HUNTON & WILLIAMS

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# Important Developments in the Municipal Bond Market

## Introduction

A number of regulatory and legislative developments will alter the municipal securities market significantly in the upcoming months. Among these developments are amendments to **Rule 15c2-12** of the Securities and Exchange Act of 1934 that will enlarge the continuing disclosure obligations of municipal bond issuers, increased post-issuance diligence obligations for issuers of **Direct Pay Build America Bonds**, guidance on **potential offsets** by the Federal government to subsidy payments owed to issuers of Direct Pay BABs, and the effects of the provisions of the **Dodd-Frank** Wall Street Reform and Consumer Protection Act of 2010. This client alert summarizes these recent developments and offers an overview of consequent changes in the operation of the municipal marketplace for the remainder of this calendar year.

In addition, this alert addresses the status of the extension of authorization for certain tax credit bond structures originally enacted by the American Recovery and Reinvestment Act of 2009 ("**ARRA**"), including Build America Bonds and Recovery Zone Bonds, as well as the extension of certain favorable tax law provisions under ARRA relevant to municipal bonds in general.

## Rule 15c2-12 Amendments for Increased Continuing Disclosure

The Securities and Exchange Commission ("**SEC**") recently approved amendments (the "**Amendments**") to its Rule 15c2-12 (the "**Rule**"). The Amendments, effective December 1, 2010 (the "**Rule Change Date**"), include significant additions and changes to the event notice requirements under the Rule and extend the continuing disclosure requirements of the Rule to previously exempted variable rate demand obligations ("**VRDOs**"). Importantly, the Amendments apply only to "primary offerings" (as currently defined in the Rule) occurring on or after the Rule Change Date. Continuing disclosure agreements entered into with respect to bonds issued prior to December 1, 2010, are *not* affected by the Amendments. A summary of the amendments is provided below:

**Variable Rate Demand Obligations**. On or after the Rule Change Date, VRDO's are no longer exempt from the continuing disclosure requirements of the Rule. As a result, VRDO's that are issued as part of a "primary offering" on or after the Rule Change Date will be subject to the continuing disclosure provisions of the newly amended Rule. Because the amended Rule applies only to primary offerings that occur on or after the Rule Change Date, **remarketings of VRDO's that are outstanding prior to the Rule Change Date will not be subject to the newly extended continuing disclosure requirements of the Rule (unless the remarketing constitutes a primary offering)**.

**Notice Events — Materiality**. The current Rule requires issuers to disclose the occurrence of any of eleven listed events ("**Notice Events**") *if the issuer determines that the occurrence of any of the events is material*. The amended Rule removes the materiality standard for seven of these eleven events, requiring that notice be filed upon the simple occurrence of any of the following Notice Events:

1) Failure to pay principal and interest

2) Unscheduled draws on debt service reserve fund reflecting financial difficulties

3) Unscheduled draws on credit enhancements reflecting financial difficulties

4) Substitution of credit or liquidity providers, or their failure to perform

5) Adverse tax opinions

6) Defeasances

7) Rating changes

Additionally, the Amendments expand the current Notice Event category "Adverse Tax Opinions" to include (i) the issuance by the IRS of proposed or final determinations of taxability, (ii) Notices of Proposed Issues (IRS Form 5701-TEB), (iii) other *material* notices or determinations with respect to the tax status of the bonds, and (iv) other events affecting the tax status of the security.

Of the Notice Events existing under the current version of the Rule, pursuant to the Amendments, notice of the following four events will remain necessary only if determined as material:

1) Non-payment related defaults

2) Modifications to the rights of bondholders

3) Redemptions

4) Release, substitution, or sale of property that secures the repayment of bonds

**Notice Events — Additional Listed Events**. Additionally, the Amendments expand the current list of eleven Notice Events to include:

1) Tender offers

2) Bankruptcy, insolvency, receivership, or similar proceeding by an issuer or a borrower

3) Mergers, consolidations, acquisitions and sales of assets (other than in the ordinary course of business), *upon a determination of materiality*

4) Appointment of a successor or additional trustee, or the change in name of the trustee, *upon a determination of materiality*

Note that disclosure of either of the first two additional Notice Events is required regardless of materiality.

