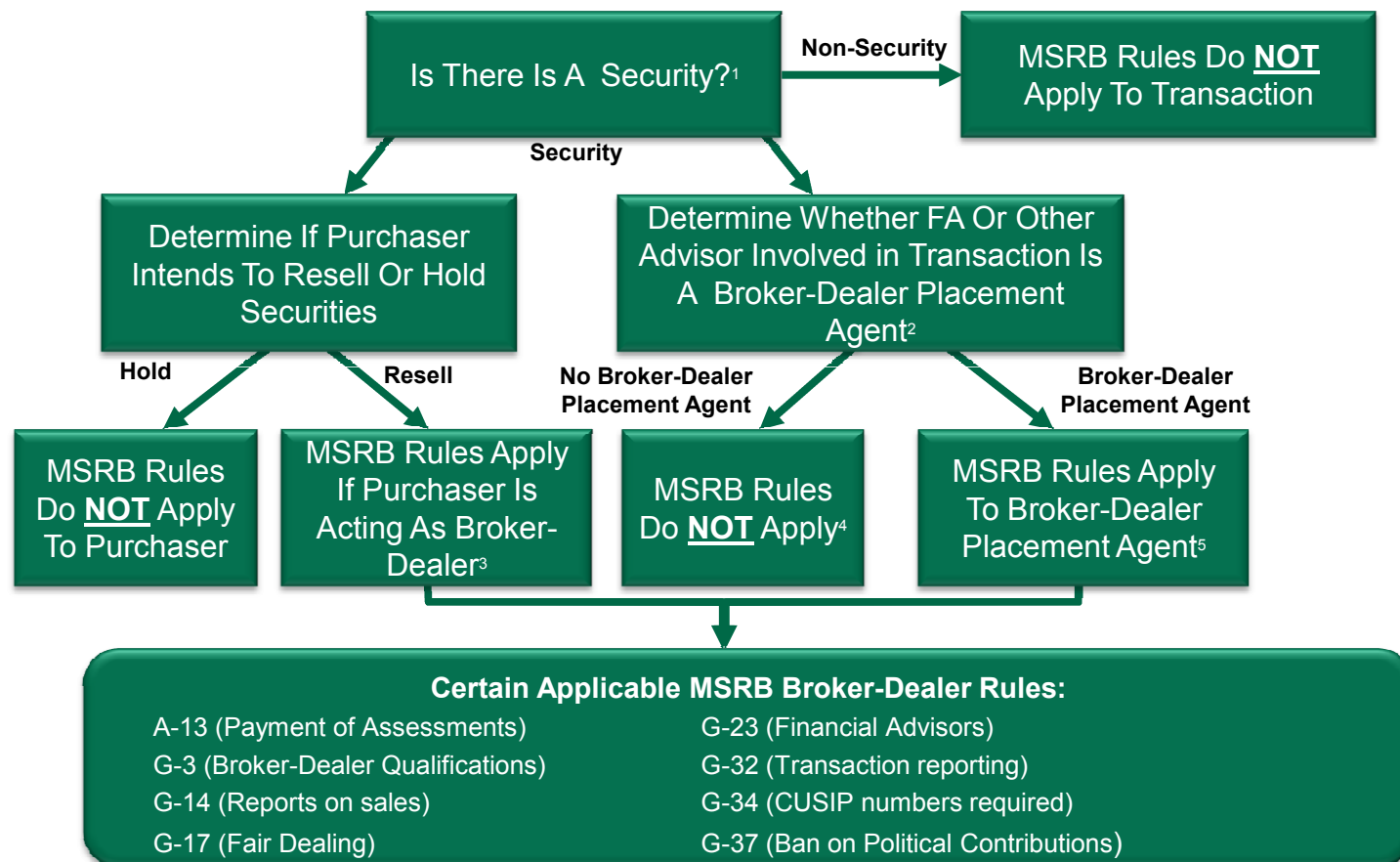
Application of *Reves* to Direct Purchases

- The determination of whether a transaction involves a security or a non-security is very fact driven and must be done on a case-by-case basis
- Task is left to SEC and federal courts to determine which financial transactions involve securities and fall within the coverage of the federal securities laws
- There is no guidance on the relative weighting of the four factors or on whether any particular factor is controlling
 - ***Practical Tip:*** If you have something evidenced by a “bond” or a “note” in your transaction, the most conservative approach will be to assume that your transaction involves a security because of the presumption under *Reves*
- The characterization of the transaction on the Purchaser’s books will not be a determinative factor under the multi-factor analysis
 - ***Practical Tip:*** Purchaser should consult its auditor to determine how application of MSRB Rules to its transactions may impact the Purchaser’s accounting treatment
- The MSRB has asked the SEC for guidance on this question

