RETHINKING *KIRCHNER V. J.P. MORGAN*: HOW SECURITIES AND BANKING LAWS SHOULD APPLY TO SYNDICATED LOANS

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INTRODUCTION

Shortly after the financial crash that spiraled into the Great Depression, Congress passed extensive laws governing securities and securities markets. These securities laws protect

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investors by imposing disclosure requirements and liability upon issuers for fraudulent practices. Absent an exception, the laws require disclosing material information or an exemption from the disclosure process and provide a private right of action for material misstatements and omissions. These protections are more extensive than common law fraud claims. More importantly, these protections are integral to the efficiency and stability of capital markets. Congress’s intent in passing these laws was to protect investors from bad actors and to substitute a policy of full disclosure for a policy of caveat emptor, or “buyer beware,” in securities markets.

Since Congress passed the Securities Acts in the 1930s, financial markets have become infinitely more complex. They have also become significantly opaquer, as issuers have found ways to gain exposure to capital markets without the disclosure—and the accompanying liability—required by securities laws. Certain markets for such assets, such as the $656 billion collateralized loan obligation (CLO) market and the nearly $1.2 trillion leveraged loan market, intentionally exist outside the scope of securities laws, likely contrary to Congress’s intent.
In May 2020, the District Court for the Southern District of New York in *Kirschner v. JPMorgan Chase Bank*\(^9\) gave a judicial stamp of approval to these opaque debt markets; the court determined a $1.775 billion syndicated loan distributed to hundreds of investors was not a security. The court analogized the loans at issue in *Kirschner* to loans like those delivered in consumer financings, short-term loans secured by a lien on a small business, or mortgages. In its incorrect doctrinal analysis, the *Kirschner* court ignored the intent of the securities laws in favor of a broad, judicially constructed exemption that excluded syndicated loans from securities laws' reach. By ruling that a syndicated loan is not a security, the court stripped investors of the protections afforded to them by the securities laws. Considering the goals of the securities laws, this Note argues that Congress should classify syndicated loans as securities.

However, if syndicated loans are securities—as this Note suggests they should be—Congress should exclude these loans from the Volcker Rule, which would otherwise prohibit banks from holding securities. Calling syndicated loans securities alone could be catastrophic to the U.S. economy because it would implicate trading and ownership restrictions under the Volcker Rule. Passed in the wake of the 2008 Great Financial Crisis, the Dodd-Frank Act, enabling the Volcker Rule, which, among other things, limits what assets a bank may hold.\(^10\) Banks are limited in owning and trading funds that own securities by the “covered funds” provision of the Volcker Rule.\(^11\) Under the Volcker Rule’s covered funds provision,\(^12\) banks may not hold a loan securitization—such as a CLO—with more than 5 percent securities.\(^13\) If a syndicated loan is a security, then CLOs would consist of significantly more than 5 percent securities, meaning that banks would need to sell their nearly $100 billion in CLO holdings immediately. This massive liquidation would cause financial


\(^12\) The covered funds provision of the Volcker Rule prohibits “a banking entity . . . [from] acquir[ing] or retain[ing] any ownership interest in or sponsor a covered fund.” 17 C.F.R. § 255.10(a)(1) (2021). A “covered fund,” generally speaking, is an investment fund—like a hedge fund or private equity fund. See id. § 255.10(b).

\(^13\) A loan securitization holding debt securities is not a “covered fund” so long as the “aggregate value of such debt securities does not exceed five percent of the aggregate value of [the] loans.” 17 C.F.R. § 255.10(c)(8)(i)(E)(1) (2021).
distress and disrupt lending markets for capital-starved companies.

To adhere to the intent of the securities laws and preserve financial stability, this Note recommends Congress clarify the status of syndicated loans as securities and exclude them from coverage under the Volcker Rule. This new law would promote the disclosure of material information about syndicated loans and provide recourse for those whom securities issuers defraud. Additionally, this proposed law would protect bank stability and adhere to existing statutory mandates regarding bank holdings.

This Note proceeds as follows: Part I provides readers with background information about syndicated lending, leveraged loans, and CLOs. Part II explains the effect of the securities laws on market participants; how securities laws apply to syndicated loans, leveraged loans, and CLOs; and why the laws should apply to syndicated loans. Part III considers the effects of classifying syndicated loans as securities under relevant banking laws. Part IV concludes the Note by arguing that legislative action is necessary to close a judicially created loophole that currently allows syndicated loans to avoid classification as securities.

I. THE LEVERAGED LOAN MARKET

This Part provides the necessary background on how the syndicated loan, leveraged loan, and CLO markets operate and commingle. “A syndicated loan . . . is financing offered by a group of lenders—referred to as a syndicate—who work together to provide funds for a single borrower.”14 Syndicated loan deals are enormous, often for hundreds of millions or even billions of dollars.15 Syndicated loan deals require more than one lender to


15. According to the Corporate Finance Institute, a syndicated loan is always over one million dollars. Syndicated Loan, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/finance/syndicated-loan [https://perma.cc/432G-4ZT6]. But the largest syndicated loan ever (as of 2018) was a $100 billion loan to Broadcom in its $121 billion acquisition of Qualcomm. Alasdair Reilly, Broadcom Gets Record $100 Billion Loan for Qualcomm Buy, REUTERS (Feb. 12, 2018), https://www.reuters.com/article/us-broadcom-loan/broadcom-gets-record-100-billion-loan-for-qualcomm-buy-idUSKBN1FW1BU [https://perma.cc/X324-NCC3]. According to the St. Louis Fed, the average loan size of loans made under participation or syndication in the fourth quarter of 2015 was $2,844,000. FED. RSRV. BANK OF ST. LOUIS, Average Loan Size of Loans Made
bear the risk of default because of the size of the deal. Borrowers have used syndicated loans to finance some of the largest and most capital-intensive projects created, such as building the Panama Canal. However, a relatively new and increasingly prevalent financial instrument is the “leveraged loan.”

Leveraged loans are syndicated loans to large, distressed borrowers, often with poor protections for creditors. The term “leveraged” refers to the high levels of debt the borrowing company holds. Leveraged loans have become far more prevalent and controversial in financial markets as potentially unstable investments. The leveraged loan market expanded dramatically after the Great Financial Crisis in 2008, growing from $497 billion in 2010 to around $1.2 trillion in 2019. As discussed in Part II, the Kirschner decision allowed the leveraged loan market to remain largely outside the scope of federal securities law, and this unregulated status makes the market notoriously opaque. Commentators draw parallels between the degradation in subprime and Alt-A mortgage lending standards preceding the Great Financial Crisis in 2008 and the increasing prevalence of “cov-lite” leveraged loans. “Cov-lite” stands for

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16. “Loan syndication occurs when a single borrower requires a large loan ($1 million or more) that a single lender may be unable to provide, or when the loan is outside the scope of the lender’s risk exposure. Lenders then form a syndicate that allows them to spread the risk and share in the financial opportunity.” Syndicated Loan, supra note 15.


19. Id.


21. Leveraged Loan Primer, supra note 18.


23. Two salient factors characterize the Great Financial Crisis of 2008: reduced lending standards and a significant increase in indebtedness. The
“covenant-lite,” describing a loan with fewer restrictions on the borrower and fewer protections for the lender. The percentage of cov-lite leveraged loans outstanding has risen from below 10 percent in 2010 to approximately 77 percent of leveraged loans outstanding in 2018.\(^\text{24}\) As the market has grown and covenant protections have diminished, the leveraged loan market has received increasing attention from financial regulators,\(^\text{25}\) commentators,\(^\text{26}\) and members of Congress.\(^\text{27}\)


\(^{24}\) Leveraged Loan Primer, supra note 18.


\(^{26}\) Sam Fleming, Janet Yellen Sounds Alarm over Plunging Loan Standards, FIN. TIMES (Oct. 24, 2018), https://www.ft.com/content/04352e76-d792-11e8-a854-33d6f82e62f8 [https://perma.cc/7BSM-L8UY]. Federal Reserve Chairwoman Janet Yellen warned the U.S. needs to deal with a “huge deterioration” in the standards of corporate lending. *Id.*

Although financial analysts and commentators have not adopted a universal definition of a “leveraged loan,” this Note adopts the most common metric for defining and quantifying leveraged loans—a metric used by S&P Global and the Loan Syndications and Trading Association (LSTA). This definition includes any syndicated loan that is (1) rated BB+ or lower; or (2) is not rated or rated BBB- or higher but has (a) a spread of LIBOR +125 or higher, and (b) is secured by a first or second lien. Debt that rated less than BBB- is considered “non-investment grade,” so leveraged loans by definition include all non-investment-grade loans. The definition also includes all investments for which investors demand 1.25 percent interest above a popular benchmark rate. Because many government reports rely on data gathered by S&P Global and the LSTA, this definition most accurately encapsulates the data used throughout this Note.

