Blogs
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Asset Management ADVocate

Could Blockchain Push Syndicated Loans over the Regulatory Edge?

Some banks are hard at work applying distributed ledger technology to trading syndicated loan transactions. Their system would make it easier than ever to invest in syndicated bank loans. At some point, the combination of widespread holdings and a major default could force a reassessment of whether syndicated loans traded over the new system are "securities" for purposes of the Securities Act of 1933 (the "1933 Act") and Securities Exchange Act of 1934 (the "1934 Act"). To prevent this eventuality, the designers may want to limit who can trade over the new system. **Why Syndicated Loans Might Become Securities** The Supreme Court established the current test for when a promissory note is a "security" in Reves v. Ernst & Young. A note (even a virtual note) is presumed to be a security unless it bears a "family resemblance" to other notes (such as mortgages) that courts have found beyond the scope of the federal securities laws. Courts must consider four factors:

- Motivations that would prompt a reasonable seller and buyer to trade the note;
- Whether the plan of distribution of the note results in "common trading for speculation or investment;"
- The reasonable expectations of the investing public; and
- Whether other factors (such as regulation by an agency other than the SEC) reduce the risk of the note, so the application of the federal securities laws would be unnecessary.

Professor de Fontenay has made compelling arguments for why syndicated loans might already qualify as "securities" under these factors. The SEC has also filed a brief arguing that syndicated loan participations were securities, although the appellate court concluded they were not. Use of distributed ledgers could promote "common trading" in syndicated loans with investment rather than commercial motivations—perhaps pushing the first and second factors over the brink and landing syndicated loans in security land. **Restricting Investors Might Help** Lenders are also exploring use of blockchain to facilitate the formation and operation of syndicates. As this would be limited to major financial institutions, it is unlikely to raise questions under the 1933 and 1934 Acts. If these financial institutions use the technology to reduce settlement times from several weeks to a day or two, however, this could broaden the secondary market in funded loans and invite reconsideration of their classification as securities. If trading in syndicated loans remains confined to sophisticated investors, then these investors should not expect to be protected by the 1933 and 1934 Acts and the third factor might provide a bulwark against characterizing the loans as securities. Investor expectations may become murkier, however, if a broad range of investors naively acquire loans. If attorneys can find sympathetic plaintiffs who lost money in syndicated loans, this could provide the impetus for a court to reclassify the loans as securities. If syndicated loans were treated as securities, they would need to comply with the requirements for private placements, insofar as it would be impractical for most companies to file a registration statement every time they need a loan. This suggests that it may be worthwhile to restrict users of the new system to qualified institutional buyers (as defined in Rule 144A) or accredited investors (as defined in Rule 501). This would limit any potential plaintiffs to investors not traditionally considered in need of the full protections of the 1933 Act and who are permitted to trade unregistered securities. It would also allow the system to convert to a private placement regime if a court ever rules adversely on the exclusion of syndicated loans from the definition of securities. If courts were to conclude that syndicated loans have become securities, however, compliance with private placement requirements would not exempt issuers and lead banks from the antifraud provisions of the 1933 and 1934 Acts, particularly Rule 10b-5.

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