Securities Law Considerations Concerning Limited Public Offerings and Private Placements

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INTRODUCTION

Private placements and limited public offerings are frequently used as an alternative to public offerings. This panel will examine particular considerations regarding standards of disclosure, investors letters and other topics that distinguish these offerings from public offerings. The role of placement agent counsel and underwriter's counsel in these transactions will also be explored as well as the appropriateness of certain opinions and due diligence.

Both limited public offerings and private placements refer to the issuance and sale of a new municipal obligation by a state or local government entity that is exempt from the primary offering provisions of Rule 15c2-12 and offered for purchase to a limited number of sophisticated investors (usually qualified institutional buyers (QIBs) and institutional accredited investors that are often investment funds, insurance companies, registered investment advisors, etc.). Oftentimes such structures are utilized for complex project finance transactions or unrated or low-rated credits that "have a story to tell."

A limited public offering is an underwritten transaction, whereas a private placement involves the placement of securities by a placement agent.

A bank direct purchase transaction is a type of private placement that involves the issuance and sale of obligations that are directly negotiated and sold to a single lending source (such as a bank, bank affiliate or other financial institution, or a consortium of such entities).

I. Defining Limited Offerings and Private Placements

A. What do limited offerings/private placements mean in the corporate securities market?

1. An offering of securities to a limited number of investors and meeting other criteria such that the issuer is not required to register the offer and sale of the securities under Section 5 of the Securities Act of 1933, as amended (the "Securities Act").

a. Section 4(a)(2) of the Securities Act exempts non-public offering of securities to a limited number of sophisticated investors.

b. Rule 144A promulgated by the SEC under the Securities Act exempts a non-public offering of securities to qualified institutional buyers (QIBs) and institutional accredited investors.

c. Regulation D safe harbors.

2. Broad anti-fraud prohibitions apply to such securities (regardless of status as exempt securities).

B. What do private placements/limited offerings mean in the municipal securities market? The term private placement does not have the kind of specific meaning in the municipal securities market as it does in the corporate securities market and several terms are often used for one kind of transaction and oftentimes one term can be used for multiple kinds of transactions.

1. Limited Public Offering

a. Underwritten by underwriter who takes responsibility for due diligence, purchases the bonds under a bond purchase agreement and sells to initial investors.

b. Utilized to either exempt issue from Rule 15c2-12 or to limit type of investors.

c. Many limited offerings provide limited offering memorandum.

2. Private Placement

a. A placement agent places bonds in a transaction in which investors perform their own due diligence.

b. Utilized to exempt transaction from Rule 15c2-12 to avoid preparing a disclosure document and other requirements.

3. Bank Direct Purchase as a form of Private Placement

a. For accounting and operational purposes, most purchasers of a direct purchase obligation classify the purchase of bonds or notes as a commercial loan transaction as opposed to a "security" to avoid "mark-to-market" regulatory requirements.

b. Although the specific criteria will vary from bank purchaser to bank purchaser, factors supporting loan treatment include some or all of the following:

(i) Physical certificate (rather than book-entry)

(ii) No CUSIP number

(iii) No rating assigned

(iv) Restriction on transferability to a limited universe of transferees (other banks or financial institutions, QIBs or accredited investors)

(v) Payments on bond or note made directly to bank purchaser

(vi) Bond documents provide for single mode rather than multi-modal (or only subject to bank mode while obligation held by bank separate from other modes)

(vii) No official statement, private placement memorandum or other offering document is provided

(viii) Purchaser certificate delivered to issuer in connection with placement of obligation will include representations that purchaser understands terms of transaction, has expertise to perform its own credit analysis and will not rely on disclosures of issuer in making determination to purchase obligation

(ix) Authorized denominations of $100,000 or more

c. No one element is more dispositive than any other.

d. Regulatory and market concern about the lack of disclosure regarding bank purchase transactions resulted in the adoption of Rule 15c2-12 amendments to add Events (15) and (16) requiring notice of incurrence of "financial obligations".

e. How are practitioners treating bank purchases (as loans or securities or both)?