Collateralized loan obligations (CLOs) are structured financial products that pool multiple loans—often syndicated loans—into a diversified portfolio, then cut the portfolio into sections called “tranches.” The CLO then sells interests in each tranche

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28. Although this definition is not perfect, it is workable given the lack of uniform definition for a leveraged loan. See Zachary L. Pechter, The Case for a Uniform Definition of a Leveraged Loan, 43 Fla. State U. L. Rev. 1409 (2016).

29. For more information about credit ratings, see generally Intro to Credit Ratings, STANDARD & POOR'S RATINGS SERVS., https://www.spglobal.com/ratings/en/about/intro-to-credit-ratings [https://perma.cc/2DVC-GM7S] (“Credit ratings are forward looking opinions about an issuer’s relative creditworthiness. They provide a common and transparent global language for investors to form a view on and compare the relative likelihood of whether an issuer may repay its debts on time and in full.”).


31. Leverage Loan Primer, supra note 18.


33. For a discussion of LIBOR, see generally DAVID HOU & DAVID SKEIE, FED. RSRV. BANK N.Y., STAFF REPORT NO. 667, LIBOR: ORIGINS, ECONOMICS, CRISIS, SCANDAL, AND REFORM (2014).

to investors based on the investor's risk preference. As borrowers make payments on the underlying loans, the cash flow is aggregated then trickles down the stack of tranches, paying off all of the debt in the highest-rated AAA tranche first, ensuring this tranche is effectively risk-free. After the payments pay off all debts in the AAA tranche, the cash flow continues to subordinate tranches in the same manner. The lowest tranche, the equity tranche, retains any excess cash flow beyond what is obligated to the senior tranches, but it also absorbs the first losses from defaulting borrowers. Investors earn a higher return by investing in lower tranches to compensate for the risk of the investment. Investment in a loan portfolio, such as a CLO, reduces any one firm’s exposure to a single borrower and spreads the danger of a borrower's default across multiple lenders in a process known as “diversification.”

Leveraged loans remain outside of the scope of the Securities Acts, likely by design. Banks provide a substantial amount of capital to CLOs, which in turn fund leveraged loan markets by buying the highest rated (AAA-rated) tranches of debt. However, the Volcker Rule prohibits banks from acquiring or retaining “ownership interests” in “covered funds” for investment purposes. Regulators have interpreted the Volcker Rule as prohibiting banks from acquiring or retaining ownership interests in CLOs that hold securities, as defined in the Securities Acts, subject to minor limitations. If syndicated loans were securities, the Volcker Rule would force banks to sell many of their CLO holdings.

35. Id.
36. Id.
38. See Kollmorgen, supra note 34.
39. See id.
41. See infra Part III.
42. Id.
II. SYNDICATED LOAN PARTICIPATIONS SHOULD BE SECURITIES

In the wake of the Wall Street Crash of 1929, Congress enacted a massive federal regulatory regime for securities, including the Securities Act of 1933 ("Securities Act") and Securities Exchange Act of 1934 ("Exchange Act") (collectively, the "Securities Acts"). The purpose of the Securities Acts, at least in part, is to provide investors with financial and other significant information concerning securities offered for public sale. The Securities Acts also created incentives for issuers to avoid the various costs of offering "securities" to the public market. Congress added legislation, most recently the Dodd-Frank Wall Street Reform and the Consumer Protection Act of 2010, to the Securities Acts to increase market transparency and stability. This Part first discusses the implications of an asset being a security, then discusses securities law theory and jurisprudence to explain why the District Court for the Southern District of New York wrongly decided Kirschner. Finally, the Part concludes with a discussion of the jurisprudence and public policy considerations that should influence legislative reclassification of syndicated loans.

A. Implications of Regulation Under the Securities Laws

Though the application of the Securities Acts protects investors, issuers often seek to avoid classification as a security because such classification is expensive, creates liability, and restricts the individuals who may hold such securities. If an issuer of a note, such as a syndicated loan, fails to rebut the presumption that the note is a security under the Reves test, the issuer will face an expensive set of compliance hurdles and will be

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45. These costs are discussed in Section II.A, infra.
47. Courts use the Reves test to determine whether a note is a security. Reves v. Ernst & Young, 494 U.S. 56 (1990).
liable for any material misstatements or omissions it makes. For example, the security must undergo registration and disclosure or be exempt from the process, and the persons trading these securities must register with federal and state compliance enforcing agencies.\textsuperscript{48} Moreover, people or entities selling securities may be administratively or judicially liable for their actions, and parties involved in the securities industry are subject to antifraud liability enforced by private plaintiffs or the Securities and Exchange Commission (SEC).\textsuperscript{49} This Section will explain issuers’ registration and disclosure requirements and provide a high-level overview of Rule 10b-5—one of the most powerful tools for private parties to defend against securities fraud.

1. Registration and Disclosure

One of the main ways Congress sought to prevent fraud was through a registration and disclosure process requisite to selling securities to the public. An issuer of securities must either file a registration statement with the SEC before it sells those securities to the investing public,\textsuperscript{50} or only sell exempt securities.\textsuperscript{51} Registration is an expensive and time-consuming process that increases the cost of raising capital and intrudes into a company’s inner workings.\textsuperscript{52} Moreover, registration creates liability for many parties.\textsuperscript{53} If the security is registered, many stakeholders are liable for material misstatements and omissions—the issuer, people who signed the registration statement, directors, experts, and underwriters, to name a few.\textsuperscript{54} Alternatively, an

\textsuperscript{48} Infra Part II.A.1.

\textsuperscript{49} Infra Part II.A.2.; see also 15 U.S.C. § 77q.

\textsuperscript{50} 15 U.S.C. § 77e(a) (requiring registration before selling a security in interstate commerce).

\textsuperscript{51} 15 U.S.C. § 77d (providing exemptions where registration would not be required under the rule stated in § 77e).

\textsuperscript{52} The cost of registration varies based on the issuer, type, distribution method of that security, and the cost of the associated attorneys’ or other professional fees. See 17 C.F.R. § 230.457 (2021) (setting forth a fee assessment structure for securities registration with the SEC); see, e.g., ALAN R. PALMITER, EXAMPLES & EXPLANATIONS FOR SECURITIES REGULATION 123 (7th ed. 2017) (“Professional fees for issuer’s counsel in a typical IPO range from $600,000 to $1,000,000, and for the auditing firm from $500,000 to $900,000.”).


\textsuperscript{54} Id.
issuer can sell exempt securities. While exempt securities can decrease the cost of registration, the exemption will not entirely avoid the associated attorneys’ fees and other related expenses of issuing a security. Nor does exemption eliminate the applicability and accompanying penalties of securities laws’ anti-fraud provisions.

Even securities professionals who conduct business in securities markets are subject to substantial regulation. Broker-dealers, investment advisors, mutual funds, private funds, and credit rating agencies are all regulated by government bodies. Any party that violates the rules of the Securities Acts or any other law regulating securities markets and their participants can be both civilly and criminally liable. For instance, if a seller fails to comply with securities registration rules, the buyer may sue to recover the price they paid for the security minus any money they recovered by selling it (recission damages). Likewise, if a registration statement contains a materially false or misleading statement, the buyer may sue to recover damages. The broad language of the Securities Acts also creates liability for negligent misrepresentations, and the government may prosecute willful violations of the Securities Acts by up to five years imprisonment and fines of up to $10,000.

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56. See PALMITER, supra note 52, at 197.
57. Id. at 198.
58. Id. at 515.
62. Id. at § 3..
64. See, e.g., 17 C.F.R. 240.10b-5 (2021) (describing the elements of civil liability); 15 U.S.C. § 77q (describing the elements of criminal liability).
65. 15 U.S.C. § 77l(a) (providing that a person who buys such noncompliant security is entitled “to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon”).
68. 15 U.S.C. § 77x.
creating such an extensive regulatory scheme for securities, Congress ensured accurate information is available to investors.

