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Over the past ten months there have been a host of announcements, notices, revenue procedures, web releases, private letter rulings, budget reports, and legislation, but no regulations or revenue rulings. The guidance covers a wide variety of areas associated with tax-exempt bonds.

Extenders Bill
The 111th Congress managed to bring one more tax bill to closure by the end of 2010, although it lacked many of the bond provisions the municipal bond community had hoped would be included, and it definitely lacked a snappy title or acronym. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. No. 111-312) (the “Extenders Act”) was signed into law on December 17, 2010, and extended four tax-exempt bond provisions and one tax credit bond provision. Most notable is the fact that none of the “stimulus” bond provisions were extended, even the Build America Bond (“BABs”) provisions that the Obama Administration had supported. Apparently as part of the compromise that allowed any tax bill to move forward, anything that looked like it originated in the American Recovery and Reinvestment Act of 2009 (“ARRA”) was not included in the package.

Qualified Zone Academy Bonds (“QZABs”) survived, with an extension of one year, but at the pre-ARRA volume cap level of $400 million and without the ability of issuers to elect to receive a direct subsidy for bonds issued using this volume cap. This throws issuers back into the hunt for purchasers who need tax credits. While the QZAB market had pretty well shut down as a result of stringent rebate requirements enacted in 2006 and a smaller market of potential purchasers with a need for tax credits, the improved rebate and spending provisions of Section 54A of the Code will, one hopes, eliminate one of the barriers to the sale or placement of QZABs as it is no longer possible to issue such bonds with taxable interest and a direct subsidy.

Although it is not particularly clear in Section 758 of the Extenders Act, the Joint Committee on Taxation’s explanation (JCX-55-10, December 10, 2010) (the “Blue Book”) states that the elimination of the direct subsidy election does not apply to 2009 and 2010 QZAB volume allocations, even if these allocations are carried forward to bonds issued after December 31, 2010, the effective date of the QZAB provisions of the Extenders Act. This is helpful, but also illustrates the increasingly complicated world of effective date language. We can no longer rely on provisions tied to the date of sale or issuance but also must look to the particular volume cap year.

Section 101 of the Extenders Act extended through December 31, 2012, the expiring provisions enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001. In the context of tax-exempt bonds, this means that, pursuant to Section 148(f)(4)(D)(vii), the small issuer rebate exception of $5 million can be increased by an additional $10 million of bonds issued to finance the costs of construction of public schools. Section 142(k) remains available as a qualified private activity bond category to finance elementary and secondary public school facilities that are operated by a public school system under a public-private partnership agreement with a “corporation.” This provision has not been used extensively, in part because the statutory language implies that the private corporation is not treated as the tax owner and in essence would
merely be serving as a financing accommodation party, eliminating much of the incentive for a private corporation to participate.

The remaining tax-exempt bond provisions in the Extenders Act all deal with geographically-limited provisions. Sections 753 and 754 extend the ability to issue enterprise zone facility bonds in federally designated empowerment zones and the District of Columbia enterprise zone, respectively, through December 31, 2011. New York Liberty Zone Bonds can be issued through 2011. Gulf Opportunity Zone bonds under Section 1400N(a) (for exempt facilities) were extended for a year and must now be issued before January 1, 2012, and the non-codified provisions relating to Midwestern Disaster and Hurricane Ike tax-exempt bonds are also extended for one year to bonds issued before January 1, 2012. In each case, no new volume cap was awarded, so some areas will not be able to take advantage of the extension. While we do not want to look a gift horse in the mouth, each of the tax provisions in the Extenders Act is fairly narrow and consequently there is a higher probability that such provisions will not be as fully used as taken into account in determining the tax expenditures; broader provisions may have been fully used.

Several tax-exempt bond provisions quietly rode off into the sunset. The expiring provisions that were not extended are as follows:
1. Modification of AMT limitations on tax-exempt bonds (Sections 57(a)(5)(C)(vi) and 56(g)(4)(B)(iv)).
2. Qualified mortgage bonds for refinancing of subprime loans (Section 143(k)(12)).
3. Expansion of availability of small issue manufacturing bonds to facilities manufacturing intangible property (Section 144(a)(12)(C)(iii)).
4. Volume cap increase (“bonus cap”) and set-aside for private activity bonds for housing (Section 146(d)(5)).
5. Bonds guaranteed by Federal Home Loan banks eligible for treatment as tax-exempt bonds (Section 149(b)(3)(A)(iv)).
6. Modification of small issuer exception to tax-exempt interest expense deduction disallowance rules for financial institutions (Section 265(b)(3)(G)).
7. 2% de minimis safe harbor exception for tax-exempt interest expense deduction for financial institutions (Sections 265(b)(7) and 291(e)(1)(B)(iv)).
8. Authority to issue Recovery Zone Economic Development Bonds (“RZEDBs”) and Recovery Zone Facility Bonds (“RZFBs,” and together with RZEDBs, “RZ Bonds”) (Sections 1400U-2(b)(1) and 1400U-3(b)(1)(B)).
9. Increase in maximum rehabilitation costs and treatment as targeted residence for qualified Hurricane Katrina residences financed with mortgage revenue bonds (Section 1400T(b)).

**Draw-down Bond Guidance**

After promising for several months to provide guidance on the application of statutory deadlines in the context of bonds issued as so-called draw-down bonds, the Service and Treasury released Notice 2010-81 on November 23, 2011 (2010-50 IRB 825, December 13, 2010) (the “Draw-down Notice”), only two days before Thanksgiving. Without any bad jokes related to turkeys, the Draw-down Notice provided both finality to certain issues and confusion in an arena that tax lawyers had long thought settled.

The Draw-down Notice creates special rules as to the issue date of “bonds” that are part of an “issue of bonds” subject to certain statutory deadlines by which the bonds must be issued.
In particular, the Draw-down Notice states that a draw under a draw-down bond will be treated as issued on the draw date for purposes of provisions “such as” BABs under Section 54AA(d), 54AA(g), and 6431, Recovery Zone Bonds under Sections 1400U-1 through 1400U-3, alternative minimum tax provisions of Sections 56(g)(4)(B)(iv) and 57(a)(5)(C)(iv), Gulf Opportunity Zone Bonds under Section 1400N, and, in a surprise move because it was not an ARRA provision, the various tax-exempt bond volume cap provisions of Section 146 of the Code.

