NOW & NEXT
Public Finance Article

OCT 20, 2022

Revisiting limited offering in the municipal securities market

By Daniel M. Deaton

In this article, Dan Deaton discusses recent SEC actions against dealers who purported to rely on the limited offering exemption under Rule 15c2-12. The SEC found that the dealers did not meet the requirements for the limited offering exemption and has warned dealers of the importance of policies and procedures implementing the exemption.

This article was originally published in the Bond Dealers of America's quarterly magazine *Fixed Income Insights*.

On September 13, 2022, the United States Securities and Exchange Commission (the "SEC") announced settlements with three dealers and filed suit against another dealer for violating Rule 15c2-12 with purported limited offerings. According to the SEC, these are the first enforcement actions it has brought against dealers for violating Rule 15c2-12 when a dealer was purporting to rely on the limited offering exception. In addition to these four actions, the SEC stated that it is continuing to look for other similar potential enforcement actions. In the press release, the SEC stated, "As a result of its findings in these investigations, the SEC staff has begun investigations of other firms' reliance on the limited offering exemption." For reasons we describe below, we believe that the SEC is seeking to make a larger change in practices within the municipal securities market. Accordingly, we think that it is important to revisit the limited offering

This newsletter is intended as an information source for the clients and friends of Nixon Peabody LLP. The content should not be construed as legal advice, and readers should not act upon information in the publication without professional counsel. This material may be considered advertising under certain rules of professional conduct. Copyright © 2023 Nixon Peabody LLP. All rights reserved.

exception, understand what the SEC is seeking to do, and develop practices that steer clear of the SEC's concerns.

What are limited offerings

When the SEC adopted Rule 15c2-12 in 1989, it crafted an exception to the Rule for what it referred to as "limited offerings." In 1989, the primary impact of the exception was that dealers did not need to obtain official statements from issuers when participating in offerings. But, when the SEC amended Rule 15c2-12 in 1995 to include continuing disclosure requirements, the limited offering exception afforded dealers a means by which to avoid both the official statement delivery requirement and the continuing disclosure requirements of Rule 15c-12.

The SEC provided considerable commentary about the limited offering exception when it adopted the Rule in 1989. The SEC noted that, "The absence of a limited placement exemption in the Proposed Rule reflected the [SEC's] concern that, without transfer restrictions, municipal securities initially sold on a limited basis to sophisticated investors could be resold to numerous secondary market investors, who lacked the sophistication of the initial purchasers." The SEC discussed in the adopting release that commentators were strongly in support of an exception and that it decided not to adopt transfer restrictions. Instead, the SEC stated that, "Rather than imposing specific transfer restrictions, the [SEC] has chosen to require that the securities be issued in relatively large denominations and that the underwriter have a reasonable belief that the securities are being acquired by the purchaser for investment." The commentary leaves the distinct impression that, while the SEC understood the market's concern that no limited offering exception could negatively impact the market, the SEC was always concerned that a limited offering exception might result in the exception becoming a "loop hole" through which municipal securities could end up in secondary market trading just like any other municipal securities but without adequate disclosure. That is, in a sense, the limited offering exception was a concession to the market because the SEC's other major private offering safe harbors involve some requirement of disclosure and some period during which the securities need to come to rest before they may be transferred freely. But in 1989, and presumably for some time after that since it didn't bring any enforcement actions until now, the SEC was comfortable that the municipal securities market was structured in a manner that didn't require such stringent requirements. It does appear that the four recent actions mean that the SEC's views have changed at least to some extent.

To secure the limited offering exception, there are three requirements. First, the municipal securities are required to have authorized denominations of $100,000 or more. Second, the municipal securities may only be sold to 35 persons. Third, the dealer is required to reasonably believe that each person to whom the municipal securities are sold "[h]as such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the prospective investment and is not purchasing for more than one account or with a view to distributing the securities."

There are some important observations to note in the limited offering exception. First, the SEC provides clarity concerning what it entails for a dealer to "reasonably believe": "Consistent with

current practice, the [SEC] believes that an underwriter will satisfy its obligation under [the limited offering exception] if it obtains a statement indicating that the investor has purchased the securities with investment intent." Thus, while the text of the Rule does not state it, the commentary by the SEC, which can have the force and effect of law as an interpretation, establishes the requirement that reasonable belief in investment intent entails obtaining a statement from the investor. Second, the SEC is clear in the commentary to the Rule and in its recent actions that the Rule requires each investor to purchase for one account. This can be deceptively significant as some "persons" purchase for more than one account—like mutual fund companies and investment advisors. Finally, the term "distribution" may sound like an ordinary English term, but it is actually one of the most crucial terms of art in the federal securities laws. It does not mean merely sell or transfer. "Distribution," as a term of art, is closely connected to a public offering of securities. In this context it means that the investor does not intend to be one link in a larger chain by which the securities are offered and sold out into the public.