2. Rule 10b-5 Antifraud Protections

As the Supreme Court noted in Lorenzo v. SEC, the “basic purpose” of the securities laws is “to substitute a philosophy of full disclosure for the philosophy of caveat emptor . . . .” Congress delegated broad authority to the SEC to enforce the provisions of the Securities Acts under section 17 of the Securities Act, which prohibits the sale of securities that (1) employ a “device, scheme, or artifice to defraud,” (2) “obtain money or property by means of any untrue statement . . . .” or (3) engage in “any transaction . . . which . . . would operate as a fraud.” The SEC later created a private cause of action with the Exchange Act’s antifraud rule—Rule 10b-5. Utilizing the language of section 17 of the Securities Act and deriving authority from section 10(b) of the Exchange Act, Rule 10b-5 states as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or


70. The SEC may also sue under other laws and regulations, such as Rule 10b-5. 17 C.F.R. 240.10b-5 (2021).

71. 15 U.S.C. § 77q(a); see also 15 U.S.C. § 77t(b) (“[W]henever it shall appear . . . that any person is engaged or about to engage in any practices which constitute or will constitute a violation of . . . this subchapter, . . . the Commission may . . . enjoin such acts or practices . . . .”); United States v. Naftalin, 441 U.S. 768, 775 (1979) (quoting Cap. Gains Rsch. Bureau, 375 U.S. at 186–87) (stating that the Securities Act was intended “to achieve a high standard of business ethics . . . in every facet of the securities industry”).
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(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.72

Rule 10b-5 intends to ensure full disclosure by creating a private cause of action that permits actual purchasers and sellers to sue issuers for material misstatements or omissions in securities disclosures.73 For example, investors have sued under Rule 10b-5 in cases where issuers failed to adequately disclose possible adverse effects from a drug,74 particularly poor investments by a company,75 or even pending lawsuits against the issuer.76 The expansive nature of Rule 10b-5 makes it a valuable tool for plaintiffs that parties involved in securities transactions have defrauded.

Rule 10b-5’s material misstatement or omission rule encourages issuers to communicate with investors clearly and accurately, and its protections extend beyond the protections of common law fraud.77 This cause of action applies to all issuances of securities, even if they are exempt from registration under the Securities Acts.78 Under Rule 10b-5, a plaintiff must show that the defendant (1) made misstatements or omissions of material fact (2) with scienter (3) in connection with the purchase or sale of securities (4) upon which the plaintiffs relied and (5) that the plaintiffs’ reliance was the proximate cause of their injury.79 To


75. See Litwin v. Blackstone Grp., L.P., 634 F.3d 706 (2d Cir. 2011).


79. In re IBM Corp. Sec. Litig., 163 F.3d 102, 106 (2d Cir. 1998).
prove reliance, a lawsuit alleging a Rule 10b-5 violation may use the “fraud on the market theory” where the plaintiff need only show (1) an alleged misrepresentation or omission was publicly known, (2) the alleged misrepresentation or omission was material, (3) either (A) the investors relied upon the misstatement or omission, or (B) the security traded in an efficient market,80 and (4) the plaintiff (or class of plaintiffs, as is often the case) traded the stock between the time the defendant made the misrepresentation and when the truth was revealed.81 Proving reliance in such a manner expands Rule 10b-5 liability well past the reaches of common law fraud actions.82 A class of plaintiffs need only show a securities market is efficient to earn class certification under Rule 10b-5. In contrast, a class in a common law fraud case must show reliance on the misstatement or omission by each member of the class. Because of the cost of bringing a securities fraud claim, plaintiffs seeking recovery almost always require class certification to make the action viable.

Another reason Rule 10b-5 is more protective of investors than common law fraud is the breadth of the legal framework. Generally, a party’s silence does not amount to fraud under common law.83 Though there are numerous exceptions to this common law rule, Rule 10b-5 covers significantly more ground. The Rule creates a duty to disclose material information to investors: it covers transactions where parties are induced to buy or sell “without disclosing to them material facts that reasonably could have been expected to influence their decisions.”84 Though “Rule 10b-5(b) [does] not create an affirmative duty to disclose any and all material information,”85 it appears to be broader than common law fraud claims.86 In addition, violations of section 10(b)

80. “Efficient market” in this context relies upon, but is different from, the efficient market hypothesis. Analysis under Rule 10b-5 looks to trading activity in a relevant market, not the availability of information on the market. See, e.g., Basic Inc. v. Levinson, 485 U.S. 224, 241–42 (1988).
81. See id. (discussing the elements and reliance requirement of Rule 10b-5).
86. ARNOLD S. JACOBS, LITIGATION & PRACTICE UNDER RULE 10b-5 § 11.01 (1999); see also Rossdeutscher v. Viacom, Inc., 768 A.2d 8, 18 (Del. 2001) ("Rule 10b-5 is almost universally viewed as broader than common law fraud claims.").
and Rule 10b-5 are federal questions and, accordingly, may be brought in federal court.\footnote{28 U.S.C. § 1331.} Rule 10b-5 allows claims across the country to be aggregated in a single venue and adjudicated, increasing the size of the plaintiff class and decreasing the cost of the action.

To exemplify the importance of Rule 10b-5, consider the \textit{Kirschner} case.\footnote{Kirschner v. JPMorgan Chase Bank, N.A., 17 Civ. 6334, 2020 WL 2614765 (S.D.N.Y. May 22, 2020); see discussion infra Section II.B.3.} If the \textit{Kirschner} court correctly decided that the loans at issue were securities, the hundreds of funds composed of individuals’ retirement money most likely would be entitled to relief from being defrauded.\footnote{This cursory analysis takes the plaintiffs’ allegations as true. Had the case been litigated further, this analysis might have changed as more information became available.} If the \textit{Kirschner} syndicated loan were a security, Rule 10b-5 would likely have applied, and the parties probably would have settled.\footnote{It is important to note that once an asset is deemed a security and a plaintiff class is certified, settlement becomes the most likely option. See, e.g., Guevoura Fund Ltd. v. Sillerman, No. 1:15-cv-07192, 2019 WL 6889901, at *7 (S.D.N.Y. Dec. 18, 2019) (quoting \textit{In re Gilat Satellite Networks, Ltd.}, No. CV-02-1510, 2007 WL 1191048, at *10 (E.D.N.Y. Apr. 19, 2007) (“Securities class actions are generally complex and expensive to litigate.”)).} Taking the plaintiffs’ allegations as true,\footnote{Such as a motion to dismiss for failure to state a claim, which applied in the \textit{Kirschner} decision. Fed. R. Civ. P. 12(b)(6).} the issuers and arranging banks violated Rule 10b-5 by creating documents that misrepresented that the borrower was exposed to no material litigation and that the borrower complied with all applicable regulations and laws. These misstatements were material because the borrower had been exposed to material litigation, had not complied with applicable regulations and laws, and was forced into bankruptcy because of the undisclosed litigation and legal noncompliance.\footnote{Kirschner, 2020 WL 2614765, at *4–5.} Since the offering documents contained misstatements about the borrower, the plaintiffs could show evidence of conscious misbehavior or recklessness; they could show scienter. Finally, because the misstatements were on offering documents, had the loan been a security, the misstatements would have been in connection with the purchase and sale of a security. The plaintiffs relied upon the offering documents, and that reliance was the cause of their injury. Thus, the plaintiffs could meet the requirements of Rule 10b-5. However, because the court did not consider
the loans securities, the plaintiffs had to rely upon common law fraud claims. The court has since denied the plaintiff’s motion for leave to amend the complaint to expand the plaintiff’s fraud theories because such amendments would be futile.93

B. Securities Laws Should Cover Syndicated Loans

A necessary condition for regulation under the securities laws is that the asset is a “security.”94 To determine whether an asset is a security, a court first looks at what type of asset exists and then applies the appropriate judicially constructed test.95 The court looks to the substance of the transaction, not its form.96 The following Section discusses some of the economic theory underlying securities regulation, reviews some hallmark cases in securities law, and examines the Kirschner decision to explain why the court decided the case incorrectly.

1. The Theory Underlying Securities Laws

Protecting investors, disclosing information, and inspiring trust in capital markets were at the core of Congress’s reasons for passing the Securities Acts.97 Where markets lack

93. The Southern District of New York decided that the Arrangers were not liable for misstatements made by Millennium, that plaintiffs failed to satisfy Fed. R. Civ. P. 9(b)’s heightened pleading standards for fraud, and disclaimers in the credit agreement gave a “separate and independent basis on which to conclude that Plaintiff’s primary fraud claims . . . are futile.” Kirschner v. JPMorgan Chase Bank, N.A., 17 Civ. 6334, 2021 WL 4499084, at *17–*21 (S.D.N.Y. Sept. 30, 2021); Fed. R. Civ. P. 9(b).


information, they may break down, bubbles\textsuperscript{98} may form, and the bubbles bursting may create systemic stress. The economic theory supporting the law is the Efficient Capital Market Hypothesis, the idea that capital markets reflect an asset’s value when material information is available to the public.\textsuperscript{99} Markets that lack the disclosure required under the Securities Acts are prone to more risk,\textsuperscript{100} and opaque markets preceded many financial crises.\textsuperscript{101} Thus, the requirement that securities be registered and issuers disclose material information to the investing public means securities laws attempt to push the value of securities toward their intrinsic value. Likewise, with antifraud liability, the implied costs of misstatements or nondisclosure encourage securities issuers to provide as much relevant information to the investing public as possible, so the aggregate knowledge of the market may accurately appraise the value of the security.\textsuperscript{102}

Opaque markets preceded many of the most severe American economic crises. In October 1929, the U.S. stock market crashed, leading to the Great Depression.\textsuperscript{103} In the bubble that preceded the stock market crash in 1929, investors became more speculative and overconfident, but access to market information shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public”).