The Draw-down Notice specifically states that this issue date analysis does not apply to the small issuer bank-qualified provision and the 2% de minimis holdings provision for bank interest expense deduction rules of Section 265(b). Section 265(b) had been the subject of Revenue Ruling 89-70 (1989-1 CB 88), which concluded that for purposes of Section 265(b), a draw-down note is issued on the date on which more than a de minimis amount of funds is first advanced under the note. The question presented in Revenue Ruling 89-70 was what amount had been issued in 1988 for purposes of the $10 million limit on qualified tax-exempt obligations. The Service looked to the statutory intent to limit the availability of bank-qualified debt and several regulations under Section 103 to reach its conclusion. While the $10 million limit is not identical to the statutory deadline for issuance contained in the ARRA provisions, it is similar enough to raise concerns about what general rule, if any, may be available. The Draw-down Notice says that Revenue Ruling 89-70 will continue in effect until further guidance is provided, “which guidance will be prospective.” The notion of prospective guidance rubs a little salt in the wound here because the Draw-down Notice has no effective date and is presumably retroactive. This is particularly surprising because the guidance was issued as a notice rather than a revenue ruling (often viewed as retroactive) or a regulation (usually prospective and subject to public comment).

Many had argued that the legal analysis provided in Revenue Ruling 89-70 should be the guiding principle for analyzing draw-down bonds, regardless of whether it was favorable or unfavorable for a particular bond rule. The approach taken in the revenue ruling also had the advantage of dovetailing with the regulations under Section 149 on filing of Form 8038 and, arguably, under Section 150 for determining when a bond was a single issue for a variety of bond purposes. However, that argument apparently was not the winner internally at the Service and Treasury, and practitioners must now try to sort out the practical problems that arise from this different approach. While the Service and Treasury have indicated an interest in helping to deal with the practical problems arising in the wake of the Draw-down Notice, no guidance has been released to date.

One of the practical problems arising from the Draw-down Notice and its presumably retroactive effect is the filing of Form 8038s, particularly for BABs and RZ Bonds issued prior to the release of the Draw-down Notice. Form 8038-B requires the issuer to indicate the issue price and attach a debt service schedule. The FAQs for filing Form 8038-B (released prior to the Draw-down Notice) dealt with draw-down bonds and stated that the issuer should attach an expected debt service schedule with expected subsidy payment amounts, on the theory that the actual interest amount could not be calculated at issuance. The Form 8038-B filed for draw-down BABs or RZEDBs would, based on Treas. Reg. § 1.149(e)-1(c)(2)(ii), use the maximum amount expected to be drawn down as the issue price and the schedule would have been based on the maximum amount expected to be drawn. These regulations have not been altered, and presumably the Service does not want a separate Form 8038-B filed for each draw, but if the full
amount was not drawn by December 31, 2010, the issue price for these previously filed Form 8038-Bs is inaccurate. Should an amended Form 8038-B be filed? How should costs of issuance be handled if the amount drawn before December 31, 2010, does not support the costs of issuance actually paid at closing and recorded on the originally filed Form 8038-B? Presumably the issuer can do a final allocation between BABs and the remaining taxable draws for the total costs of issuance to avoid a violation of the 2% limit. The expected direct subsidy amount can be recalculated for purposes of the Form 8038-CP filing, but should the issuer also attach a new schedule for the bonds based on the amount that was ultimately drawn by December 31, 2010? For draws made after December 31, 2010, the issuer still owes the taxable rate to the holder. Most draw-down loans are amortizing loans, without separate maturities, so should the issuer treat the BABs portion as amortizing last in order to try to recoup some of the subsidy it thought it would get when it agreed to pay the higher taxable rate to the holder, or can the subsidy only be calculated based on the percentage drawn by December 31, 2010 and applying that percentage to the total interest paid (thus assuming that the BABs portion is paid down pro-rata)?

Perhaps the most vexing problem arising in the fallout from the Draw-down Notice has centered around the reference to volume cap under Section 146. The private activity bond volume cap has a general statutory rule permitting the cap to be carried forward up to three years if the appropriate forms are filed, but the carryforward is required to be used on a first-in, first-out basis. Draw-down bonds requiring private activity bond volume cap, such as multifamily housing bonds, that were issued prior to the release of the Draw-down Notice would have received an allocation for the maximum amount that could be drawn and the Form 8038 would have been filed with the volume cap certification for that maximum amount. In some cases the volume cap was a carryforward, including a carryforward of the so-called “bonus cap” under the Housing Act of 2008, which had to be used by December 31, 2010. In many cases it was not possible for the draws to be accelerated to cause cumulative draws equal to the full amount by December 31, 2010, because the lender was unwilling as a financial matter to accelerate or the budget numbers were so tight that the project could not afford the negative arbitrage on funds sitting in an account waiting to be applied as construction progresses. Given the release date of the Draw-down Notice, issuers were not able to pull back the allocation that was not expected to be used under the rules of the Draw-down Notice to reallocate to another project, and even if able to find another project by the end of 2010, under the first-in, first-out rule, the allocation may have been required to go to project that had already received an allocation from another carry-forward that now would not meet the first-in, first-out rule. The issue is further complicated by the fact that the authority to make allocations and all the various rules associated with allocations was given to the states and some state procedures simply could not accommodate the cascading effect of the new approach announced in the Draw-down Notice.

The Service and Treasury have suggested that draw-down loans that involve construction should be given current year volume cap, which can be carried forward for the maximum time, but that may not be possible with the first-in, first-out rule. Lenders are rightfully concerned about whether the project will be able to obtain the full amount of volume cap if the draws span different calendar years, and some projects are on hold waiting for states and the Service to sort this out. This is particularly a problem for low income housing tax credit projects, which obtain the tax credits pursuant to rules under Section 42 that are based on at least 50% of the project costs being financed with tax-exempt private activity bonds. If parties cannot get assurance that
the bonds drawn across several years will obtain the allocation amount sufficient to meet the 50% test, the project may not move forward.