(i) What happens if the commercial bank and issuer disagree on how to characterize the obligation?

II. Application of Federal Securities Laws to Private Placements and Limited Offerings

A. Must first determine if the transaction involves the offering of securities

1. *Reves v. Ernst & Young - 494 U.S. 56, 110 S. Ct. 945 (1990):* Intention of Congress in adopting the Securities Act and the Securities Exchange Act of 1934, as amended (the "Exchange Act") "was to regulate investments, in whatever form they are made and whichever name they are called".

   a. The Court identified several instruments that it considered not to be a security (family resemblance test). Presumption that every note or bond is a security can be rebutted if it can be shown to "bear a strong family resemblance" to any item on the Court's list. Application of family resemblance test requires a fact-specific analysis.

   b. The Court then set forth a four-pronged test to determine which other instruments should also not be considered a security.

      (i) The motivations that would prompt a reasonable seller and buyer to enter into the transaction.

      (ii) Plan of distribution: to determine whether it is an instrument in which there is common trading for speculation of investment.

      (iii) Reasonable expectations of the investing public.

      (iv) Risk-reducing factors: as one court stated, "need for Federal securities laws."

   c. Notes issued to evidence commercial loan transactions are generally not considered "securities" subject to federal securities laws.

   d. Other factors taken into account in determining whether an instrument is a "security":

      (i) Does the bank intend to hold bond in its portfolio during its entire term? If so, more likely viewed as a loan.

      (ii) Does the bank seek to profit through resale/transfer of bond? If so, more likely viewed as a security.

   e. Notable Federal Court of Appeal Cases

      (i) *United States SEC v. Zada*, 787 F.3d 375 (6th Cir. 2015)

      (ii) *McNabb v. SEC*, 298 F.3d 1126 (9th Cir. Cal. 2002)

(iii) *Banco Espanol de Credito v. Security Pac. Nat'l Bank*, 973 F.2d 51, 55 (2d Cir. 1992), 125 L. Ed. 2d 687, 113 S. Ct. 2992 (1993). *cert. denied*

(iv) *Bass v. Janney Montgomery Scott, Inc.*, 210 F.3d 577 (6th Cir. 2000)

f. *In the Matter of Town of Sterlington, Louisiana*, SEC Rel. No. 33-11069 (June 2, 2022); SEC Rel. No. 34-95024 (June 2, 2022)

(i) Why no consideration of this obligation being treated as a loan?

2. Differing perspectives between dealers and issuers

a. SEC and FINRA examinations of dealers and municipal advisors

b. Dealer concerns about how private placement transactions are treated in SEC and FINRA examinations

3. Consequences of Treatment as a Security

a. Application of Federal securities laws:

(i) Federal anti-fraud laws

(ii) Rule 15c2-12

b. Application of MSRB Rules

(i) Only "municipal securities" (not private bank loans) may be subject to MSRB rules – MSRB Notice 2011-52 (September 12, 2011)

c. Application of Muncipal Advisor Rules

B. Federal antifraud laws

1. Application of Section 10(b) and Rule 10b-5 under the Exchange Act and Section 17(a)(2) of the Securities Act.

a. Elements

b. Applying the Federal anti-fraud laws to limited offerings and private placement transactions

c. Nature and scope of disclosure required is uncertain in light of SEC commentary regarding Rule 15c2-12 which endorses more limited disclosure for limited offerings to sophisticated investors.

2. How do the Federal anti-fraud laws apply when there is no disclosure document?

a. What are the "statements" that would be tested?

b. What are the concerns?

(i) Well-meaning disclosures that are misleading in their nature

(ii) Well-meaning disclosures that omit facts

C. Analysis of Due Diligence Obligations of Underwriters/Placement Agents

1. 1988 Interpretative Release (Release 34-26100 (Sep. 22, 1988); 53 FR 37778 (Sep. 28, 1988) ("1988 Release")

a. SEC solicited comments regarding the nature and scope of "private placement exemption" but did not articulate such an exemption.