**Notice Events — Timing of Notice**. Currently under the Rule notice of the occurrence of a Notice Event must be filed in a "timely manner." On or after the Rule Change Date, issuers or obligated persons **will be required to provide notices within ten (10) business days** of the occurrence of the Notice Event (the "**Notice Period**"). Importantly, the Notice Period is triggered upon the *occurrence* of the event, *not* at the time the issuer or the borrower becomes aware of such occurrence.

As a result of the Amendments, as we approach the Rule Change Date, increased attention will be paid to disclosure related to primary offering documents for VRDO's. In addition, for *all* primary offerings subject to the amended Rule, issuers and borrowers will need to consider the need for continuing disclosure with respect to the expanded list of events. As the Rule Change Date nears, issuers and borrowers are urged to set up good disclosure practices to ensure that notices of Notice Events are filed with the MSRB's Electronic Municipal Market Access system ("**EMMA**") within the Notice Period. Such enhanced disclosure practices may include additional notice covenants in various financing documents — such as requiring parties likely to be in possession of relevant information to provide immediate notice to the issuer or borrower following the occurrence of a Notice Event.

## Build America Bonds — Recent Developments

### Issue Price Concerns

Among the various requirements for bonds to qualify as "Build America Bonds" ("**BABs**"), such bonds may not be issued with more than a "*de minimis* amount" of premium over their stated principal amount, determined on a maturity-by-maturity basis. Whether a BAB is deemed to be issued with more than *de minimis* amount of premium is determined under rules similar to the provisions of Section 1273(a)(3) of the Internal Revenue Code of 1986, as amended (the "**Code**"). Treasury Regulations Section 1.1273-1(d) provides that *de minimis* premium for a bond *means a premium not to exceed .25% of the stated redemption price at maturity of the bond multiplied by the number of complete years from the bond's issue date to its maturity date* (or an earlier call date if the exercise of such call would produce a lower yield on such bond). For bonds that mature in 10 or more years, up to 2.5% of premium over the stated principal amount of the bond may be considered to be *de minimis* premium. This *de minimis* premium limitation applies to "**Tax Credit BABs**" (BABs that provide a 35% refundable tax credit to the holders of the bonds), "**Direct Pay BABs**" (BABs that provide a direct payment subsidy to the issuer equal to 35% of the interest payment due on the bonds) and other "**Direct Pay Tax Credit Bonds**" authorized by the Hiring Incentives to Restore Employment Act (the "**HIRE Act**"). Thus, if Direct Credit BABs are sold with more than that amount of premium in their issue price, the issuer would not get the benefit of BAB treatment and therefore would not receive the 35% subsidy but would still have to pay the higher taxable rate.

The requirement that BABs be issued with only a *de minimis* amount of premium has increased scrutiny by the IRS on the issue price of BABs and has thus increased concern in the public finance community with respect to the issuance of Direct Pay BABs. In particular, two recent developments have suggested that, in order to comply with the requirement, issuers of Direct Pay BABs (directly or through their financial advisors or others engaged for this purpose) may be required to track trading activity and perform due diligence on sales of Direct Pay BABs between the sale date and the delivery date (the "**Delivery Period**").

1. **Compliance Check Questionnaire (Form 14127)** — The IRS is sending a compliance check questionnaire (Form 14127 — revised May, 2010) to all issuers of Direct Pay BABs (the "**Compliance Questionnaire**"). The Compliance Questionnaire asks, with respect to negotiated sales of Direct Pay BABs: (i) whether an issuer or consultant on behalf of the issuer reviewed the trading activity data (if available on EMMA) during the Delivery Period and (ii) whether, during the Delivery Period, any "customer" (as defined in EMMA) purchased the bonds at a price higher than the stated initial offering price of the bonds. Where an issuer indicates that one or more customers purchased the bonds at a price in excess of the initial offering price, the Compliance Questionnaire asks whether the underwriter has explained why the customers were willing to make such a purchase. Through the questions posed in the Compliance Questionnaire, the IRS seems to indicate that issuers have an obligation to follow up with underwriters when bonds have been purchased in excess of the initial offering price during the Delivery Period. The Compliance Questionnaire also asks whether the issuer has written procedures to ensure compliance with the *de minimis* premium requirement. We expect that the IRS will issue a similar compliance questionnaire for Direct Pay Tax Credit Bonds, implying similar diligence obligations for issuers of these bonds.