A more subtle problem exists for draw-down bonds that were issued to finance manufacturing projects before the release of the Draw-down Notice. Section 146 does not permit volume cap to be carried forward for manufacturing bonds under Section 144(a). Due to the small size of these bonds, they are often placed with banks as draw-down loans. If the full amount could not be drawn by December 31, 2010, the remaining draws would be tax-exempt only to the extent that the issuer was willing to award a portion of its 2011 volume allocation. If the manufacturing project took advantage of the temporary rule permitting financing of facilities that manufactured intangible products, draws after December 31, 2010 would not qualify for tax-exempt financing even if 2011 volume cap was available. Going forward, these manufacturing transactions will be more difficult if the project cannot be completed and funds fully drawn within a calendar year if the State cannot make promises as to volume cap availability in subsequent years.

The Draw-down Notice takes a position somewhat contrary to an earlier private letter ruling addressing the applicability of the favorable ARRA alternative minimum tax provisions to an issuer’s commercial paper notes. In PLR 201038014 (dated June 25, 2010 and released September 24, 2010), the Income Tax and Accounting Branch of the Service looked to Treas. Reg. § 1.150-1(c)(4) to conclude that the issue date of commercial paper was the date the aggregate amount of commercial paper issued under a program exceeded the lesser of $50,000 and 5% of the aggregate issue price of commercial paper in the program, which date was after December 31, 2003. The issuer had proposed to issue bonds to refund all the outstanding notes issued under the commercial paper program prior to January 1, 2011, and sought a ruling that the interest on the refunding bonds would not be subject to AMT pursuant to the special refunding rules of Section 57(a)(5)(C)(vi). The special refunding exception provides that bonds issued after December 31, 2003, and before January 1, 2009, are not subject to AMT. The commercial paper program otherwise met the requirements for treating all issuances under the program as a single issue, in that all issuances were within 18 months of the first issuance, the final maturity did not exceed 30 years from the issue date, and the issuer had elected to treat the issuances under the program as a single issue.

The AMT relief under the special refunding exception was part of ARRA. The single issue rule of Treas. Reg. § 1.150-1(c)(4) for commercial paper is almost identical to the single issue rule of Treas. Reg. § 1.150-1(c)(3) for draw-down bonds. The PLR was issued before Notice 2010-81 by a branch of the Service not involved in Notice 2010-81. Although the actual dates are redacted in the ruling, it appears as though all new money issuances were accomplished before Notice 2010-81 and thus, even applying the revised issue date rules applicable to AMT relief under Notice 2010-81, all of the notes would have been issued before the statutory deadline, whether treated as a single issue or as the issuance of separate bonds. The result seems to point out the potential difficulties of changing long-established regulations without a readily identifiable principle such that other parts of the Service may apply the wrong rule.

**VCAP Program Related to Debt Extinguishment**

Various reissuance notices issued starting in 2008 and culminating in Notice 2010-7 (2010-3 IRB 296, December 22, 2009) have progressively moved the final date of the holding period during which state and local government issuers were permitted to purchase and hold their own
tax-exempt bonds without resulting in extinguishment of the bond. Notice 2008-41 (2008-15 IRB 742, April 14, 2008) provided perhaps the clearest explanation of the tax issue raised by the purchase by issuers of their own debt. Under the tax rules, such a purchase by an issuer of its own debt would, absent the special rules, result in the extinguishment of the debt, and in the absence of a refunding or purchase by an unrelated party, the original debt could not be refinanced under the general tax-exempt bond rules once extinguished. The series of notices acknowledged the inability of issuers to find purchasers of their bonds, particularly auction rate and qualified tender bonds during the period of market disruption.

Announcement 2011-19, released on February 25, 2011, 2011-11 IRB 553 (March 14, 2011) (the “Extinguishment Guidance”), does not technically extend the prior December 31, 2010 deadline, but instead provides a voluntary closing agreement program that permits extension of the deadline – at a price. The VCAP offer must be submitted by December 31, 2012 and will be available only for those bonds that are likely to be successfully remarketed or reissued within up to a 180-day period. Under the Extinguishment Guidance, bonds will be treated as outstanding during the period beginning on the later of January 1, 2011, and the date the issuer purchases its own bonds and ending on the earliest of: (1) the date that is 180 days after execution of the closing agreement with the IRS or any earlier date requested; (2) the date the bonds are successfully sold to a third party; (3) the date the bonds are successfully currently refunded; and (4) the date the bonds are cancelled on the books and records of the issuer. For the majority of bonds to which the Extinguishment Notice applies, issuers will want to submit a request as quickly as possible to protect the status of the bonds, though the Extinguishment Notice obviously accommodates market disruption rates, which may happen at any time prior to the December 2012 deadline.

The ability to take advantage of this VCAP offer is conditioned on three things. First, the issuer must submit a resolution that has been adopted regarding its intent to resell or currently refund the extinguished bonds as tax-exempt bonds within the time period described above, and the resolution must be based on the opinion of the issuer’s financial advisor as to the likely success of such intent to resell or refund. Second, the issuer must represent that the debt is still outstanding under state law and, assuming that the bonds are treated as remaining outstanding, qualify as tax-exempt obligations under Section 103 of the Code. These representations may come from the issuer itself or may be established by an opinion of bond counsel. Finally, the issuer must pay a fee equal to the par value of the outstanding bonds to be held by the issuer multiplied by .029% for each month from the later of January 1, 2011, and the date of purchase of the extinguished bonds and continuing through the closing date of the VCAP. The original version of the Extinguishment Notice stated the penalty percentage as “one thirty-fifth of one percent (.35%),” which caused a lively debate reminiscent of law school as to whether the written amount of “one thirty-fifth of one percent” trumped the numerical portrayal in the parenthetical “(.35%).” TEB clarified that .029% was the correct number, and this appears both in the Internal Revenue Bulletin and on the TEB website.

In early Fall 2010, the IRS raised concerns about whether the purchase by a state pension fund of that state’s BABs would result in an extinguishment of the BABs on the theory that the pension fund was related to the state. On December 29, 2010, the IRS announced on its website that it expected to release further guidance on extinguishment of debt, which some observers may have thought would be covered by the upcoming guidance. However, as it turned out, the Extinguishment Guidance does not deal with the BABs related party issue.
Annual Updates

Inflation Factors. Revenue Procedure 2010-40, 2010-46 IRB 663 (November 15, 2010) contains the indexed numbers for several tax-exempt bond provisions. Section 3.09 raises the 2011 volume cap to the greater to $95 for each resident of the state and $277,820,000 (up from $90 and $273,775,000, respectively). Section 3.10 raises the loan amount for land for first time farmers to $477,000. Section 3.11 increases the rebate computation credit of Treas. Reg. § 1.148-3(d)(4) by $20 to $1,520. The broker fee safe harbor is increased from $35,000 to $36,000, and the overall limit for broker fee for an issue is similarly raised by $1,000 to $101,000; the minimum per contract broker fee safe harbor remains at $4,000.


