Financial Regulatory Alert

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Second Circuit Considers Whether Syndicated Term Loans Are Securities

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Key Points

- The 2nd Circuit is considering whether syndicated term loans—i.e., loans to corporate entities provided by a group of lenders, rather than a single lender—are "securities" under a U.S. Supreme Court decision known as *Reves*.
- The LSTA recently filed an *amicus curiae* brief arguing that syndicated term loans are not securities and warning of the devastating effect on the $1.4 trillion market any other conclusion would cause.
- If the 2nd Circuit holds that syndicated term loans are securities under *Reves*, the resulting practical complications and compliance costs for loan and CLO market participants could make it far more difficult for certain businesses to access debt financing and for those businesses to engage in liability management transactions. Such a ruling could even create a heightened risk of insider trading claims under the federal securities laws.

Background

The trustee of the Millennium Lender Claim Trust brought an action against numerous financial institutions alleging that a $1.8 billion syndicated loan transaction violated state securities laws.

On May 22, 2020, Judge Paul G. Gardephe of the U.S. District Court for the Southern District of New York granted Defendants' motion to dismiss, holding that the syndicated loan notes at issue (the "Notes") were not securities under the "family resemblance" test as articulated in *Reves v. Ernst & Young*, 494 U.S. 56 (1990).[1]

In *Reves*, the Supreme Court recognized that a presumption exists that notes are securities and that many kinds of notes are, in fact, securities. However, *Reves* also enumerated several categories of notes that are *not* securities under federal securities law, including, for example, notes secured by home mortgages, consumer financing notes and notes evidencing loans by commercial banks for current operations. Recognizing that many kinds of notes would not fall squarely within these enumerated categories, the Supreme Court held that where a particular note bears a "family

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resemblance" to notes commonly understood to be non-securities, the presumption that a note is a security may be rebutted.[2]

Judge Gardephe reasoned that the Notes were analogous to bank loans—not securities—because:

- (1) The plan of distribution for the Notes was relatively narrow such that it was not subject to common trading for speculation or investment.
- (2) The confidentiality language in the governing loan documents would lead a reasonable investor to conclude that the Notes constituted loans and not securities.
- (3) The sale of loan participations to "sophisticated purchasers" is subject to certain policy guidelines from the Office of the Comptroller of the Currency such that the Notes were subject to an existing regulatory scheme.

Judge Gardephe found that the remaining *Reves* factor (i.e., whether the transactional motivations were akin to a securities transaction) did not weigh heavily in either direction.

On October 28, 2021, the plaintiff appealed to the U.S. Court of Appeals for the 2nd Circuit, arguing that that the district court erroneously disregarded the *Reves* presumption that notes are securities, and that it misapplied the "family resemblance" test.

The LSTA's Amicus Brief

On May 23, 2022, the Loan Syndications and Trading Association (LSTA) submitted an *amicus curiae* brief to the 2nd Circuit arguing that syndicated term loans are not securities subject to state and federal securities laws. In support of the District Court's holding, the LSTA emphasizes that treating syndicated term loans as securities would jeopardize a trillion-dollar-plus market that is vital to the U.S. economy.

The LSTA argues that the additional practical and compliance issues that would arise from treating syndicated loans as securities would impose enormous costs and constraints on borrowers. Market participants would by obligated to comply with a patchwork of state and federal laws that would only drive up the costs of borrowing. Further, loan syndication and trading activity would likely need to be conducted through broker-dealers registered with the U.S. Securities and Exchange Commission (SEC), and any market participant that receives compensation tied to loan transaction would need to determine whether it needs to register as a broker-dealer. Moreover, the LSTA highlights that treating syndicated term loans as securities would profoundly disrupt customary arrangements between borrowers and loan market participants.

Potential Additional Far-Reaching Implications

A ruling from the 2nd Circuit that syndicated term loans are securities could have potentially far-reaching implications, which go beyond the concerns laid out in the LSTA *amicus curiae* brief.

- ***Insider Trading Implications***: Market participants that trade term loans often choose to access private-side data rooms, which may include confidential material that is arguably material non-public information (MNPI). Other participants may choose to trade term loans without accessing such private-side information, fully aware that their counterparties may be in possession of this potential MNPI.[3] These

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transactions are premised on the assumption—and at this point, well-established market convention—that term loans are not securities. If the 2nd Circuit reverses the decision below, market participants with access to private-side information could face an increased risk of insider trading liability, particularly from regulators such as the SEC.