2. **May 25, 2010 Teleconference** — During a teleconference sponsored by the National Association of Bond Lawyers ("**NABL**") on May 25, 2010, IRS officials indicated that an issuer's reliance on certification by the underwriter as to issue price may not be sufficient to comply with the *de minimis* premium requirement. Instead the IRS officials suggested that the issuer, or consultants on the issuer's behalf, should monitor the pricing data of Direct Pay BABs (if the pricing data can be found on EMMA). Furthermore, it was stated that if an issuer finds pricing trends above the initial offering prices, the issuer should

seek an explanation from the underwriter. In other words, the IRS officials strongly encouraged issuers of Direct Pay BABs to perform due diligence before simply accepting an underwriter's issue price certificate at face value.

On the May 25th call, the IRS officials cited three situations in a negotiated underwriting context that should prompt issuers to question whether Direct Pay BABs have been offered to the public above the stated initial offering price and to seek an explanation from the underwriter:

(i) EMMA trade data shows that a portion of a maturity had been purchased by some customers at the initial offering price and other portions by customers at prices in excess of the initial offering price.

(ii) EMMA trade data shows an upward trend in prices that some portion of a maturity was sold directly or indirectly to the underwriter, affiliates of the underwriter or related accounts of the underwriter.

(iii) EMMA trade data shows that the dealers were the purchasers of all or a portion of a maturity at the initial offering price and then offered the same bonds to customers at prices in excess of the initial offering price.

These examples describe potential "flipping" situations where a dealer or institutional investor purchases a bond and then immediately resells it to a retail investor at a higher price. Following the May 25th call, market commentators have expressed concern that, in an audit situation, the IRS might use such trading information to conclude that the BABs were sold with more than a *de minimis* amount of premium and as a consequence might withhold or reduce the subsidy payment to the issuer.

Since the NABL teleconference, other IRS officials have sought to mollify issuer concerns as to these new due diligence responsibilities — emphasizing that IRS Notice 2010-35 (April 26, 2010), specifically states that the issue price definition applicable to traditional tax-exempt bonds under Treasury Regulations Section 1.148-1(b) also applies to BABs. Notwithstanding these more recent IRS statements, there remains significant uncertainty in the public finance community as to what prudent steps an issuer should undertake to protect the subsidy provided by the U.S. Government for Direct Pay BABs and Direct Pay Tax Credit Bonds. Consequently, we recommend that issuers ask their financial advisors or other consultants to monitor the trading activity of their Direct Pay BABs during the Delivery Period, to the extent such trading activity is available on EMMA. We also recommend that issuers of Direct Pay BABs request written explanation from the underwriters of any trading activity that reflects prices in excess of the initial offering prices. We are aware of several independent advisors willing to review the EMMA data for issuers for a fee one has quoted to us a fee of $500 per issue for this service).

**Offset Concerns**

Issuers should remember that the legislation authorizing BABs provides that the subsidy payments for Direct Pay BABs can be offset against outstanding obligations owed by the issuer to the federal government in non-bond related programs. Examples of outstanding obligations include an issuer's failure to timely pay payroll taxes in full or to make certain grant repayments or health care payments to the federal government. Even where the amount owed to the federal government is in dispute, it is possible that the Treasury Department may still apply an offset or reduction against the subsidy payments to the issuer, leaving the issuer with less money than budgeted for BABs interest payments. This possibility may be of more concern for some Direct Pay BABs issuers than for others. In particular, issuers that have slimmer cash flow margins might be advised to investigate the potential of federal offsets and understand how delayed or reduced subsidy payments may impact the issuer's financial condition, including its ability to pay debt service.

## Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

Dodd-Frank, signed last week by President Obama, makes modest changes in the regulatory scheme governing municipal finance and lays the groundwork for future changes.