2011 QZAB Volume Cap Allocation. Revenue Procedure 2011-19, released on January 21, 2011 (2011-6 IRB 465), provides the allocation of the $400 million of QZAB authority for calendar year 2011. QZAB volume cap is allocated to states in proportion to their respective populations of individuals below the poverty line (as defined by the Office of Management and Budget). All of the states with an overall population in excess of 10 million residents received a QZAB allocation in excess of $10 million. Puerto Rico, with a population of 3,725,789, received an allocation of $15,765,000, which was larger than that allocated to the more populous states of Michigan, Illinois, Ohio, and Pennsylvania.

Among the 56 state, territory, and possession allocations, 12 were below $1 million for the entire state, and only 10 had allocations in excess of $10 million, again for the entire jurisdiction. The 2% limitation on costs of issuance will make it difficult to issue these small bond issues.

Income Limits for Mortgage Revenue Bonds. Revenue Procedure 2011-37, (2011-26 IRB 663 (June 27, 2011), provides information necessary for calculating area median income figures for mortgage revenue bonds and mortgage tax credit certificates under Sections 143(a) and 25(e) of the Code, respectively. Based on HUD data (www.huduser.org/portal/datasets/il.html), the national area median income of $64,200 again decreased from the prior year, though only by $200. Section 143(f) of the Code permits issuers to use either the applicable median gross income as released to HUD regional offices on May 14, 2010, or the data released on May 31, 2011, in each case requiring that issuers use the selected data consistently. Revenue Procedure 2011-37 generally applies to commitments to provide financing that are made, or if the purchase precedes the financing commitment for residences that are purchased in the period that begins May 31, 2011, and ends on the date Revenue Procedure 2011-37 is rendered obsolete by a new revenue procedure. Revenue Procedure 2011-37 itself renders Revenue Procedure 2010-23 obsolete.

Although Revenue Procedure 2011-37 does not technically apply to the income limits with respect to residential rental projects under Section 142(d) of the Code, the HUD data is so used. The official release of the figures has moved from March to May this year, and though it generally does not apply retroactively, the change in dates may affect the operational rhythm of long-time residential rental projects that qualify tenants to meet the set-aside requirement.

Purchase Price Limits for Mortgage Revenue Bonds. On March 22, 2011, the Service released Revenue Procedure 2011-23, 2011-15 IRB 626 (April 11, 2011), which provides the average purchase price for purposes of mortgage revenue bonds under Section 143 of the Code and
mortality credit certificates under Section 25 of the Code. The national average purchase price increased to $220,000, up from $217,300 last year. The Revenue Procedure provides the information for the states, District of Columbia, and possessions and territories. The method used has not changed from the prior year.

Advance Refunding Bonds Compliance Check Questionnaire
On May 24, 2011, TEB released a copy of a new compliance check questionnaire that it sent to approximately 269 governmental issuers and 31 501(c)(3) organizations that were conduit borrowers of advance refunding bonds issued during the one-year period from July 1, 2009, through June 30, 2010. The questionnaire covers familiar ground with some of the questions related to written procedures, record retention, documentation of issue price, training in post-issuance compliance, and awareness of VCAP and other remedial actions. Beyond the general questions, the questionnaire seems to target the extent to which advance refundings are used to free up revenues (perhaps directed to the budget crises faced by many state and local governments) and extends the previous inquiries into bidding procedures and yield-restricted escrows.

The first portion of the questionnaire delves into state law procedures that are applicable to embarking on an advance refunding, including questions related to the level of approvals and the need to establish savings. The questionnaire asks which party is responsible for determining whether the specific tax law requirements are met, such as whether the permitted number of advance refundings has been exhausted and whether the bonds are being redeemed in a timely fashion. The questionnaire also moves to the sublime by asking who determines whether the refunding will result in an overburdening of the market.

TEB has obviously learned some lessons in survey techniques, as the questionnaire now has more “N/A” options, and the questions with respect to written procedures has “written” underscored. The final questions on awareness of remedial actions should help TEB in reporting on its outreach efforts.

TEB has announced that it has a new group headed by Bob Griffio to deal with “distressed governments.” While state and local governments have requested additional guidance on long-term working capital and for relief to deal with large budget gaps, this TEB group was described at the NABL Tax and Securities Institute as hoping to be creative in dealing with budget deficits but not intending to give a pass for violations. Given the nature of the questions, this questionnaire would seem to be part of that effort.

Streamlined Form 8038-CP Filings
TEB announced a streamlined process for the filing of Form 8038-TC for QSCBs and QZABs with multiple maturities. The procedure is not available for new CREBs or QECBs.

TEB released a copy of a letter being provided to issuers of QSCBs and QZABs outlining specific changes to lines of the form. In general, the issuer is to provide aggregate interest information on Line 19, both as calculated at the tax credit rate and at the bond rates.

The alternate method would seem to be an efficient method for processing subsidy payments, but apparently at this point TEB is only willing to do this for bonds that provide a 100% credit. It would seem a natural extension to permit one form for any of the tax credit bonds with a backup schedule from the issuer calculating the subsidy payment for each maturity, so that will, one hopes, be the next step. The fewer checks processed, the less stress on the system. At
this point, it is probably hard to predict how many tax credit bonds have more than one maturity. With the tax credit version, it was to the advantage of the parties to maximize the credit by leaving principal outstanding. The same incentives may not exist in the direct subsidy option if the interest rate exceeds the permitted tax credit rate.

The letter notes that the original method of a separate filing for each maturity will continue to be available until the instruction form is changed.