(i) Number of investors

(ii) Institutional nature vs. sophistication

(iii) Investment intent vs. intent to resell

(iv) Holding periods or transfer restrictions

b. Recommendation of municipal securities by underwriter must have reasonable basis (including reasonable basis for belief in the accuracy, truthfulness and completeness of representations and disclosure)

c. Establishing a reasonable basis requires:

(i) Reasonable care

(ii) Reasonable review

(iii) Reasonable investigation

d. Affirmative due diligence obligation

e. Factors relevant in determining reasonableness of underwriter's basis:

(i) Extent to which underwriter relied upon others

- FN 86: "The Commission wishes to caution underwriters that this factor does not imply that an underwriter may merely rely upon formal representations ……. The underwriter must review the information submitted to it with a view to resolving inaccuracies and inconsistencies."

- "Sole reliance on the representations of the issuer would not suffice."

(ii) The type of bonds being offered (GO, revenue, or private activity)

(iii) Other

Note: Factors must be weighed in their entirety; not one factor more important than another.

f. *See also Hanley v. SEC*, 415 F.2d 589 (2d Cir. 1969)

2. The SEC has indicated that a placement agent in a private placemernt has similar due diligence obligations as that of an underwriter in a public bond offering. *See SEC v. Rhode Island Commerce Corporation (f/k/a Rhode Island Economic Development Corporation), et.al.,* No. 116-cv-107, Complaint (U.S. District Court, D. RI.) (March 7, 2016)

3. Determining when a placement agent makes a recommendation

a. FINRA guidance

(i) FINRA Regulatory Notice 12-25 (July 2012), FINRA Regulatory Notice 11-02, and FINRA Regulatory Notice 10-06, at 3–4 (Jan. 2010).

- Broker-dealer must have reasonable basis to believe that a recommended securities transaction is suitable for the customer, based on the information obtained through the reasonable diligence of the broker-dealer to ascertain the customer's investment profile.

b. Can a dealer disclaim its recommendation?

4. How does underwriter/placement agent satisfy its due diligence obligations in the absence of a disclosure document?

a. Identification of "total mix of information"

b. Analysis of whether the information is materially inaccurate or misleading

c. Consideration of whether additional information or disclosure needs to be provided to investor

D. Rule 15c2-12

1. Requirements of Rule 15c2-12

a. Underwriters in a "primary offering" of municipal securities over $1 million

(i) "Primary offering" is defined as any offering of municipal securities directly or indirectly "by or on behalf of" an issuer, including remarketings involving reductions in minimum denomination to below $100,000 or in the frequency of tender rights to greater than every 9 months.

b. Underwriter requirements:

(i) Obtain "deemed final" official statement from issuers

(ii) Distribution of POS to prospective investors

(iii) Delivery of final official statements to investors

(iv) Reasonably determine that issuer has entered into a written undertaking to provide continuing disclosures

c. While the Rule applies only to underwriters, it indirectly imposes disclosure and continuing disclosure requirements on issuers and obligated persons.

2. Underwriter's obligations:

a. "Sole reliance on the representations of the issuer would not suffice" to establish a reasonable basis to believe in the truthfulness and completeness of the issuer's key representations.

b. "[The] presence of credit enhancements does not foreclose the need for a reasonable investigation [by the underwriter] of the accuracy and completeness of key representations concerning the primary obligor."