**MSRB Changes**

The greatest immediate changes are in the structure and jurisdiction of the Municipal Securities Rulemaking Board ("**MSRB**"). Historically, the MSRB was a "self regulatory" body controlled by municipal securities dealers (who constituted two-thirds of its membership) with rule-making power limited to municipal securities dealers. Under this structure, going back to 1975, independent financial advisors often alleged that the MSRB was controlled for the benefit of municipal securities dealers, while municipal dealers, many of which serve as financial advisors, complained about an "uneven playing field" because they were subject to MSRB rules while serving as a financial advisor, but independent financial advisors were not subject to such rules. The new provisions reflect an attempt to address both concerns. Municipal securities dealers will now constitute only a minority of the MSRB's membership and at least one member must be associated with a "municipal advisor" with the strong expectation that such a person would be an employee of an independent financial advisory firm. With a broad definition of "municipal advisor," the provisions also address widespread concerns that a variety of advisory firms that are not subject to any direct form of regulations have in recent years provided inappropriate advice to municipal issuers on derivatives and investment contracts.

"Public Members" must now constitute a majority of the MSRB and must be persons "not associated with any broker, dealer, municipal securities dealer, or municipal advisor." There may be some uncertainty as to how these definitions apply to lawyers, consultants and others who do work for investment banking firms.

The expanded jurisdiction gives the MSRB power to make rules applicable to "municipal advisors," a broadly defined terms that clearly includes independent financial advisors not previously subject to MSRB rules as well as GIC and swap providers. The application definition includes any person that:

> provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structuring, timing, terms, and other similar matters concerning such financial products…

The provisions will require any "municipal advisor" to register with the MSRB and be subject to rules relating to training and supervision. Municipal advisors will be prohibited from communications "in connection with which such municipal advisor engages in any fraudulent, deceptive, or manipulative act or practice."

The provisions appear to give the MSRB discretion in determining whether all of its rules will apply equally to all regulated parties or instead certain rules will apply to regulated parties playing particular roles. The MSRB will be grappling with these issues in the next few months. The MSRB is required to have the public member board majority in place by October 1, 2010, which suggests that it may at least temporarily exercise its right to expand its membership to a number larger than 15.

In the coming months the MSRB will be required to determine what of its current rules, in existing or modified form, will apply to "municipal advisors." Those of special importance include the following:

> **G-17**. Rule G-17 is a rule currently requiring that regulated parties "shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice." The breadth of this rule is obvious on its face. The concept of "unfair practices" almost certainly goes beyond the traditional requirements for proof of fraud.
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> **G-20**. Rule G-20 severely limits the amounts of gifts regulated parties may make "in relation to the municipal securities activities of the employer of the recipient." This limits gifts to employees of municipal clients such as public officials and employees of non profit organizations for whom conduit bonds are issued. If applied to independent financial advisors, the rule would limit their ability to make gifts to client employees.

**G-37**. Rule G-37 severely limits political contributions to elected officials by regulated parties doing business with public bond issuers directly or indirectly controlled by such officials. Application of this or a similar rule to financial advisors would make them subject to the MSRB's "pay to play" regime.

**Studies of Municipal Disclosure and Municipal Markets**

Despite the support of several members of the Securities and Exchange Commission, Dodd-Frank did not repeal the "Tower Amendment" limiting the ability of both the SEC and the MSRB to require municipal issuers to file with either body. Instead Dodd-Frank requires the Comptroller General of the United States to undertake two studies: (1) a "study and review of the disclosure required to be made by issuers of municipal securities" and (2) "a study of the municipal securities markets."

The first study must include a description of the disclosure practices currently in the municipal market, comparisons with disclosure practices in the corporate securities markets and an evaluation of the costs and benefits of both issues and investors of additional disclosures. The study is to be completed in not more than 24 months and is specifically required to contain recommendations for municipal disclosure requirements, including repeal or retention of the Tower Amendment.

The second study, due in 18 months, is to address "the mechanisms for trading, quality of trade executions, market transparency, trade reporting, price discovery, settlement clearing, and credit enhancements" and likewise to contain recommendations for improvement.

These two studies will likely lay the groundwork for future attempts to impose additional regulation on municipal disclosure and municipal market practices.