**Form 8038 Revisions**

The Service released revisions to three of the Form 8038s – Form 8038, Form 8038-R (requests for refunds), and Form 8038-T (rebate and yield reduction payments). All forms were updated to provide a space for the issuer to identify a representative not employed by the issuer with whom the Service can communicate about the particular Form 8038 filing and to require Paid Preparer information. With respect to the designated representative, the instructions are clear that if an issue designates a person who is not the issuer, the issuer is waiving the disclosure restrictions that would otherwise prevent the Service from speaking to anyone other than the issuer. Given the increasing amount of information requested on the Form 8038, it may almost negate the need for a Power of Attorney in subsequent inquiries. The Paid Preparer information certainly seems more appropriate for the Form 8038-R, 8038-T, and 8038-CP, each of which is essentially a payment form, but its extension to Forms 8038, 8038-G, and 8038-TC still seem to be a bit over-reaching for an information return.

As might be predicted, Form 8038 now requires the issuer to respond with regard to whether a guaranteed investment and/or swap have been entered into with respect to the bond issue, with the name of the provider and additional information required in both cases, and as with revisions to other versions of Form 8038, the issuer must indicate whether it has written procedures for taking remedial actions upon noncompliance and for monitoring compliance with arbitrage and rebate requirements. However, Form 8038 has now added yet another question related to compliance at issuance, this time requesting the amount of proceeds to be used for reimbursement and the date of the declaration of intent. This question seems destined to be added to Forms 8038-G, 8038-GC, and 8038-TC in the next go-around.

The questions about written procedures for compliance have raised some issues, as typically Form 8038 would be used in the context of a conduit financing where the conduit borrower rather than the issuer may be in control of most elements of compliance. This further highlights the lack of clarity as to the responsibility of a conduit issuer vis-à-vis the conduit borrower. The issuer may feel that the indenture and loan agreement lay out the allocation of responsibility for compliance, and indemnification provisions to protect the issuers from the consequences of the failure of the conduit borrower to comply are a mainstay of the indenture and loan documents. Both the role of the conduit issuer and the nature of the written procedures that the Service might view as adequate need to be clarified, particularly when the issuer is signing the form under penalty of perjury and bond counsel is often signing as Paid Preparer.

If the conduit borrower is a 501(c)(3) organization, it is likely to have faced the matter of written compliance procedures because of the questions in Schedule K to Form 990. For manufacturers or other for-profit entities that may borrow only once on a tax-exempt basis, the notion of written compliance procedures may be an entirely foreign concept, and these conduit borrowers may well believe that the tax certificate or loan agreement are the written procedures.
In the context of proposed amendments to Circular 230 that would extend to tax-exempt bond opinions, the Service raised questions about the level of due diligence completed before issuance. NABL and several other organizations have developed checklists to address this concern. While the Service never formally responded with respect to whether it thought the checklists were sufficient to address its concerns, as more questions are added to the various Form 8038s, the form itself begins to look like a checklist.

The revised forms carry a date of April 2011, though in fact they did not appear on the IRS website until May (June in the case of the 8038-T). The instructions themselves do not contain any information as to the effective date of the form. Presumably issuers that had completed and signed Form 8038s for transactions closing before the release date could still file the prior version during some kind of transitional period. Given the current preference for cost saving “closings by mail or e-mail” as opposed to the in-person closings of yesteryear and the requirement for additional information and more signatures, it is becoming more difficult to have the Form 8038 ready for filing on the date of issuance.

**Clean Renewable Energy Bond Supplemental Allocations**

Announcement 2010-54, 2010-38 IRB 386 (September 20, 2010) solicited applications from cooperative electric companies for new CREBS volume cap. The allocation was available because existing qualified application requests fell short of the $800 million available for cooperatives by $190,795,445. The due date for applications was November 10, 2011, and on March 17, 2011, the Service announced that 13 entities had received the unallocated amounts. Issuers have three years from the date of the letter issuing the allocation. Presumably there could be future solicitations of applications if allocated amounts are returned unused.

**Tribal Economic Development Bonds**

For all of the pressure to end the ARRA provisions by December 31, 2010, the Service provided relief for issuers that had received an allocation of volume cap for the Tribal Economic Development Bonds under Section 7871 of the Code. The first tranche of allocations required that bonds be issued by December 31, 2010, though the statute itself did not contain such a deadline. Announcement 2010-88, 2010-47 IRB 753 (November 22, 2010) provides an automatic extension for issuance of bonds to June 30, 2011, with the ability to request an additional six months for issuer requests received by the Service by March 31, 2011. The request for an additional six months requires an explanation of the delay and indication of continued intent to issue, all to be provided under penalty of perjury. The extension request must relate to the project described in the original allocation request, with some insubstantial deviations permitted. However, it appears as though an issuer that returned cap because it did not expect to be able to meet the issuance deadline does not get a “do-over.” If the tribal government had notified the Service that it did not intend to use its allocation, the volume cap is forfeited and cannot be revived, at least for that allocatee. The Notice reiterates that an allocation for bonds not issued in a timely manner, taking into account any permitted extension, is treated as forfeited and may be made available by the Service for reallocation.

The Service states that the Notice is not intended to extend the December 31, 2011 deadline for the issuance of bonds receiving an allocation of the second $1 billion tranche, nor does the Notice extend the statutory deadline for issuing the TEDCs as Build America Bonds. Thus,
Tribal Economic Development Bonds that were not issued by December 31, 2010, will have foregone the opportunity to obtain the 35% direct subsidy payment.

2010-2011 Priority Guidance Plan
The Office of Tax Policy of the Treasury Department and the Service released their joint 2010-2011 Priority Guidance Plan (the “Business Plan”) on December 7, 2010, half way through the plan year. This year there are seven items on the Business Plan for the tax-exempt bond area, down from eleven last year during the throes of ARRA. The Business Plan is meant to set forth the priorities for deployment of resources of Treasury and the Service over the year. Given that there are 25 items under the healthcare/employee plan portion of the Business Plan and 50 under the Tax Administration category, it is apparent that the resources of Treasury and the Service are being stretched to address other Congressional directives. As projects funnel up through the upper level of reviewers in the Service and the Treasury, tax-exempt bond projects must compete for the limited time and attention of the reviewers.