What did the SEC do?

On September 13, 2022, the SEC announced that it had reached settlement with BNY Mellon Capital Markets LLC ("BNY"), TD Securities (USA) LLC ("TD"), and Jefferies LLC ("Jeffries"), and that it had filed a litigation action against Oppenheimer & Co. Inc. ("Oppenheimer") for violations of Rule 15c2-12 based on purported limited offerings. The SEC states that each of the dealers had executed multiple offerings that violated Rule 15c2-12 on this common fact pattern (254 offerings in the case of BNY, 35 in the case of TD, 18 in the case of Jeffries, and 354 in the case of Oppenheimer). The SEC's essential finding is that the dealers sold the municipal securities to broker dealers and investment advisors without, in the SEC's view, reasonable belief that they were purchasing the securities for investment intent. The SEC found that they did not inquire, or otherwise determine, the intentions of why the broker dealers and investment advisors were purchasing the municipal securities. In addition to this finding, the SEC found that each of the dealers lacked policies and procedures reasonably designed to ensure that it complied with the limited offering exception. Consequently, in the case of the three settlements, they were required to disgorge profits and fined a penalty ($300,000 for BNY and $100,000 for each of the other two). In the case of Oppenheimer, the SEC is seeking a similar remedy without specificity on the level of penalty.

What lessons can be learned from what the SEC did?

The SEC is focused on limited offerings in a way it wasn't in the past, and it is important for dealers to review their practices.

The SEC is clear that it will continue to look for other enforcement actions against dealers to ensure that offerings designed to comply with the limited offering exception comply with Rule 15c2-12. In the SEC's press release, it not only states that it is looking for other transactions that did not comply but also tells dealers who think they are not compliant to contact the SEC. Underwriters who rely at all on the limited offering exception should evaluate their offerings and their policies and procedures to ensure that they are reasonably designed to ensure compliance

and provide appropriate supervisorial oversight of the use of limited offering exceptions. In particular, the SEC focuses in its actions on the underwriter undertaking appropriate inquiry and determination that the investor is purchasing for investment intent.

Is the SEC making a larger point?

The SEC makes a number of statements in these actions that call into question whether the SEC is trying to slow down the number of offerings that are entering the municipal securities market through the limited offering exception and end up being traded in secondary market transactions not much differently than those with disclosure. Here are some observations of SEC's actions and the larger message they may be sending to market participants:

- Each of the actions seems to address a program of limited offerings and not individual specific offerings. The SEC appears to have targeted transactions where the dealer engaged in a systematic program or regular practice of using the limited offering exception rather than focusing on whether a particular offering failed to comply with the exception.
- The SEC appears to take specific issue with how Oppenheimer marketed to issuers. The SEC stated in the Oppenheimer action, "Oppenheimer's marketing materials tout its "[f]ine-tuned Limited Placement Notes Issuance Process," as well as its "prowess" and "rare experience" with such offerings. Oppenheimer also markets Limited Offerings to municipal issuers in particular to obtain "quick access to short-term funding," without the burden and expense of providing disclosure to investors." While the SEC merely cites this as part of the factual allegations, Oppenheimer's marketing materials really do not factor into the Rule 15c2-12 allegations. The point of making this factual statement is to highlight that Oppenheimer was marketing the limited offering exception not to deal with the complex transactions for which, in the SEC's mind, the limited offering exception was crafted but was marketing for the express purpose of avoiding preparing disclosure materials.
- While the SEC references or alludes to several parts of the 1989 adopting release, what it does not cite in the 1989 adopting release is notable. In the 1989 adopting release, as noted above, the SEC stated that it believed "that an underwriter will satisfy its obligation under [the limited offering exception] if it obtains a statement indicating that the investor has purchased the securities with investment intent." The SEC does not restate or cite this statement and, instead, states only that "the Rule requires that underwriters make a subjective determination that investors meet the purchaser qualifications." This seems harsher than the SEC's commentary in the 1989 adopting release and, at some level, suggests that an investment letter or statement may not be sufficient in all cases to address this "subjective determination."

  The SEC does make other statements that shed some light on why the SEC would not have reiterated what it stated in 1989. The SEC states that all four dealers sold municipal securities to broker-dealers and investment advisors whom the dealers knew, or should have known, were not purchasing such securities for investment purposes. Specifically, as it relates to the

Oppenheimer action, the SEC stated that Oppenheimer "knew or should have known those entities may have been buying on behalf of customers and/or clients that were unknown to Oppenheimer." Broker-dealers, in particular, represent a problematic purchaser since broker-dealers are in the business of buying and selling securities and thus are largely incapable of having requisite investment intent in the first instance. But it is notable that the SEC appears to stay away from language that would lead the market to believe that an investor letter would satisfy the reasonable belief standard of the limited offering exception in all instances.