- ***Tender Offer Issues***: A ruling that term loans are securities could subject certain transactions in the term loan market to the federal tender offer rules. Borrowers and third parties would need to consider whether a proposed offer to purchase term loans for cash or to exchange term loans for other consideration constitutes a "tender offer" under applicable case law. The tender offer rules could also potentially be implicated (under the "new security" doctrine) by proposed amendments to basic financial terms, such as a proposed change to the applicable interest rate or an extension of maturity. In the event a transaction constitutes a tender offer, the borrower or other offeror would need to comply with Regulation 14E under the Securities Exchange Act of 1934, including the requirements that the offer be held open for 20 business days and that the offer remain open for at least 10 business days after any change in consideration or the percentage of the tranche being sought. Application of tender offer rules would greatly reduce loan market participants' flexibility to propose liability management transactions and efficiently negotiate changes to terms.
- ***Collateralized Loan Obligation (CLO) Restrictions***: As the largest investor group in broadly syndicated leveraged bank loans, CLOs would be particularly adversely affected if such loans were deemed to be securities. Most CLOs permit only a small amount of securities to be included in their pools as eligible assets. A determination that certain types of syndicated loans are securities would diminish the universe of eligible assets for investment by CLOs. If banks need to hold more loans on their books as opposed to syndicating them out to CLOs and other traditional buyers of such loans, in response to such reduced liquidity, banks can be expected to fund fewer loans to eligible borrowers. As a result, it will be much more difficult for businesses to gain quick access to funding on flexible, bespoke terms, and for lenders to pool funds quickly and easily to offer loans to borrowers that might not qualify for other types of financing, which will have a wide-ranging negative impact on the U.S. economy.
- ***Potential Impact on Other Markets***: A broad ruling from the 2nd Circuit could have an impact on the burgeoning areas of decentralized finance (DeFi) and cryptocurrency. The SEC highlighted *Reves* in a recent settled administrative order that found certain digital tokens were securities.[4] The SEC's position on the application of *Reves* to DeFi has yet to be tested in court and a sweeping decision in *Kirschner* could impact future decision-making by that agency in this completely separate and rapidly developing market.

Participants in the syndicated loan market—including private fund managers that employ strategies in the credit space—should pay close attention to the *Kirschner* litigation going forward. At this point, no other *amicus* briefs have been filed, and briefing on the appeal will conclude in mid-June with the filing of plaintiff's reply brief. Oral argument will likely be held sometime in the fall, and the 2nd Circuit can be expected to issue its opinion thereafter.

[1] While Plaintiff alleged Defendants violated state rather than federal securities laws, the Court accepted Plaintiff's assertion that the *Reves* "family resemblance test" applied.

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[2] The four factors of the "family resemblance test" are: (1) "the motivations that would prompt a reasonable seller and buyer to enter into [the transaction]"; (2) "the plan of distribution of the instrument"; (3) "the reasonable expectations of the investing public" and (4) "the existence of another regulatory schemed [to reduce] the risk of the instrument, thereby rendering application of the Securities Act unnecessary." *Id.* at 66-67.

[3] The trade confirms that are typically used to settle syndicated loan transactions contain standardized "big boy" provisions that require the parties to acknowledge that they are willing to proceed with the transaction even if they have chosen not to access private side information that may have been reviewed by the other party. While these types of representations provide the parties with protections from private litigation in the syndicated loan market, the SEC has suggested that they would not be a defense to a regulatory enforcement action for insider trading. *See* SEC Litigation Release No. 20132, Barclays Bank Pays $10.9 Million to Settle Charges of Insider Trading on Bankruptcy Creditor Committee Information (May 30, 2007), http://www.sec.gov/litigation/litreleases/2007/lr20132.htm.

[4] *See In the matter of Blockchain Credit Partners d/b/a DeFi Money Market, Gregory Keough, and Derek Acree* (SEC Aug. 6, 2021), available at https://www.sec.gov/litigation/admin/2021/33-10961.pdf.

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