MSRB Notice 2011-37: Financial Advisors and Placement Agents

- **MSRB Notice 2011-37 (August 3, 2011) alerted Financial Advisors engaging in certain activities with respect to direct purchases of municipal securities that they may be acting as “Brokers” and “Placement Agents” subject to MSRB Rules (including the requirement to register as a Broker-Dealer)**
- **The Notice described the following as Placement Agent activities of a Broker (under principles described in SEC No-Action Letters):**
 - Introduction of investors to issuers and/or negotiation with investors; and
 - Receipt of transaction-based compensation
- **Financial Advisors engaging in these activities could unintentionally become subject to (and violate) Rule G-23 and other MSRB Broker-Dealer Rules (even if the Financial Advisor is already registered with the MSRB as a Municipal Advisor)**

Application of MSRB Broker-Dealer Rules to Direct Purchase Transactions



¹ See MSRB Notice 2011-52.

² See MSRB Notice 2011-37.

³ Purchaser may want to involve Broker-Dealer affiliate to act as Broker-Dealer in transaction and take responsibility for compliance with MSRB Rules.

⁴ MSRB Municipal Advisor Rules may apply.

⁵ Financial Advisor may want to involve separate Placement Agent in transaction to avoid being characterized as Broker-Dealer and potential violations of Rule G-23.

Step One: Is There A Security?

- The MSRB Rules only apply to municipal securities regulated by the federal securities laws
- While there likely are exceptions to any general conclusions in this area (and additional guidance from the SEC may be forthcoming in response to the MSRB's request), the typical direct purchase instruments generally fall within the following categories:

Security	Non-Security
Bonds	Loan Agreement without a promissory note (a "true loan")
Notes	Participations of true loans
Loan Agreement with promissory note	Lease Agreement
Participations of securities	

Step Two: Is the Purchaser Acting As A Broker or Dealer?

- If it has been determined that the transaction involves a security, the Purchaser must determine if it is acting as a Broker or Dealer
- If the Purchaser purchases outstanding VRDOs from a remarketing agent, the remarketing agent is a Broker-Dealer and will comply with the MSRB Rules on the transfer. The act of purchasing the outstanding VRDOs alone should not make the Purchaser a Broker-Dealer
- If the Purchaser negotiates a new transaction with a municipal entity that involves a security:
 - If the Purchaser *intends to hold* the municipal securities for its own account, it should not be considered to be acting as a Broker or a Dealer
 - If the Purchaser *intends to resell* the municipal securities, the Purchaser may be acting as a Dealer and should involve a Broker-Dealer affiliate to act as placement agent in the transaction to avoid being a Dealer itself and to take responsibility for compliance with the MSRB Rules
- One way to determine whether the Purchaser who resells is a Broker-Dealer is to ask whether the Purchaser solicits other investors and is compensated by the issuer for its role in soliciting other investors

Consequences of Subsequent Sale

- What happens if the Purchaser intended to hold the municipal security to maturity when it was purchased, but now needs to sell?
- If Purchaser is not engaged in the business of buying and selling municipal securities, it should not be considered a Dealer due to an unexpected need to sell a security it originally intended to hold to maturity
- A Purchaser's intent is important but these determinations may be subject to regulatory hindsight
 - SEC may view a course of conduct as evidence of intent
- **Practical Tip:** The Purchaser may want to use its Broker-Dealer affiliate for any unanticipated sales
- **Practical Tip:** The sale may change the accounting treatment

How Do Tender Option Bond Structures Impact the Analysis?

- **The most common tender option bond (“TOB”) structure involves fixed rate bonds being purchased by a trust – where the trust issues variable rate certificates of beneficial interest**
 - The bonds being purchased by the trust need to be rated (or be credit enhanced to obtain a rating) so that the certificates of beneficial interest that the trust issues will also be rated
 - The primary purpose for undertaking a TOB transaction is to provide a funding mechanism for the bonds being purchased
 - The certificates of beneficial interest issued by the trust are “securities,” but not “municipal securities” because the trust is not a municipality
- **It is less common to have a loan or lease (or pools of loans or leases) purchased by a trust in a TOB transaction because loans or leases are less likely to be rated (unless wrapped with credit enhancement which is rated)**
- **Practical Tip: Focus on whether the MSRB Rules are applicable to the initial bonds/loan/lease being purchased by the trust**

Step Three:

Is the Financial or Other Advisor Acting As A Broker?