Final public approval (TEFRA) regulations, final solid waste regulations, and regulations on arbitrage investment restrictions are making a repeat appearance from last year’s plan. With the delayed release of the Business Plan, the QZAB final regulation project under Section 1397E has already been completed. The final regulation project for allocation and accounting rules under Section 141 is not on this year’s plan, despite the fact that the regulations have not been finalized last year. Regulations on reissuance are on the Business Plan this year, along with regulations related to tax credit bonds that qualify for the direct subsidy under Section 6431 of the Code. Addressing the issues arising from the Draw-down Notice are also a priority item for this year, presumably focusing on the ongoing implications for the volume cap under Section 146, as discussed above.

Requests for suggestions for projects for the 2011-2012 plan were solicited within only a few months of the release of the Business Plan. While the Business Plan probably continues to be a model for deployment of resources, in many ways it looks like the hamsters are still running on the never-ending wheel as Congress enacts new provisions and lets other provisions expire before all questions are addressed.

SLGS Window Closed
The SLGS “window” has closed again. In his May 2, 2011 letter to the House of Representatives, the Secretary of the Treasury announced suspension of SLGS subscriptions until further notice as of May 6, 2011. On its website (www.treasurydirect.gov), the Bureau of Public Debt states its usual policy of honoring the issuance of SLGS for which it had received a subscription before the May 6, 2011 suspension date and its policy of not accepting new subscriptions until the suspension is lifted.

Revenue Procedure 95-47, 1995-47 IRB 12, released in the midst of one of many prior SLGS suspensions, provides a procedure for dealing with alternate reinvestments in escrows that would otherwise violate the yield restriction on the escrow if not invested in a 0% SLGs, though there were many restrictions and all earnings on the alternate investment had to be rebated. Proposed arbitrage regulations from 2007 would convert the procedure into another permitted yield reduction payment under Treas. Reg. § 1.148-5(c) and expand it to all investments purchased during SLGS suspension. An issuer may elect to take advantage of this yield reduc-
tion payment provision for investments purchased on or after September 26, 2007 (the date of publication of the proposed regulations in the Federal Register).

It is unfortunate that the SLGS program has been suspended in the midst of the advance refunding compliance check questionnaire described above, as the unavailability of SLGS leaves issuers that must use open market securities in a more vulnerable position with respect to establishing fair market value in a continuing negative environment of accusations related to bid rigging.

**TEB Reissuance Summary and Frequently Asked Questions**

On May 19, 2011, TEB published on its website “Reissuance of Tax Exempt Obligations: Some Basic Concepts,” with accompanying Frequently Asked Questions (FAQs). As with other FAQs, TEB states that the information is not intended to be cited as an authoritative source on the requirements. The information is of a general nature and serves to remind issuers that a reissuance may move up the rebate payment date, require 8038 filings and result in deemed termination of an integrated swap. While no new ground is broken, the piece seems to be placing a marker on the question of whether a reissuance “may present a problem” for bonds with statutory issuance deadlines, such as Build American Bonds, that do not contain explicit language on refundings after the bonds can no longer be issued.

The Service has yet to announce its position on refundings of the various bonds with statutory expiration dates that are treated as exempt facility bonds. Both Gulf Opportunity Zone (“GO Zone”) Bonds and Recovery Zone Facility Bonds are generally treated as exempt facility bonds, and both are similar to the enterprise zone facility bonds (“EZ bonds”) and Liberty Zone bonds in that they all are designed to provide relief to geographically designated areas that have experienced economic distress. By regulation in the context of the EZ bonds and by questions and answers in the case of the Liberty Zone bonds, the Service has permitted a current refunding after expiration of the provisions or geographic designation even though the statute was silent. While it would seem appropriate to allow refundings on the same theory here, in the absence of specific guidance from the Service, issuers will have to be particularly vigilant to avoid reissuance.

**Administration Budget Proposals**

The Administration released its tax proposals for the Fiscal Year 2012 budget on February 14, 2011. The FY2012 proposals look very similar to the FY2011 ones, none of which was enacted by Congress last year. The General Explanation of the Administration's Fiscal Year 2012 Revenue Proposals (the so-called “Green Book”) provides a snapshot of the BABs issuance through 2010, stating that more than $181 billion in BABs were issued in over 2,275 transactions in all 50 states, the District of Columbia, and two territories, and that during 2009-2010, BABs gained a market share of over 25 percent of the total dollar supply of state and local governmental debt. The Treasury uses this data to support its assertions that BABs tap into a broader market of investors, deliver a more efficient federal subsidy and have reduced tax-exempt rates by relieving supply pressures. The Administration is quick to note that the 35% subsidy payment represented a deeper subsidy to stimulate the economy, and that any permanent BABs program would have a revenue neutral subsidy (as compared to the tax-exempt bond subsidy).

The Administration's proposal would make BABs, which expired on December 31, 2010, permanent at a 28% subsidy rate for bonds issued after the date of enactment In addition, the direct payment BABs program would not be limited to the financing of capital expenditures, but
would be expanded to include current refundings that produce interest savings, and short-term working capital expenditures subject to a 13-month maturity. This expansion would cover many, but not all, situations where tax-exempt bonds could be used. The Administration would also extend BABs to 501(c)(3) organizations, presumably with restrictions similar to the governmental bond expansion. This modification and expansion of BABs is estimated to cost $28 billion over 10 years, up $4 billion from the proposed revenue estimate in last year's budget proposal, again taking into account the combined effects of both receipts (taxable income) and outlays (the subsidy payments).

Making yet another appearance in an Administration budget is a proposal to provide a tax credit to New York State and New York City in lieu of the previous stimulus provisions of Section 1400L enacted to address the economic and infrastructure problems post 9/11, which the Administration stated “likely will not be usable in the form in which they were originally provided” (page 31 of the Green Book). The Liberty Zone proposal differs from the QZAB-type tax credit proposals and the ARRA provisions because it is a credit against any payments (other than payments of excise taxes and social security and Medicare payroll taxes) made by the city and state under any provision of the Code rather than a “refundable credit.” This Liberty Zone credit is proposed to be $200 million a year from 2012 to 2021 ($2 billion total) for expenditures relating to the construction or improvement of transportation infrastructure in or connecting to the New York Liberty Zone.

The Administration's budget includes other so-called “extenders” for expiring provisions, including an extension of the Liberty Zone and Gulf Opportunity Zone bond provisions and so-called Green building bonds under Section 142(l), at an estimated 10-year cost of $159 million, $277 million and $10 million, respectively. As with last year, the Administration has proposed to revive the Superfund Environmental Income Tax for the taxable years beginning after December 31, 2011 and extending through 2021.