\textsuperscript{98} A “bubble” is a “metaphor that seems to mean any volatile market in which prices have risen dramatically.” Erik F. Gerdin, \textit{Laws Against Bubbles: An Experimental-Asset-Market Approach to Analyzing Financial Regulation}, 2007 WISC. L. REV. 977, 979.


\textsuperscript{100} BENJAMAS JIRASAKULDECH ET AL., \textit{FINANCIAL DISCLOSURE, INVESTOR PROTECTION AND STOCK MARKET BEHAVIOR: AN INTERNATIONAL COMPARISON}, 37 R. QUANTITATIVE FIN. & ACCT. 181, 197–200 (2011) (high disclosure companies are less likely to experience high variance in stock market returns).

\textsuperscript{101} See, e.g., Keller, supra note 97 (arguing that severe market opacity preceded the financial crash causing the Great Depression); MARTIN NEIL BAILY ET AL., \textit{BROOKINGS INST., THE ORIGINS OF THE FINANCIAL CRISIS 7–8} (2008) (CDO and CDS prevalence preceding the Great Financial Crisis led to increased market opacity).

\textsuperscript{102} For more information about the efficient capital markets hypothesis, see Fama, supra note 99.

was limited.\textsuperscript{104} In response to the market failure preceding the Great Depression, Congress passed the Securities Acts to prevent abuses by company insiders and market professionals by requiring more disclosure and by subjecting bad actors to liability for misinformation provided to the public.\textsuperscript{105}

More recently, institutional investors failed to recognize the presence of risky debt in opaque mortgage-backed securities, leading to the 2008 Great Financial Crisis.\textsuperscript{106} On one side of the transaction, the mortgage securitization industry was fraudulently approving people for home loans, in many extreme cases giving “NINJA” and jumbo loans to individuals who could not afford them.\textsuperscript{107} On the other side of the transactions, market participants securitized these already-fraudulent loans into ever-more complex assets.\textsuperscript{108} Like syndicated loans into CLOs, these risky mortgages were packaged as collateralized debt obligations (CDOs) and even re-securitizations of the risky CDO tranches into CDO-squared and -cubed.\textsuperscript{109} Financial institutions also provided insurance on these hyper-complex assets called “credit default swaps,” which became the catalyst between risky mortgages and the worldwide Great Financial Crisis.\textsuperscript{110}

Ultimately, institutional investors’ inability to access information led to the loss of over 12.5 million jobs, $11 trillion in stock market capitalization, $3.4 trillion in retirement account losses, and $7 trillion in real estate losses.\textsuperscript{111} The intent of


\textsuperscript{105} Stephen J. Choi & A.C. Pritchard, \textit{Securities Regulation Cases and Analysis} 1 (Saul Levmore et al. eds., 5th ed. 2019).

\textsuperscript{106} Erin Coghlan et al., \textit{What Really Caused the Great Recession}, INST. FOR RSCH. ON LAB. & EMP. (Sept. 19, 2018), https://irle.berkeley.edu/what-really-caused-the-great-recession [https://perma.cc/6WD7-YXK9].

\textsuperscript{107} “NINJA” refers to loans given to individuals “with no income, no job, and no assets,” while “jumbo loans” refer to large loans for luxury homes. \textit{Id.}

\textsuperscript{108} Martin Buffet, \textit{How Do CDOs and CDSs Influence the Crisis of 2008}, 6 LINGNAN J. BANKING, FIN. & ECON. 17, 18–20 (2016).

\textsuperscript{109} \textit{Id.} It is important to note, however, that CDOs and CLOs are different in many significant ways. \textit{See, e.g.}, Laila Kollmorgen, \textit{CLOs Versus CDOs: What’s the Difference?}, PINEBRIDGE INVS. (Oct. 31, 2018), https://www.pinebridge.com/en/insights/clos-versus-cdgos-whats-the-difference [https://perma.cc/BQ3S-GVZ8] (explaining that CLOs “are backed by corporate credit in the form of leveraged loans” whereas CDOs are “based on mortgages”).

\textsuperscript{110} Buffet, \textit{supra} note 108.

securities laws—such as the Securities Acts and the Dodd-Frank Act—is to prevent financial crises like the Great Financial Crisis by limiting opaque markets and bolstering efficient markets.¹¹²

2. Reves and Howey—How Courts Analyze Securities

The intent of Congress in passing the Securities Acts, and courts’ interpretations of the acts, will drive the analysis about whether a syndicated loan is a security. To understand the Supreme Court’s initial interpretation of the term “security,” one must look to Sec. v. W. J. Howey Co. where the Court first devised a test for determining what constitutes an “investment contract.”¹¹³ To be covered by the Securities Act, an instrument must be one of those defined in section 2(a) – such as “stock,” a “note,” or an “investment contract.”¹¹⁴ In Howey, the Court defined an investment contract as (1) an investment of money (2) in a common enterprise (3) premised on the reasonable expectation of profit (4) derived solely¹¹⁵ from the efforts of others.¹¹⁶ Implicit in the Howey test is the Court’s desire to protect passive investors who have little or no control and face collective action obstacles. Relying heavily on the intent of Congress, the Court impliedly intended to protect capital flow and investors’ money from fraud and other malfeasance, thereby increasing trust and investment in capital markets.¹¹⁷ Though the Howey test does not directly apply to notes, the Howey Court’s analysis supports Congress’s goals of market access to information and protection from fraud, which are implicit in the Securities Acts.

¹¹². See supra Section II.B.1.
¹¹⁵. Courts have since read the term “solely” to mean “predominantly.” See, e.g., SEC v. Merch. Cap., L.L.C., 483 F.3d. 747, 765–66 (11th Cir. 2007) (explaining that sole control is not necessary; the investor must have no real alternative but the third party as manager).
¹¹⁷. Id. at 298 (“It is therefore reasonable to attach that meaning to the term [‘investment contract’] as used by Congress, especially since such a definition is consistent with the statutory aims.”). See Keller, supra note 97, at 340, 342, 347–48, for a discussion of the statutory aim of Congress to prevent fraud while instilling trust in markets.
Where the financial investment in question is a note, courts will apply the Reves test. When Congress defined “securities” in the Securities Acts, it did not want the laws to apply to every transaction where parties exchanged capital for an expected return. Section 2(a) of the Securities Act (where the term “security” is defined) limits the definition of security with the phrase “unless the context otherwise requires . . .,” indicating Congress’s intent to avoid subjecting every exchange of assets to securities laws. Accordingly, the Reves Court specified that “‘any note’ should not be interpreted to mean literally ‘any note,’ but must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts.” To analyze whether a security is a “note,” the Court adopted a “family resemblance” test. Under the family resemblance test, the issuer of a note may “rebut the presumption that a note is a security if it can show the note in question ‘bear[s] a strong family resemblance’ to an item on the judicially crafted list of exceptions . . . or convinces the court to add a new instrument to the list.” This list is as follows:

1. the note delivered in consumer financing, 2. the note secured by a mortgage on a home, 3. the short-term note secured by a lien on a small business or some of its assets, 4. the note evidencing a ‘character’ loan to a bank customer, 5. short-term notes secured by an assignment of accounts receivable, 6. a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is

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118. A “note” is “a written promise by one party (the maker) to pay money to another party (the payee) or to bearer.” Note, BLACK’S LAW DICTIONARY (11th ed. 2019).
120. Id. at 62.
122. See generally, Keller, supra note 97 (explaining that Congress was concerned with fraud and market manipulation in securities markets).
123. Reves, 494 U.S. at 63.
124. Id. at 65.
125. Id. at 64 (citing Exch. Nat’l Bank of Chi. v. Touche Ross & Co., 544 F.2d 1126, 1138 (2d Cir. 1976)).
collateralized)\textsuperscript{126} [, and 7] notes evidencing loans by commercial banks for current operations.\textsuperscript{127}