3. Securing the limited offering exemption ("LOE") per Rule 15c2-12(d)(1)(i)

a. Basis for LOE

(i) 1989 Interpretative Release (Release 34-26985) (July 10, 1989); 54 FR 130. ("1989 Release")

(ii) SEC recognized that exemptions are reasonable where the proposed rule "would have created unnecessary hardships." "The exemptions contained in the Rule are designed to facilitate certain of those offerings where the Commission believes that, given the sophistication of the investors and the alternative mechanisms developed by the industry to facilitate disclosure in connection with such offerings, the specific requirements of the Rule are not necessary to prevent fraud and encourage the dissemination of disclosure into the secondary market."

b. Exemption from primary offering requirements (no CDA or official statement required) for municipal securities in denominations of at least $100,000 that:

(i) are sold in a limited placement to no more than 35 sophisticated investors or

(ii) mature within 9 months

c. Underwriter must reasonably believe that each of the 35 investors:

(i) has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the prospective investment

- Rule requires that the underwriter make subjective (not objective) determination that each investor is sophisticated.

(ii) is not purchasing for more than one account or with a view to distribute.

- Account = investor for 35-investor rule
- Distribution refers to anything other than investment intent.
- SEC acknowledged in the 1989 Release that future sales may happen due to changing market conditions and for that reason didn't impose specific transfer restrictions.
- SEC acknowledged in the 1989 Release that underwriter will satisfy its obligation "if it obtains a statement indicating that the investor has purchased the securities with investment intent."

  Query: Is this still true in the case of broker-dealers or investment advisors?

d. Common use of Investor Letter ("big boy" letter) and disclaimers therein to support meeting underwriter's reasonable basis

(i) Purchaser is a sophisticated investor

(ii) Purchaser is buying for its own account with no current intent to resell or transfer

(iii) Purchaser has had opportunity to make, and has made, such investigation as it deems necessary

(iv) Purchaser has received all information that it has requested

e. Still subject to anti-fraud provisions of the Securities Act and the Exchange Act, including Sections 10b-5 and 17a, regardless of satisfaction of LOE

f. 1989 Release states that placement agents are acting as "underwriters" for purposes of the Rule in connection with a "private offering."

4. Potential pitfalls associated with satisfying LOE elements

a. Authorized denominations

(i) Impose restrictions on sale or transfer in amounts less than $100,000

b. Determining investor intent

c. Identifying the makeup of investors ("one account" rule)

(i) Must drill down to actual accounts

5. Enhanced SEC scrutiny on underwriters who fail to satisfy LOE

a. *SEC v. Oppenheimer & Co. Inc.*, No. 1:22-cv-7801, Complaint (U.S. District Court, S.D.N.Y) (September 13, 2022)

b. *In the Matter of BNY Mellon Capital Markets LLC*, SEC Rel. No. 34-95750 (September 13, 2022)

c. *In the Matter of TD Securities (USA) LLC*, SEC Rel. No. 34-95751 (September 13, 2022)

d. *In the Matter of Jefferies LLC*, SEC Rel. No. 34-95749 (September 13, 2022)

e. *In the Matter of PNC Capital Markets LLC,* SEC Rel. No. 34-96558 (December 21, 2022)

Impact of such cases:

- What was the SEC's primary concern with the conduct of underwriters?
- What are the lessons or takeaways from these enforcement actions?
- How should the practices and policies of underwriters and issuers and their counsel change as a result?
- How have such enforcement actions altered the scope and nature of necessary documentation and due diligence items?

6. Establishing the Underwriter's Reasonable Basis is Critical

   a. Efforts required by underwriter to verify compliance with LOE

   b. Establish and follow policies and procedures to ascertain accounts, investor sophistication and investment intent

      - See MSRB Rule G-27(c)

7. SEC alleged that the underwriters knew, or should have known, that the broker-dealers and investment advisers that were the initial purchasers of the securities would immediately sell them to their customers. Underwriters failed to investigate such customers to determine if LOE was met. According to SEC, the exemption should be used if no secondary market exists and not as tool to avoid primary disclosure obligations.