**Swaps and Hedges**

Dodd-Frank has delegated to the Commodity Futures Trading Commission (the "**CFTC**") and, in lesser part, to the SEC, the power to regulate the swaps market. Most of the anticipated regulatory requirements will be imposed on swap dealers and major swap participants. It appears unlikely that any municipality engaging in swaps or other hedges to "hedge or mitigate commercial risk" will be directly impacted by the provisions of Dodd-Frank in this area.

However, all swaps will be reported to a swap data repository. In addition, compliance with Dodd-Frank by counterparties to municipal swaps will increase their costs. These requirements may include meeting and maintaining initial and variation margin requirements on uncleared swaps, clearing other swaps with a regulatory agency, maintaining applicable prudency standards, and collateral requirements. Notwithstanding that Dodd-Frank includes a provision requiring regulators setting such rules to take into account the potential cost to end users, it seems nearly certain that the cost of swaps for public finance entities will increase under Dodd-Frank.

Finally, Dodd-Frank contains language that should prevent counterparties from requiring end users on current swaps to post margin or collateral on the basis of a change in law, but there are some variations in contract language which that may make this ineffective.

For more general information on Dodd-Frank see recent Hunton & Williams Client Alerts on Dodd-Frank.

## Extension of Tax Credit Bonds and Municipal Bond Tax Law Provisions under ARRA

Several of the provisions of ARRA permitting new bond structures expire this year, unless they are extended by Congress. These types of bonds include BABs (Code Section 54AA(g)), Qualified School Construction Bonds whether issued with a credit to holders or with direct pay credit to the issuer (Code Section 54F(c)), GO Zone Bonds for repair and reconstruction (see Code Section 1400N(a)(7)), certain mortgage revenue bonds in GO Zones (Code Section 1400T(b)), Recovery Zone Facility Bonds (Code Section 1400U-3(b)(1)), and Recovery Zone Economic Development Bonds (Code Section 1400U-2(b)(1)).

Several bills in Congress, including HR 4213, the American Jobs and Closing Tax Loopholes Act of 2010 (renamed the Unemployment Compensation Extension Act of 2010 just before passage) have included extensions of certain tax provisions of ARRA, but no bill incorporating such extensions has passed both houses of Congress. Extenders of ARRA provisions that have been considered by Congress include the following:

- **Build America Bonds** — Authorization for BABs for an additional two years through December 31, 2012, with a reduced subsidy for Direct Pay BAB's (for example, 35% in 2010 to 32% in 2011 and 30% in 2012.)
- **Recovery Zone Bonds** — Extension of the deadline for issuing Recovery Zone Facility Bonds and Recovery Zone Economic Development Bonds to December 31, 2011, with an additional allocation of both kinds of Recovery Zone Bonds in 2011.
- **Bank Qualified Bonds** — Extension of the provisions ARRA that (i) increase the bank qualified limits under Section 265(b)(3) of the Code from $10,000,000 to $30,000,000 and (ii) permit 501(c)(3) issuers to be treated as bank qualified issuers through the end of 2011 (but no extension of the *de minimis* exception of banks found in 265(b)(7)).
- **AMT** — Extension of the exemption of tax-exempt private activity bonds and current refundings of bonds issued after 2003 from AMT through the end of 2011.

There are efforts underway to have Congress consider these or comparable provisions as soon as Congress returns after the August recess. On Monday July, 26, 2010 Senator Levin of Michigan was reported as intending to submit a new bill on extensions, "including many" of the extension provisions previously considered by Congress. But, no assurance can be made that extension provisions will be introduced or passed, leaving the possibility that the current provisions and expiration dates will remain in place. Further, even if the provisions authorizing them are extended, such bonds will be less valuable to the issuers (*e.g.*, the credit percentage on BABs would be reduced from 35% to 32% or lower). As a result, we expect to see significant efforts made by issuers to advance into fourth quarter 2010 issues which would otherwise have been issued in 2011 or even 2012. Accordingly the volume of bond issues in the fourth quarter is likely to be record-breaking. We recommend that issuers take into account this expected bulge in volume in the market at year end and the likely consequent effects on bond pricing.

For more information on any aspect of the various subjects discussed in this alert, please contact any of the Hunton & Williams public finance attorneys listed hereon.

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