The Reves Court also crafted a four-factor test to analogize notes to the instruments on this non-exhaustive list and contemplate additions to the list.\textsuperscript{128} When analogizing a note to a non-security debt contract, a court looks to (1) the motivation of the buyer and seller, (2) “the plan of distribution,” (3) “the reasonable expectations of the investing public,” and (4) the presence of alternate regulatory regimes or other factors that may protect investors.\textsuperscript{129}

The first factor—motivations of the buyer and seller—contemplates whether the issuer of the note uses proceeds for a general business purpose (whereby it would more likely be a security), or if the borrower uses it to buy consumer goods or for some other “commercial” purpose (where it would more likely be a non-security).\textsuperscript{130} This factor adopts an objective reasonable person test.\textsuperscript{131} Specifically, Reves analysis requires a court to consider how a transaction is “most naturally conceived” by investors.\textsuperscript{132}

The second factor, the plan of distribution, instructs courts to “determine whether [the note] is an instrument in which there is ‘common trading for speculation or investment.’”\textsuperscript{133} A note need not be traded on an exchange; however, it must be offered and sold to a broad segment of the public for the plan of distribution factor to weigh in favor of a “security.”\textsuperscript{134} Where restrictions on the notes “work[] to prevent the loan participations from being sold to the general public,” or “only institutional and

\textsuperscript{126} Id. at 65 (citing Touche Ross & Co., 544 F.2d at 1138).
\textsuperscript{127} Id. (citing Chem. Bank v. Arthur Anderson & Co., 726 F.2d 930, 939 (2d Cir. 1984)).
\textsuperscript{128} Id. at 67.
\textsuperscript{129} Id. at 66–67.
\textsuperscript{130} Id. at 66–68.
\textsuperscript{131} Id. at 66 (“[W]e examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it.”).
\textsuperscript{132} Id. at 68.
\textsuperscript{133} Id. at 66 (quoting SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943)).
\textsuperscript{134} Compare id. at 68 (notes offered “over an extended period to its 23,000 members, as well as to nonmembers”), with Landreth Timber Co. v. Landreth, 471 U.S. 681, 692 (1985) (holding that a closely held corporation’s stock, not traded on any exchange, is not a “security”), and Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (holding nonnegotiable but transferable “withdrawable capital shares” in a savings and loan association to be a “security”).
corporate entities were solicited” for sale, the distribution plan is seemingly narrow—meaning that the note is less likely to be a security.135

The third *Reves* factor inquires into the “reasonable expectations of the investing public: The Court will consider instruments ‘securities’ based on public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not ‘securities’ as used in that transaction.”136 Where purchasers of the debt are sophisticated and given ample notice that the instruments were participations in loans—not investments—the reasonable expectation should be that the instrument is not a security.137

The fourth and final factor in the *Reves* test instructs the court to look for the presence of other regulatory schemes “which significantly [reduce] the risk of the instrument, thereby rendering the Securities Act unnecessary.”138 Insurance through the Federal Deposit Insurance Corporation (FDIC) and applicable banking laws,139 regulation under the Employee Retirement Income Security Act of 1974 (ERISA),140 or policy guidelines issued to address the sale of loan participations by the Office of the Comptroller of the Currency,141 for example, weigh against applying the securities laws to the asset.142 These other regulatory regimes would, in effect, make the application of the Securities Acts redundant.143

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136. *Reves*, 494 U.S. at 66. Compare *Landreth*, 471 U.S. at 687, 693 (relying on public expectations in holding that common stock is a security), with *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 851 (1975) (stating that common sense suggests purchasers of residential apartments for personal use in state-subsidized cooperatives “are not likely to believe that in reality they are purchasing investment securities simply because the transaction is evidenced by something called a share of stock”).
137. *Banco Espanol*, 973 F.2d at 55.
139. *Id.* at 69 (citing *Marine Bank v. Weaver*, 455 U.S. 551, 557–58 (1982)).
141. *Banco Espanol*, 973 F.2d at 55.
143. *Id.*
The *Reves* factors are considered holistically, with no one factor dispositive of the outcome. Where one of the factors does not lead to a clear conclusion, but the other factors indicate a note is not a security, the court may still conclude that the note is not a security. Even where one of the factors indicates the note is a security, the court may still find the note is not a security.

3. The *Kirchner* Decision Deviates from *Reves* and *Howey*

In May 2020, the U.S. District Court for the Southern District of New York decided that syndicated term loans are not “securities” as defined by the Securities Acts. Thus, investors in syndicated term loans, or at least those resembling the loans at issue, are not entitled to the protections of the Securities Acts. Consequently, the issuers of the syndicated loans at issue were not required to disclose material information to syndicates of hundreds of institutional investors, nor were they liable for material misstatements or omissions under Rule 10b-5. Instead of increasing the availability of information in capital markets as Congress intended when passing the Securities Acts, the *Kirchner* decision deprived investors of any transparency.

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144. SEC v. Wallenbrock, 313 F.3d 532, 537 (2002) (citing McNabb v. SEC, 298 F.3d 1126, 1132 (9th Cir. 2002)).

145. E.g., *Kirchner* ex rel. Millennium Lender Claim Tr. v. JPMorgan Chase Bank, N.A., 17 Civ. 6334, 2020 WL 2614765, at *8, *10 (S.D.N.Y. May 22, 2020) (concluding that notes are not securities despite the mixed motivations of buyers and sellers under the first *Reves* factor); *Resol. Tr. Corp. v. Stone*, 998 F.2d 1534, 1540 (10th Cir. 1993) (the public perception factor did not lead to a clear conclusion while the remainder of the *Reves* factors indicated this was not a security, so the court determined the automobile loan papers at issue were not securities).

146. See, e.g., Heine v. Colton, Hartnick, Yamin & Sheresky, 786 F. Supp. 360, 372–73 (S.D.N.Y. Mar. 9, 1992) (though no alternative mechanism for reducing risk existed, the first through third *Reves* factors weighed against classifying the defendant’s fraudulent schemes as “notes”).

147. *Kirchner*, 2020 WL 2614765, at *10. The Southern District of New York’s decision is significant because, as of 2017, about 22 percent of all securities and commodities civil suits are filed in that district—more than double the rate of the next most popular district for such suits. See *Securities and Commodities Exchange Litigation Up 37 Percent*, TRAC REPS. (June 19, 2017), https://trac.syr.edu/tracreports/civil/473 [https://perma.cc/R3N7-8FFX].


The plaintiff in *Kirschner* was a trust consisting of “roughly 400 mutual funds, hedge funds, and other institutional investors (the ‘Investors’).”\(^\text{151}\) The defendants were JPMorgan Chase, Citibank, SunTrust Bank, and some of their subsidiaries (“Arrangers”).\(^\text{152}\) The Arrangers structured and organized a $1.775 billion syndicated loan transaction funding Millennium Laboratories LLC (“Millennium”)—a California-based urine drug testing company.\(^\text{153}\) The syndicated loan transaction “proceeded in three inter-related and contemporaneous steps”\(^\text{154}\) where JPMorgan Chase performed the initial funding, Millennium sold loan participations to the Investors, and then the Investors became obligated to JPMorgan Chase to purchase the amount of the loan for which they subscribed.\(^\text{155}\) The transaction closed in April 2014, triggering the Investors’ obligations.\(^\text{156}\)

In November 2015, after two unrelated lawsuits concluded unfavorably for Millennium and “the Centers for Medicare and Medicaid Services threatened to debar Millennium [from government contracting] based on allegations of illegal billing practices,” Millennium declared bankruptcy.\(^\text{157}\) Millennium’s bankruptcy petition led to the formation of the trust in the present case.\(^\text{158}\) The Investors’ claims arise out of, among other things, the Arrangers’ alleged negligent misrepresentation and violations of securities laws.\(^\text{159}\) According to the Investors, some Arrangers created offering materials that contained misstatements and omissions that induced the Investors’ purchase of the Millennium notes, Chase did not give contemporaneous notice of the adverse legal actions or Medicare’s threat to debar Millennium, and the Arrangers failed to perform adequate due diligence on Millennium before selling the loans, among other violations of contract laws.\(^\text{160}\)

Applying the *Reves* family resemblance test, the *Kirschner* court determined the loans at issue were not “securities” as

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152. *Id.* at *2.
153. *Id.* at *1.
155. *Id.*
156. *Id.* at *4*.
157. *Id.* at *4–5*.
158. *Id.* at *5*.
159. *Id.*
160. *Id.*
defined by the Securities Acts because the syndicated loans were “analogous to the enumerated category of loans issued by banks for commercial purposes.”161 The court reasoned that the first Reves factor was neutral, but the remaining factors weighed against finding that the syndicated loan was a “security.”162 When analyzing the motivations of the buyer and seller—the first Reves factor—the Kirschner court determined that the motivations of the two parties did not “weigh heavily in either direction.”163 Millennium’s purpose in the transaction was “commercial”: it used the debt to finance loan repayment and pay a dividend.164 However, the Investors acquired the notes as an investment, and the Investors were predominantly pension and retirement funds that purchased the notes for investment portfolios.165 The court decided this question correctly, but its proper analysis of the securities laws ended with the first factor.