The FY2012 Budget did have a new set of proposals related to simplification of the Code with respect to tax-exempt bonds. While new to more recent Budget proposals, the proposals will look familiar, and some of the rebate exceptions had appeared in the 1997 Budget. Under the first proposal, the general yield restriction rules would be eliminated in favor of the rebate regime. Since the enactment of the rebate requirement, issuers have argued that yield restriction is unnecessary if earnings must be rebated. Despite the desire to simplify, the proposal keeps the both yield restriction and rebate rules for advance refundings.

The rebate simplification proposals also include the elimination of the two-year spending exception in favor of a new three-year spending exception, similar to the one enacted for tax credit bonds under Section 54A, and the increase of the small issuer rebate exception from $5 million (where it has been since 1986) to $15 million, an annual inflation adjustment for subsequent years. The proposal would also drop the requirement that an issuer have general taxing powers in order to take advantage of the small issuer exception.

The private activity bond tests would also be simplified under the Administration's proposal through the elimination of the 5% limit on unrelated or disproportionate use. While the regulations (Treas. Reg § 1.141-9) sought to provide some guidance based primarily on the Conference Report and Blue Book for the Tax Reform Act of 1986, the intent and boundaries of these limitations were fuzzy enough that counsel often advised issuers of governmental bonds to use a more conservative 5% limit in lieu of the permitted general 10% private business tests.
Revisions to Schedule K
The 2009 filing season for Form 990, Schedule K was a difficult one for 501(c)(3) organizations with outstanding tax-exempt bonds. Although the Service had released drafts of Schedule K and made some changes in response to comments, the instructions proved to be confusing with respect to many of the questions, particularly in Parts II and III of Schedule K. The Service has released the 2010 Schedule K with revisions, but not all areas of confusion are resolved. The Service has provided a toll free number and e-mail address for questions, but my experience and those of others was that the Service did not answer the question; it just provided additional information in hopes you could figure out the answer. In my case, a whole raft of paper was mailed via USPS, which looked like a computer search of IRS materials using a keyword that seemed relevant to my inquiry.

The 2010 Schedule K revises the form to correct the failure to include a separate line in Part II for costs of credit enhancement. The instructions to the 2009 Schedule K told the organization to aggregate credit enhancement fees with costs of issuance but to separately report the credit enhancement fees on Schedule O. The 2010 Schedule K has a separate line for reporting credit enhancement fees, eliminates the need to provide additional information on Schedule O, and provides space directly on Schedule K for comments and explanations.

The basic issue with completing Part II of Schedule K was the frequent use of the phrase “cumulative amount of proceeds . . . as of the end of the 12-month period.” While this makes sense for recording costs of issuance or capital expenditures, it did not make sense to do a cumulative amount of unspent proceeds in line 4 of Part II. The 2010 instructions correct this to require the amount unspent as of the end of the 12-month period.

Another confusing aspect of the 2009 Schedule K, Part II related to the refunding escrow question. The preliminary language for Part II in the 2009 Schedule K states that lines 1 and 3 through 7 concern proceeds, while line 2 on refunding escrows concerns gross proceeds, such that the aggregate of amounts entered on lines 2 through 7 may not equal the amount entered on line 1. That seems to suggest that the numbers otherwise will add up. Similar language is included in the 2010 version. However, the instructions for the refunding escrow question (now line 6) ask the entity to enter the proceeds held in the refunding escrow as of the end of the 12-month period. If the refunding is held for only 90 days, that amount would appear only in the first Schedule K filed after issuance and, because the question does not ask for cumulative amounts, would not appear in subsequent filings – so, the lines in subsequent filings will definitely not add up to total proceeds in Part II. Similar issues exist if some portion of the escrow is paid out over the 12-month period. The 2010 question does not clear this up and may further muddy the waters by asking the entity to include investment earnings in the escrow, presumably those over the 12-month period, because it does not use the term “cumulative amounts.” This may result in duplicate reporting of earnings, as line 3 also suggests that earnings will be included as part of the “total amount of proceeds” of the bond issue. The 2010 version does not state whether this is the cumulative amount, but that can be inferred from the remainder of the instructions for that line, which ask for an explanation if the amount on that line does not equal the issue price of the bonds. It would probably be more efficient in this line to ask for an explanation only if the additional amounts are not earnings.

Part III remains largely unchanged. Questions in this area seemed to revolve around the measurement of private or unrelated business use. For example, one interpretation of the
instructions for the 2009 Schedule K was that the percentage reported should be the private use of the particular building in which the use occurred; the alternate interpretation was that it should reflect the percentage of bond proceeds used for the private business use (and thus a smaller number if other buildings or equipment were financed and had no private business use). Perhaps the biggest issue with Part III lies not with the form, but with the fact that there are no final allocation and accounting rules for private business use and the management contract safe harbor guidelines need to be updated to reduce the amount of uncertainty related to the newer types of provisions that were not in existence in 1997, when Rev. Proc. 97-13 was released. Neither was on the 2010-2011 Business Plan.

The 2010 Schedule K asks several additional questions in Part IV on hedges, specifically whether the hedge was superintegrated or terminated. For both the hedge and GIC questions, the entity is to enter the term of the contract to the nearest tenth of a year. Presumably this is the original term, not the remaining term as of the end of the 12-month period. It would seem easier to just put in the termination date.

**Private Letter Rulings**

**Broadcast Rights/Advertising Contract as Incidental Private Business Use.** The Service put a little more flesh on the bone with respect to the incidental uses exception to private business use in PLR 201049003 (dated July 6, 2010, and released December 10, 2010). The letter ruling deals with an agreement with a corporation (the “Corporation”) that relates to certain stadium and arena facilities owned by a state university (the “University”), the improvements to which are proposed to be financed with tax-exempt bonds. The contract is described as providing the Corporation with the following rights: (1) radio broadcast and telecast rights, (2) advertising sales and corporate sponsorship program rights, and (3) publishing and vending rights.