- The activities of many Financial Advisors in direct purchases may be placement agent activities of a Broker if they are requesting proposals from direct purchase banks, negotiating the terms of the direct purchase and receiving transaction-based compensation
- The activities of the investment banking affiliate, division or department of the Purchaser in the direct purchase may also be placement agent activities of a Broker
- If the Financial Advisor is considered a Broker, then the MSRB Broker-Dealer Rules do apply to it, including Rule G-23, which would prohibit a fiduciary of the issuer from changing roles and becoming a Placement Agent or Underwriter in the same transaction
- ***Practical Tip:*** The Financial Advisor may want to involve a separate Placement Agent in the transaction to avoid being characterized as a Placement Agent and potential violations of Rule G-23

Impact of MSRB Rules on Purchasers

- **If it has been determined that there is a municipal security and the Purchaser is acting as a Broker-Dealer, the MSRB Rules apply to the Purchaser**
- **Even if the MSRB Rules do not apply to the Purchaser because it is not acting as a Broker or Dealer, if a Broker-Dealer/Placement Agent is involved in placing the municipal security with the Purchaser, the MSRB Rules will apply to the transaction:**
 - May impact the Purchaser's preferred form and structure of the transaction; and
 - May impact accounting treatment
- **The MSRB Rules were not written with direct purchases in mind, and therefore, require some effort by compliance and legal to determine which ones really do apply**

Certain MSRB Rules Applicable to Direct Purchases

The following is a brief summary of certain MSRB Rules applicable to direct purchases of municipal securities

- **A-13: Underwriting and Transaction Assessments for Brokers, Dealers and Municipal Securities Dealers (Broker-Dealer herein)**
 - Requires payment by each Broker-Dealer to the MSRB of an underwriting assessment for all municipal securities purchased from an issuer by or through such Broker-Dealer as part of a primary offering
 - ✓ \$.03 per \$1,000 of par value
 - ✓ Required where Broker-Dealer acts as agent for issuer and arranges the direct placement of the securities
 - Requires payment by each Broker-Dealer to the MSRB of a transaction fee and technology assessment for each inter-dealer municipal securities sale that it reports to the MSRB under Rule G-14(b)
 - ✓ Applies to both primary and secondary market

Certain MSRB Rules Applicable to Direct Purchases (cont.)

- **G-3: Classification of Principals and Representatives; Numerical Requirements; Testing; Continuing Education Requirements**
 - Establishes qualification requirements for Broker-Dealers which apply as long as they are registered as Broker-Dealers
- **G-14: Reports of Sales or Purchases**
 - Prohibits Broker-Dealers from distributing reports of purchases or sales of municipal securities unless the report is made without fraud, deceptive or manipulative purposes
 - Requires Broker-Dealer to report to the MSRB about each purchase and sale of municipal securities
- **G-17: Conduct of Municipal Securities and Municipal Advisory Activities**
 - Requires Broker-Dealers and Municipal Advisors to deal fairly with all persons which they conduct municipal securities business or municipal advisory business
 - Duty to disclose all material information about transaction and security

Certain MSRB Rules Applicable to Direct Purchases (cont.)

- **G-23: Activities of Financial Advisors**
 - Establishes ethical standards and disclosure requirements for Broker-Dealers acting as Financial Advisors
 - Effective November 27, 2011, prohibits Broker-Dealers from serving as Financial Advisor to an issuer and Underwriter or Placement Agent on the same issue
 - Financial Advisor may be acting as a Placement Agent
- **G-32: Disclosures in Connection with Primary Offerings**
 - Requires underwriters in primary offering to submit electronically to EMMA official statements, advance refunding documents and related primary market documents
 - Requires underwriters to provide notice to EMMA of exempt offering
 - Requires underwriters to confirm the existence of a continuing disclosure agreement
 - Requires Broker-Dealers in negotiated sales to furnish to customers certain information concerning underwriting arrangements

Certain MSRB Rules Applicable to Direct Purchases (cont.)

- **G-34: CUSIP Numbers, New Issue and Market Information Requirements**
 - Requires Broker-Dealer managing the underwriting of a new issue of municipal securities for the purpose of distributing such securities to apply for CUSIPs and ensure that assigned CUSIPs are affixed to the securities
 - Resales of securities
- **G-37: Political Contributions and Prohibitions on Municipal Securities Business**
 - Prohibits Broker-Dealers from engaging in municipal securities business with an issuer within 2 years after certain contributions
 - Establishes reporting requirements to MSRB

Practical Tips for Compliance Practices

- **Establish policies and procedures for:**
 - Bankers to be in regular contact with their compliance and legal departments to analyze each type of transaction to determine whether it involves a “security”, how to address regulatory compliance and how those determinations impact the accounting treatment
 - Involving a Broker-Dealer affiliate to take responsibility for MSRB compliance if a Purchaser is purchasing a municipal security with intent to resell
 - How to address MSRB compliance if a Purchaser who purchases with intent to hold to maturity chooses to sell prior to maturity -- to avoid regulatory hindsight, best practice may be to involve Broker-Dealer affiliate in any such sales
- **Continue to monitor future changes in MSRB Rules and their interpretation as SEC may release further guidance directed at direct purchases**

Questions for the Orrick Direct Purchase Team

- **The Orrick Direct Purchase Team is ready to assist with any questions relating to the MSRB Rules or direct purchases generally. Please do not hesitate to contact any of us or your contact at Orrick:**
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