The Kirschner court misapplied the second Reves factor, which looks to the issuer’s plan of distribution. In the eyes of the court, the plan of distribution weighed against classifying the loan as a security since the issuers solicited investment managers and other institutional investors.166 The “[solicitation] of hundreds of investment managers across the country”167 did little to change the court’s conclusion, since the defendants only solicited the notes to institutional and corporate entities, while restrictions on the notes “worked to prevent the loan participations from being sold to the general public.”168 Nevertheless, this analysis was incorrect. It failed to recognize the economic reality of the transaction. When analogizing to the Reves family—all of which traditionally have only two participants: a lender (typically a bank) and a borrower169—the hundreds of investors participating in a loan looks much less like a member of the Reves family. Though covenants in the loan prohibited sales to the

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161. Id. at *10 (quoting Banco Espanol de Credito v. Sec. Pac. Nat’l Bank, 973 F.2d 51, 56 (2d Cir. 1992)).
162. Id.
163. Id. at *8.
164. Id.
165. Id.
166. Id. at *8–9.
167. Id. at *8.
168. Id. at *8 (quoting Banco Espanol de Credito v. Sec. Pac. Nat’l Bank, 973 F.2d 51, 56 (2d Cir. 1992)). Examples of restrictions included assignment only with permission from the lender, no assignment to natural persons, and a $1 million minimum investment amount. Id. at *8.
169. See supra text accompanying notes 126–129.
general public, hundreds, or even thousands, of people were exposed to the risk of this loan either directly as an investor or indirectly as an investor in a fund that held these notes. The economic reality of this transaction indicates the syndicated loan was a security because the Arrangers broadly offered the notes, unlike the \textit{Reves} family, which typically consists of a small loan between two parties. The participation of hundreds of investors looks like an investment of money in a “common enterprise” premised on the reasonable expectation of profit derived solely from the efforts of others\textsuperscript{170}—not a loan delivered in consumer financing, a small business loan, or a mortgage.\textsuperscript{171}

To determine the reasonable expectations of the investing public—the third \textit{Reves} factor—the \textit{Kirschner} court looked to the agreements between the parties and found that this factor weighed against classifying the notes as securities.\textsuperscript{172} According to the court, “the governing documents . . . made clear to the parties that they were participating in a lending transaction, not investing in securities.”\textsuperscript{173} Further, the credit agreement made repeated references to the “loan documents” and used words such as “loan” and “lender” instead of the term “investor.”\textsuperscript{174} According to the court, “[i]nterests in bank debt . . . typically have been considered not to constitute ‘securities’ for purposes of the securities laws.”\textsuperscript{175} The court also found no precedent holding that a syndicated term loan is a security and, therefore, found that the reasonable expectations of the investing public weigh heavily against these notes being securities.\textsuperscript{176} Contrary to the court’s findings, however, from a generalized perspective, reasonable observers would probably believe these are the type of asset that the securities laws would regulate.\textsuperscript{177} Indeed, there were hundreds of participants to this broadly syndicated loan

\textsuperscript{171.} Reves v. Ernst & Young, 494 U.S. 56, 65 (1990).
\textsuperscript{173.} Id. at *9.
\textsuperscript{174.} Id.
\textsuperscript{176.} Id.
and, by the court’s admission, the participants viewed these like an investment.\textsuperscript{178}

Finally, when the \textit{Kirschner} court analyzed the fourth \textit{Reves} factor, it concluded that the existence of federal banking regulations also weighed in favor of non-security treatment for the loans.\textsuperscript{179} The \textit{Kirschner} court found sufficient “existence of another regulatory scheme” in federal banking regulations because multiple federal banking regulators set policy guidelines,\textsuperscript{180} unlike the “uncollateralized and uninsured” instruments with “no risk-reducing factor” at issue in \textit{Reves}.\textsuperscript{181} However, it is worth noting that banking regulations alone should not have a determinative effect. Looking to banking regulations as an indicator for whether an asset is a security leads to a circularity problem. Because banks cannot trade securities or have an ownership interest in funds that hold securities,\textsuperscript{182} the court’s consideration of banking laws counterintuitively means that securities look less like securities under the fourth \textit{Reves} factor and non-securities look more like securities. Stated differently, a bank can own a syndicated loan because it is not a security, and the syndicated loan is not a security because the bank can own it. Even if banking regulations limit the risk a bank may assume, such regulations differ significantly from the comprehensive legislative and regulatory scheme like ERISA.\textsuperscript{183}

Moving away from the \textit{Kirschner} court’s analysis, one can further distinguish the \textit{Reves} family from syndicated loans by looking at the examples in \textit{Reves}.\textsuperscript{184} All of the notes in the \textit{Reves}
family—those that are not considered “securities” for the application of the Securities Acts—are relatively small loans made to individuals or small businesses.185 One can easily distinguish these small loans from the $1.775 billion syndicated loans funded by hundreds of investors at issue in Kirschner.186 Indeed, the only type of note listed in Reves that is comparable to the Kirschner syndicated loan is a note “evidencing loans by commercial banks for current operations.”187 However, the syndicated loan in Kirschner is so drastically different than a note in consumer financing, home mortgages, short-term small business loans, character loans, notes secured by accounts receivable, and notes that formalize open-account debts incurred in the ordinary course of business that it is hard to imagine the Reves Court would include it in the family. Because a syndicated loan is nothing like the members of the Reves family, it stands to reason that it would not deserve an exemption from the Securities Acts because it does not bear a resemblance to those non-securities.188

Lastly, the Howey test indicates that the Kirschner syndicated loans are securities.189 Under Howey, this loan would be an investment contract because this syndicated loan is (1) an investment of money (2) in a common enterprise (3) premised on the reasonable expectation of profit (4) derived from the efforts of Millennium.190 Unlike in Kirschner, the Howey Court recognized Congress’s intent to protect passive investors who have little control over the company and to shield investors from fraud and malfeasance.191 Because the lenders in a syndicate have no control over the single loan agreement contract that the arrangers negotiate, the passive role of the syndicate participants

185. Id.
186. See id.
187. Id.
188. The analysis begins by presuming a note is a security, but this presumption is rebuttable upon showing the note “bears a resemblance to one of the instruments identified” in the Reves family. Id. at 65–66 (internal quotations omitted).
189. As discussed infra Section II.B.2, though Howey does not apply to notes, the reasoning the Howey Court used should be instructive as to the purpose of the securities laws.
191. See infra Section II.B.2.
resembles investors in securities. Congress’s goal was to protect these passive investors—a goal which should apply to notes, even if the Howey test does not.

C. According to Public Policy and Reves, Syndicated Loans Should Be Securities

Trading broadly syndicated term loans through a two-step process allows the risky $1.2 trillion leveraged-loan market to exist almost entirely outside of regulatory scrutiny, meaning borrowers can still access capital from public market investors without disclosing large amounts of material information. Currently, to avoid the regulatory scrutiny of the securities laws, a borrower seeking money may go to a bank to obtain a large amount of capital. If the borrower’s capital requirements are high enough, the bank may arrange a syndicated loan deal by finding investors, structuring the deal, and providing the capital to the borrower. Sellers resell interests in these loans to institutional investors through either direct loan holdings or interests in collateralized loan obligations. Because institutional investors are simply investment vehicles for the broad public, companies may still access a massive capital market while circumventing the need to comply with the expensive and revealing security registration and disclosure requirements.

By reclassifying syndicated term loans as “securities” as defined in section 2(a)(1) of the Securities Act, issuers will be

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193. See, e.g., Keller, supra note 97, at 348–51 (the Exchange Act prohibits numerous schemes which could defraud investors, such as insider trading, manipulative devices, manipulative pricing, and certain broker and dealer activities).

194. FED. RESV., FINANCIAL STABILITY REPORT: MAY 2020, at 20 (2020). Outstanding leveraged loans are worth $1.193 billion as of Q4 2019. Id.