E. Compliance with MSRB Rules that apply to private placements and limited offerings

1. Rule G-11
2. Rule G-19
3. Rule G-23
4. Rule G-32
5. Rule G-34

III. SIFMA Placement Project (https://www.sifma.org/resources/news/sifma-issues-muni-model-placement-engagement-agreements/)

A. Background for the need of the project (See https://www.sifma.org/wp-content/uploads/2019/02/SIFMA-Model-PAEA-Commentary-2019.pdf)

1. Varying views of the application of federal securities laws

2. Need to formulate a more standardized manner of what is delivered in connection with private placements

B. Form Placement Agent Agreement

1. See https://www.sifma.org/resources/general/municipal-securities markets/#placer

2. Agreement sets forth the agreement for services as placement agent between issuer and placement agent.

C. Need for Bond Purchase Agreement?

IV. Dealing with disclosure documents

A. Should there be a disclosure document in private placement or limited public offering?

1. Depends on the kinds of investors and the complexity of the issue

2. Nature of the statements that would form the "total mix of information" if no disclosure documents

3. Reasonable steps to ensure investors are not misled by an absence of a disclosure document

B. What should issuers do if there is no disclosure document?

1. Total mix of information approach to disclosure

2. Developing an approach to evaluate the totality of statements

3. Use of Virtual Data Rooms

a. Need to summarize or highlight material concerns in such documents?

b. Benefits

c. Risks

C. What should underwriters and placement agents do if there is no disclosure document?

1. Should dealers prepare terms sheets or presentations to summarize financial and operating information?

    a. Discussion of *Lorenzo v. Securities and Exchange Commission*, 587 U.S. __ (2019), and *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2011)

    b. Discussion of the role of underwriter and placement agent as a reviewer of statements as opposed to a maker of a statement

2. Developing a due diligence approach

    a. Identification of total mix of information

    b. Reasonable investigation into potentially inaccurate or misleading statements

V. Requirements of Issuers, Underwriters and Placement Agents as to Documents

A. Opinions and certificates

1. Should underwriters and/or placement agents obtain 10b-5 opinions and certificates?

B. Placement Agreement

1. How are representations, warranties and other terms different than in a Bond Purchase Agreement?

2. Consideration of SIFMA Model Placement Agent Agreement

C. DTC

1. Should bonds be physical?

D. Transfer restrictions

1. When should the investor be restricted in transfers?

2. Discussion of impact of Article 8 of the UCC on transfer restrictions.

    a. Impact of 1994 amendments to Article 8 of the UCC on efforts to impose transfer restrictions on book-entry securities

E. Investor Letters (also referred to as Investment Letters)

1. What are the key elements that investor letters should contain?

2. Rule 15c2-12 Considerations. *See* Final Rule in 1989 (Release 34-26985 (Jul. 10, 1989))

   a. "Consistent with current practice, the Commission believes that an underwriter will satisfy its obligation under paragraph (c)(1) if it obtains a statement indicating that the investor has purchased the securities with investment intent. Furthermore, as suggested by the American Bar Association, in order to maintain the integrity of the 35-person limit, the Rule requires that each of the purchasers acquire securities for only one account. Finally, the Rule requires that the underwriter make a subjective determination that each investor have the knowledge and experience required to evaluate the merits and risks of the prospective investment. The Commission believes that this procedure also is consistent with the current practice in the municipal securities markets, where limited placements are generally made only to institutional purchasers."

   b. However, guidance indicates that reliance on investor statement may not be enough unless selling to institutional investor. If the purchaser is a broker-dealer or an investment advisor (i.e., purchasers unlikely to be buying with investment intent), a letter is likely not enough to establish reasonable basis because the guidance is clear that an underwriter cannot rely on certificates or representations without independent investigation where inconsistencies and inaccuracies may exist.

F. Should the issuer require Certificate of Placement Agent/Underwriters as to Compliance with Limited Offering Exemption?

   1. Does the issuer have responsibility to ensure that underwriter has satisfied requirements of LOE?

G. Other documents or covenant terms

   1. Contractual disclosure/reporting requirements are common.

   2. Depending on the nature of the credit and transaction, documentation may contain extensive terms, especially in cases of bank direct purchases.