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FINRA Examiners Probing Firms' Involvement with Bank Loans

By Jack Casey
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NEW YORK – Financial Industry Regulatory Authority examiners are probing firms' involvement with bank loans and other alternative financings in the municipal market, a FINRA official said at an industry seminar here.

Bonnie Bowes, associate director for fixed income regulation with FINRA, made her comments at a seminar on bank loans and direct placements hosted by the Securities Industry and Financial Markets Association on Tuesday.

Bowes said that dealers should expect examiners to ask for things like lists of direct placement deals and the details of those transactions. Firms should also be able to show adherence to policies and procedures they've established to determine whether the transactions involve bank loans or securities as well as their analysis of how they made those determinations, she added.

Bowes also listed several examples of insufficient answers firms have provided in the past of why they classified a debt instrument as a loan instead of a security.

The examples included the firms saying: the bank or purchaser didn't want the instrument to be labeled a security; the issuer didn't want the expected additional costs if something were labeled a security; counsel would not give a legal opinion on the issue; and labeling the instrument as a loan is how the firm always conducts business with the bank.

Bowes and Robert Fippinger, chief legal counsel for the Municipal Securities Rulemaking Board, echoed an April notice from the two self-regulators that advised dealer and municipal advisor firms to look to the U.S. Supreme Court Case Reves v Ernst & Young, Inc. as the legal authority on determining whether a note is a security.

That case held that a note is presumed to be a security unless it is specifically identified otherwise. Examples of non-securities under the case are: notes secured by a mortgage on a home; short-term notes secured by a lien on a small business or its assets; short-term notes evidenced by accounts receivable; and notes evidencing loans from commercial banks for ordinary operations.

If a note is not explicitly deemed a non-security, it may qualify as a non-security if it bears a "strong family resemblance" to the non-security notes identified in the case.

The "family resemblance test" from the case has four factors to consider: the motivations of the buyer and seller; the plan of distribution; the reasonable expectations of the investing public; and the existence of an alternate regulatory regime.

One audience member at the seminar asked whether there were any instances so far where FINRA had reviewed a dealer's direct placement history and concluded that the firm had miscategorized an instrument as a bank loan or other alternative financing instead of a security.

In response, Bowes said FINRA has reviewed the Reves analyses given to examiners by firms and also reviewed transaction documents to study whether transactions are secured by a note as well as other characteristics, but have not concluded something was miscategorized in an enforcement matter.

She later noted, in response to a question about how much weight examiners give to policies and procedures, that during examinations FINRA staff takes into consideration the strength of a firm's policies and procedures that were created as well as the firm's adherence to them.

Fippinger also advocated for strong policies and procedures.

"If you have procedures in place to make a conclusion based upon factors, I think you're probably alright," Fippinger said, adding he was speaking for himself and not necessarily the MSRB. He added that a firm working with direct placements should be aware of the ways in which it can fall into either underwriter or municipal advisor activity. A firm should "try not to be both" as it would mean they could fall under MSRB provisions prohibiting a firm from acting as an underwriter and advisor on the same transaction, he added.

The jointly issued MSRB and FINRA notice from April that Bowes and Fippinger brought up during the panel told firms they need to conduct adequate due diligence on the bank loan and direct placement issue after regulators concluded some firms may not have fully considered the applicability of the securities laws and rules underlying bank loans. The notice also warned that municipal advisors may be engaging in direct placements without fully understanding whether they are acting as municipal advisors or broker-dealers.

The notice was similar to an MSRB notice released in September 2011 that warned market participants that some loans could actually be considered securities. Muni market groups and the MSRB have been seeking guidance from the Securities and Exchange Commission on when private placements and bank loans involve securities. So far, the SEC has refrained from providing such guidance, but Ed Fierro, senior counsel with the commission's Office of Municipal Securities, said during Tuesday's panel that staff is continuing to review the issue.