196. Alternatively, investors can purchase shares of a CLO—collateralized loan obligation. See supra Part I.

197. Though many people think of “Wall Street” as large funds that have no bearing on everyday Americans, it is important to keep in mind that these funds invest money on behalf of everyday Americans. For example, the funds in Kirschner were mutual funds, pension funds, universities, CLOs, and other institutional investors. Complaint at 7, Kirschner ex rel. Millennium Lender Claim Tr. v. JPMorgan Chase Bank, N.A., 17 Civ. 6334, 2020 WL 2614765 (S.D.N.Y. Aug. 21, 2017).

required to disclose material information to investors, and they will be liable for any misstatements or omissions made to investors. Disclosure requirements of the securities laws will increase the availability and accuracy of information about corporate borrowers. Though borrowers may utilize private placement exemptions to avoid the complex process of issuing a public security, they must still disclose some information. These private placements of loan syndications will exempt the offerings from registration, but they will still be subject to the antifraud liability rules found in section 10(b) and Rule 10b-5. Because antifraud rules apply, issuers will be more careful about the information it discloses to the syndicate, and issuers, not the investing public, will bear the cost of misstatements and omissions. Correctly applying securities laws to broadly syndicated loans promotes financial stability by increasing publicly available information.

Setting aside Reeves, some industry professionals argue that public policy requires syndicated loans be classified as non-securities—an argument that deserves great deference. Even when classified as non-securities, disclosure in syndicated loan offerings is still necessary because lenders do not blindly lend hundreds of millions of dollars without understanding who is borrowing their money. Indeed, many proponents of the status quo argue that participants in a syndicate rely on confidential—often material non-public information under the securities laws—in deciding whether to lend to the borrower. According to the LSTA, “syndicated term loans are originated, syndicated, and traded on the basis of confidential information.” Some argue that should a loan in a syndicate be a security, issuers would have to disclose this information to the market—counter to the traditions of loan syndications—supplying competitors with key information about the borrowing company. Participants in loan syndicates also point to the bargaining power of a lender in a syndicate compared to an investor in a bond issuance. A

203. Id. at 8.
204. Id. at 3.
lender in a loan syndicate has a direct contractual lending relationship with the borrower so that parties may adjust the terms and conditions of the agreement more readily than the terms of a bond indenture.205

Opponents of classifying syndicated loans as securities also point to the expectations of the market. Loans have not traditionally been securities, so the market has grown to expect minimal disclosure requirements and minimal antifraud liability for issuers.206 Accordingly, syndicated loan market participants “are expected to have the capacity to independently evaluate their transactions in the loan market, to make informed decisions regarding the amount of due diligence that is appropriate under the circumstances, and to undertake such due diligence deemed appropriate by them.”207 In practice, this places the impetus on lenders to search for information and the cost of any borrower’s concealment on the general public.

Admittedly, many of these arguments are salient, but they fail to consider the possibilities for private placements under section 4(a)(2) of the Securities Act.208 Issuers may sell securities outside of public markets in a private placement, and counterparties can still be subject to nondisclosure agreements, hiding confidential information from the market.209 Private placements also do not change lenders’ bargaining status since the same number of lenders may be solicited and these lenders will likely be the same parties. In fact, should the Volcker Rule be amended

205. Id.
206. Id. at 14.
209. One example of private placements is selling some or all of a company’s equity in a merger or acquisition. See, e.g., Joel Crank, Issuances of Securities in M&A Transactions, COLO. BAR ASS’N BUS. ENTITY NEWSL. (Nov. 24, 2021). Another example is selling equity in a startup company to a venture capitalist or angel investor. E.g., AF Bureau, Real-World Private Placement Examples and Their Impact on the Businesses, ALCOR FUND (Nov. 2, 2020), https://alcorfund.com/insight/real-world-private-placement-examples-and-their-impact-on-the-businesses [https://perma.cc/XHM4-4EB7]. Another private placement example would be selling hedge fund interests in the fund to accredited investors. Id. Lastly, yet another private placement example would be the sale of a company’s debt. JASON ROTHENBERG, METLIFE INV. MGMT. PRIVATE PLACEMENT DEBT INVESTMENTS (2020), https://investments.metlife.com/content/dam/metlifecom/us/investments/insights/research-topics/private-capital/pdf/MetLife-Investment-Management-Private-Placement-Debt-Investments-Overview.pdf [https://perma.cc/D3C8-JRJE].
as described below in Part III, the parties would be in the same position during a private placement loan syndication apart from the application of antifraud liability to issuers. If syndicated loans were securities, Rule 10b-5 would apply, allocating the cost of finding information from the lenders to the borrowers.

Rule 10b-5 is especially significant because of the prevalence of cov-lite lending. Cov-lite refers to the reduction of provisions known as covenants that protect lenders in debt contracts by limiting what a borrower may do—such as taking on excessive debt.210 A covenant is “a part of . . . [a] loan agreement that limits certain actions a . . . [borrower] may take during the term of the loan to protect the lender’s interests.”211 Covenants will often require borrowers maintain certain financial conditions, refrain from making excessively risky decisions, give lenders additional control over the company’s decisions, or provide information to lenders.212 In many cases, the absence of covenants will allow flexibility in calculating financial ratios, increasing the likelihood of dishonesty.213 Given the reduction in protective covenants in leveraged loans,214 Rule 10b-5 could play an integral role in protecting investors from misstatements by borrowers who have taken too many liberties in calculating their financial numbers. Some argue that cov-lite loans provide necessary mobility to companies, allowing borrowers to adapt in a dynamic business world.215 While this may be true, Rule 10b-5 could serve as a countervailing force in ensuring that businesses can access capital while still protecting investors from bad actors and borrower malfeasance.

Congress should regulate syndicated loans as securities to increase the availability of material information and allocate the

215. See Cordone, supra note 213.
cost of misstatements and omissions to issuers. Given the precedent in Kirschner and prior cases like Banco Espanol,216 and considering the financial stability implications of reclassifying syndicated loans as discussed in Part III, courts may be hesitant to revise their jurisprudence to classify syndicated loans as securities under Reves. Congress’s intervention is necessary because, as will be discussed in Part III, reclassification implicates banking laws that administrative agencies may not be able to change. Congress must address multiple interconnected areas of law at once to avoid causing massive distress in lending markets.217

Finally, if Congress reclassifies syndicated loans as securities, the newly applicable registration requirements, trading limitations, liability rules, and antifraud provisions may slow the speed at which syndicated term loan issuances occur and decrease the frequency at which new loan transactions occur. To obviate these new costs, enforcement agencies may consider creating a new, alternate version of the registration and disclosure requirements to help ameliorate some of the regulatory burdens on loan markets.218

III. IF SYNDICATED LOANS ARE SECURITIES, CONGRESS MUST AMEND THE VOLCKER RULE TO COMPLY WITH THE BANK HOLDING COMPANY ACT

Calling syndicated loans securities alone could be catastrophic to the U.S. economy because it would implicate trading and ownership restrictions under the Volcker Rule. Passed in the wake of the 2008 Great Financial Crisis, the Dodd-Frank Act enabled bank regulators to create the Volcker Rule, which, among other things, limits what assets a bank may hold.219 Banks may be limited in owning and trading funds that own securities by the “covered funds” provision of the Volcker Rule.220 Practically, the covered funds provision means that if syndicated loans are securities, banks may not hold CLOs. Accordingly, if syndicated loans (including all leveraged loans) are securities,

217. Such distress is discussed in Part III, infra.
218. This, however, is outside the scope of this Note.
banks would have to offload massive amounts of debt previously considered risk-free. To unload billions of dollars of debt quickly would require financial institutions to sell at fire-sale prices, creating massive losses in what banks and bank regulators consider safe investments. Such reclassification would also restrict capital flow from banks to borrowers since banks could no longer trade their loan exposures. Banks and other interest groups have litigated to avoid these adverse consequences and to prevent classifying syndicated loans as securities. This Part first defines the Volcker Rule’s covered funds provision, then reviews the policy considerations for banks should syndicated loans be securities.