Taken as a whole, it is reasonable to infer from the SEC's actions and statements that it is concerned with the emerging practice of using the limited offering exception merely to avoid preparing disclosure if the municipal securities are likely to end up trading in the secondary market like other municipal securities. In particular, the SEC's statements in the Oppenheimer complaint may be an indication that the SEC may be focused on dealers who market such a program to issuers for this purpose. Even then, it appears that the SEC is not opposed to dealers using the limited offering exception so long as reasonable steps are taken to ensure that the purchasers do in fact have investment intent and that the limited offering exception is not being used as a back door to distribute municipal securities to the market without appropriate disclosure and continuing disclosure.

What are some best practices?

In light of these SEC actions, here are some recommended best practices:

Develop, maintain, and comply with good internal policies and procedures.

The SEC clearly implored dealers to develop internal policies and procedures that specifically address limited offerings. This appeared to be a major contributor to the violations, from the SEC's perspective. The policies and procedures should incorporate all the requirements of the limited offering ($100,000 authorized denominations and the reasonable belief standards). In particular, the SEC seems to allude to the policies and procedures being effective enough to (a) establish when the underwriter has reasonable belief in the investment intent of the investor and (b) identify when the limited offering exception is being used inappropriately, such as when the municipal securities are being sold to broker-dealers when they really cannot have the requisite investment intent because they are in the business of buying and selling securities.

Make sure to track the 35-account rule.

The SEC makes specific comments regarding investment advisors with respect to the 35 maximum accounts. The SEC is clear that it is not sufficient to merely obtain a statement of investment intent but to know enough about what is happening to the municipal securities that the dealer knows that the municipal securities are not being placed into more than 35 accounts. Mutual fund firms and investment advisors can place municipal securities in multiple accounts. The SEC is clear in the actions that receiving a statement or letter from an investment advisor concerning its intent without understanding into what accounts the investment advisor intends

to place the securities is not sufficient to satisfy the requirements of the limited offering exception.

Make sure to obtain investor statements (and document them).

In each of these actions, the SEC cited that the essential violation of the underwriters stemmed from the failure of the dealers to inquire of the purchasers concerning their investment intent. While the SEC has never proscribed the form by which an underwriter should obtain a statement from an investor, and while that form can be an investor letter that is executed by the investor or a statement that is then memorialized in some fashion, what the SEC's actions make clear is that the underwriter needs to be able to document and prove that it inquired of the investors and was able to obtain the requisite reasonable belief that the purchaser was purchasing for investment intent.

When regularly using the limited offering exception, develop an ongoing awareness of what those investors are doing with municipal securities sold using the limited offering exception.

It is notable that in these actions, the SEC omitted any statement similar to that included in the 1989 adopting release to the effect that underwriters could establish their reasonable belief through obtaining a statement from an investor. The SEC's findings related to sales to broker-dealers present unique difficulties because, even if an underwriter obtained a statement of investment intent from a broker-dealer, it would be difficult for that underwriter to reasonably rely on such statement since broker-dealers are in a business that is incompatible with investment intent.

The SEC seems to have opened the door to questioning when an underwriter may reasonably rely on an investor statement of investment intent. While a broker-dealer presents a somewhat obvious fact pattern where reasonable reliance is questionable, what about other investors? While not in the four corners of the SEC actions, it may make sense for underwriters who sell municipal securities pursuant to a limited offering exception to an investor on a regular basis to generally be aware of what that investor does with municipal securities that it purchases stating it had investment intent. If an underwriter sells multiple issuances of municipal securities to an investor and that investor has a pattern of quickly selling those municipal securities, the SEC's approach in these actions raises the question whether the SEC may question whether the underwriter appropriately relied on a statement of investment intent when that investor's trading activity was inconsistent with its statement and the underwriter could have been aware of that if it investigated its trading activity.

Be mindful of the larger impact on the municipal securities market.

Stepping back from the four actions, the SEC seems to be making a larger market message concerning how the limited offering exception was impacting the municipal securities market. Reading between the lines of the actions, the SEC seemed to be complaining that the systematic use of the limited offering exception is increasing the volume of municipal securities regularly traded in the market that are not accompanied by disclosure or continuing disclosure obligations. Simply put, if these transactions are multiplied across the market, then, from the

SEC's perspective, it would create a situation where the basic purposes and protections of Rule 15c2-12 are undermined. In the Oppenheimer complaint the SEC appears to connect dots from marketing materials to distribution channels, and to a lack of policies and procedures to demonstrate how the limited offering program that Oppenheimer conducted allegedly undermined the purpose of the municipal securities disclosure regime. It remains helpful for market participants to consider how the SEC would view their transactions and programs of transactions. By engaging in a systematic pattern of transactions that, if spread throughout the market, would undermine the SEC's fundamental goals and expectations for the market, the SEC may feel obligated to fix that problem one way or the other.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

Daniel M. Deaton
213.629.6050
ddeaton@nixonpeabody.com