A. Defining the Covered Funds Provision

The Volcker Rule, one of the flagship components of the Dodd-Frank Act, amended the Bank Holding Company Act of 1956 to prohibit banks from, among other things, “acquir[ing] or retain[ing] any equity, partnership, or other ownership interest in or sponsor[ing] a hedge fund or a private equity fund.” Known as the “covered funds” provision, the Volcker Rule expressly prohibits any banking entity from “directly or indirectly] acquir[ing] or retain[ing] any ownership interest in or sponsor[ing] a covered fund.” Covered funds traditionally include asset-backed securities, but regulations exempt asset-backed securities composed of loans and other debt securities provided that, among other things, “the aggregate value of such debt securities does not exceed five percent of the aggregate value of loans held [within the asset-backed security].” Under


227. Id. § 255.10(c)(8)(G)(E)(1).
the covered funds provision, where an asset-backed security (such as a CLO) consists of 95 percent or more loans within the collateral pool, a bank may hold the asset.228

The Bank Holding Company Act expressly authorized loan securitizations. Section 13(g)(2) of the Act states: “Nothing in this section shall be construed to limit or restrict the ability of a banking entity . . . to sell or securitize loans in a manner otherwise permitted by law.”229 In the adopting release of the covered funds provision, the Office of the Comptroller of Currency (OCC), Board of Governors of the Federal Reserve System (Fed), Federal Deposit Insurance Corporation (FDIC), and SEC explained the reason for the exemption: the importance of enabling banks to “continue to provide financing to loan borrowers at competitive prices.”230 According to the agencies, “[l]oan securitizations provide an important avenue for banking entities to obtain investor financing for existing loans, which allows such banks greater capacity to continuously provide financing and lending to their customers.”231 As such, the Volcker Rule’s covered funds provision permits banks to own, sell, and invest in CLOs. The 2013 version of the covered funds provision allowed banks to hold loan securitizations so long as loan securitizations held only loans and a small number of other assets that were not “securities.”232

In 2020, the OCC, Fed, FDIC, and SEC amended the covered funds provision to allow banks holding loan securitizations with up to 5 percent debt securities.233 However, industry participants criticized the rule, claiming that it impermissibly restricted a bank’s right to hold, sell, and securitize loans under the Bank Holding Company Act.234 Because the covered funds provision was so restrictive, the agencies amended the rule to permit banks to own securitizations “hold[ing] limited amounts

231. Id.
233. Id. at 46,432–33; 17 C.F.R. § 255.10(c)(8)(i)(E)(1).
of non-loan assets” to “promote the ability of banking entities to sell or securitize loans” and “respond to investor demand.” The new rule allows banks to hold securitizations with up to 5 percent debt securities to better facilitate Congress’s intent in exempting loan securitizations from the covered funds provision.

B. If Syndicated Loans are Securities, Capital Markets Will Fundamentally Change

If Congress or the courts reclassify syndicated loans as securities, the Volcker Rule will prohibit banks from holding CLOs. If the Volcker Rule were to prohibit bank ownership of CLOs, it would either run afoul of the Bank Holding Company Act, cause massive economic turmoil, or both. Section 13(g)(2) of the Bank Holding Company Act permits banks to sell and securitize loans. The Volcker Rule, which is a regulation, would directly conflict with the statutory requirements of the Bank Holding Company Act, meaning the Volcker Rule would likely be repealed in relevant part. Were this the case, bank regulators would lose their ability to prohibit banks from holding loan collateralizations, and banks may even begin to hold the risky collateralizations the Volcker Rule intended to prevent.

If the Volcker Rule and section 13(g)(2) could both exist, the Rule would prohibit banks from holding CLOs. Accordingly, banks would have to immediately “divest themselves of approximately $86 billion in interests in CLOs holding syndicated term loans—25% of CLOs’ AAA notes.” This divestiture of a significant portion of banks’ assets would cause at least two significant economic events. First, banks would have to sell at fire-sale prices, meaning that banking institutions would sustain

235. Id. at 46,432–33.  
236. Note, however, this exclusion does not permit holding non-debt securities in a securitization.  
heavy losses on their investments.\textsuperscript{241} This massive liquidation would impose a tremendous financial burden and force massive losses on what banks previously believed were “risk-free” assets.\textsuperscript{242} Placing such a strain on banks, especially during severe economic distress,\textsuperscript{243} could be catastrophic and cause disastrous effects on the world economy.\textsuperscript{244} To address the fire-sale issues that would occur, legislators could add a grandfather provision allowing banks to hold any CLO they held prior to the date upon which the loans became securities. A grandfather provision, however, is a partial solution to the problem.

The second, and more significant, problem is that a major disruption to the CLO market would likely reduce capital flow to firms.\textsuperscript{245} As of the first quarter of 2020, banks held just under $99 billion in CLOs, up about 12 percent from 2019.\textsuperscript{246} Banks hold about 16 percent of CLOs outstanding.\textsuperscript{247} In October 2020, CLOs held about half of the $1.2 trillion in leveraged loans outstanding.\textsuperscript{248} Without the involvement of banks in the market, a significant portion of the capital supplied to the leveraged loan market—which ultimately provides much-needed capital to
distressed businesses—would dry up. Likely, tens of billions of dollars in financing would become unavailable to distressed borrowers, all but sealing borrowers' and their creditors' fate in bankruptcy court. Other leveraged loan market participants may invest in the place of banks, but replacing nearly $100 billion with insurance companies, hedge and mutual funds, and other industry participants is unlikely, especially considering banks' growing role in the CLO market.

Additionally, banks frequently purchase the highest-rated tranches of CLOs, supplying capital to syndicated term loans and loan originators.\(^\text{249}\) Other investors may prefer riskier investments with a greater return, meaning they may not step into the banks' shoes. Alternatively, they may demand a higher return, increasing the cost of capital for already struggling firms. Without the capital from banks funding billions of dollars in the CLO and leveraged loan markets, businesses would have limited access to capital, and global economies would experience a credit crunch.\(^\text{250}\)

Given that precedent states syndicated loans are not securities and the adverse consequences of their reclassification, courts ruling that syndicated loans are securities is unlikely. However, if Congress decides to act by classifying syndicated loans as securities as is suggested in Section II.C, then it must simultaneously act to prevent fire-sales and credit crunches in the CLO, syndicated loan, and leveraged loan markets. Congress must accompany any amendment to the securities laws with an amendment to the Bank Holding Company Act. Such action would underscore the importance of section 13(g)(2), which protects banks' ability to securitize loans.

Some may argue against this proposed Volcker Rule exemption because the Volcker Rule intends to protect banks from taking part in excessively risky investments. This argument overlooks three critical details about bank holdings of CLOs. First, banks already hold CLOs as permitted by the Volcker Rule,\(^\text{251}\) so reclassifying the same asset would not lead to increased exposure to the risks associated with CLOs. Second, taken in

\(^{249}\) See id.

\(^{250}\) A "credit crunch" is when "economic conditions . . . make financial organizations less willing to lend money, often causing serious economic problems." Credit Crunch, CAMBRIDGE DICTIONARY, https://dictionary.cambridge.org/us/dictionary/english/credit-crunch [https://perma.cc/B6NH-66SH].

\(^{251}\) 17 C.F.R. § 255.10(c)(8) (2021).
tandem with the proposed amendments to the Securities Acts, this legislative change decreasing the risk of banks’ investments in CLOs by increasing their access to information about the underlying loan and providing recourse for misrepresentations by the loan’s originators. Finally, as explained above, changing the classification of syndicated loans under the securities laws would likely cause substantial harm to financial stability in the banking system without also amending the Volcker Rule, making an amendment necessary.

CONCLUSION

This Note discusses the judicial loophole utilized by the syndicated term loan market to avoid securities laws and maintains an opaque lending market. Courts have pushed the boundaries of the Reves test, and in what seems to surpass Congress’s intent, the Kirschner court placed a judicial stamp of approval on the $1.2 trillion opaque leveraged loan market by stating that syndicated loans are not securities. This Note concludes that the Kirschner court erred in its ruling, and the Note suggests a legislative remedy would be appropriate.

Classifying syndicated term loans as securities increases disclosure to investors and shifts the burden of searching for information from investors to issuers. Antifraud liability protects the public’s confidence in capital markets and creates incentives for issuers to avoid material misstatements and omissions. Though financial engineering on the scale that exists today was neither present nor imaginable in the 1930s when Congress passed the Securities Acts, Congress likely intended to regulate opaque, trillion-dollar markets owned by an array of institutional investors. As applied in Kirschner, the Reves test circumvents Congress’s broad-reaching regulatory framework intended to increase publicly available investment information and avoid fraud.

Considering the breadth of the Securities Acts, Congress likely intended to regulate syndicated loans. However, in isolation, classifying a syndicated term loan as a security would cause massive disruption to markets, credit crunches, and fire-sales, resulting in economic turmoil. To prevent widespread economic distress and honor the Securities Acts’ intent, Congress must amend the definition of a security to include syndicated loans and modify the Bank Holding Company Act to protect the
current banking infrastructure and businesses' access to capital markets.