Generally, the Corporation has the right to the revenues resulting from the exercise of its rights under the agreement and pays certain of the related expenses. For these rights, the Corporation must (1) pay a stated annual fee to the University in semi-annual installments over the term of the agreement, (2) pay the University a royalty in each contract year, equal to a percent of certain net revenues (as particularly defined in the agreement) in excess of specified threshold amounts, (3) make investments in signage and technological upgrades, and (4) promote the University's athletics scholarship fund by providing a media package with a specified value.

The ruling describes each of these rights in some detail, in some cases describing the type of physical use by the Corporation (small portion of the press box, folding courtside table, and roving reporter with no stationary position), the intangible rights created through the sale of advertising (including advertising on drinking cups, pocket schedule cards, and promotional schedules), signage rights for advertising, the right to purchase tickets at face value, parking passes, and publishing and vending rights for game programs and subsequent sales of the programs in kiosks.

The Service frames the question as whether the agreement conveys special legal entitlements for the Corporation's use of the bond-financed facilities that are comparable to ownership, leases, management contracts, output contracts, or research contracts. The analysis starts with ownership and without further discussion concludes that the agreement does not give ownership rights. The Service states that certain aspects of the agreement resemble a management contract as the Corporation is providing services for various functions of the venues among other services it provides to the University. For example, the Corporation uses its expertise to vend...
the official game programs and other promotional print items and is responsible for developing, marketing, and promoting the corporate sponsorship program. Other aspects of the agreement resemble a lease in that the Corporation retains certain revenues, pays certain expenses, and pays the University, among other amounts, a stated annual fee in exchange for the right to use certain University property. Yet, the lease-like rights set forth in the agreement concern mainly intangible property, such as the right and responsibility of the Corporation to produce, distribute, and syndicate radio broadcasts and telecasts of certain of the sports games and to sell advertisements to be aired during the broadcasts and telecasts. Further, even where the Corporation's right is to use certain tangible property of the University, like the advertising signs and other articles on which the advertisements appear, these items themselves are not part of the bond-financed improvements. The inability to characterize specifically the agreement as falling into one or more private use arrangements does not deter the Service from concluding that the agreement provides the Corporation with special legal entitlements to use portions of the bond-financed improvements that must be analyzed to determine if they cause private business use.

The Service agrees that the agreement does not give the Corporation control over the teams, ticket sales, security, personnel management, or general management of the venues, and the Corporation does not have control over any element of the game schedules, such as the number of games, the dates games are played, or the selection of opposing teams.

The Service also points to the fact that the agreement specifically provided the Corporation with certain rights to tangible use of the bond-financed portions of the venues. The Corporation uses broadcast equipment and certain personnel at the Venues. These include the personnel broadcasting courtside or from the press boxes and the sideline reporter. The Corporation has the exclusive right to sell advertising displayed on the tickets, parking passes, programs and other print items, cups, food containers, and signs within the venues. The Corporation's rights also include the right to conduct promotional home game activities. The Corporation has the right to vend the official game programs and other game-related publications within the venues. The Corporation has the right to a small number of public address announcements and scoreboard announcements at each game to promote program vending sales. To the extent that the equipment, personnel, or signs are present; tickets, parking passes, programs, other print items, cups, or food containers are sold or otherwise distributed; or promotional activities or announcements occur in or on the bond-financed improvements, these are uses of the bond-financed improvements. The Corporation also has the right to obtain a specified number of game tickets for the radio and TV affiliates, advertisers, and sponsors.

The Service finds that the right to broadcast and telecast certain games is a valuable intangible legal entitlement, but the value is in the advertising. The Service believes the airing, distribution, and syndication of productions and sale of advertising are too remote to be considered use of bond-financed facilities. The Service goes on to state that it does not believe that possession is necessary to finding private use where there is control of the bond-financed facility, citing Example 5 under Treas. Reg. § 1.141-3(f).

Example 5 was the same analysis applied in PLR 200323006, the infamous naming rights ruling. In that ruling, the corporation with the naming rights had rights to make sure that all signs, newsletters, employee uniforms, trash cans, paper cups, stationery, and ticket stock used the “official name,” which the Service viewed as rules regarding the manner in which the facility would be operated and thus resulted in control of the facility. In comparison to the right
to schedule events, determine rates, and set guidelines for the type of activities to occur, which are obvious markers of control, the rights described in both this and the naming rights rulings seem to be directly related to controlling the advertising rather than controlling the operation of the facility. However, this is not the approach taken by the Service. Unlike the naming rights ruling, the Service here determined that these contractual rights fit within the incidental uses exception to private business under Treas. Reg. § 1.141-3(d)(5). Based on the representations of the borrower that the uses would not exceed 2.5% of the proceeds, the Service concluded that the contract did not result in private business use. The ruling does not directly discuss how the private use was measured.

Private Business Use through Renewable Energy Certificates. The concept of special legal entitlements that give rise to private business use was dealt with in PLR 201037006 (dated June 14, 2010 and released September 17, 2010) with regard to renewable energy certificates (“RECs”). The authority requesting the ruling proposed to refinance the acquisition of a partially-constructed wind power generating facility and to finance additional costs of the facility. The state in which the facility operated had imposed mandatory “renewable portfolio standards” that require some or all electric utilities providing service within those states to demonstrate that a specified portion of their electric supplies are derived from renewable generating resources. Many states imposing such renewable portfolio standards allow utilities to meet the requirements by purchasing RECs from renewable electric generating resources. RECs represent the environmental attributes of renewable energy, with one REC representing the attributes for one megawatt-hour generated by a renewable energy resource.

The authority expects to sell RECs related to the facility to one or more nongovernmental persons. The contract is expected to contain several provisions that are designed to assure the purchaser of the RECs that it will receive the expected RECs from the facility. Expected provisions in the contract include a requirement to provide RECs in a subsequent month if the facility generates less than the capacity of electricity associated with the full allotment of the purchaser’s RECs during a particular month (which may involve extending the term of the contract), extension of the contract upon failure to operate the facility due to force majeure, ability of the purchaser to terminate the contract for failure to perform, payment of liquidated damages if the authority fails to deliver the requisite number of RECs in certain cases (including abandonment of the facility by the authority), and termination and payment of a termination amount if the authority does not deliver RECs that are qualified under the State procedures. In the case of a failed delivery, the contract does not limit the purchaser’s rights in a manner that would preclude specific performance, but the authority represented to the Service that, in the event of a breach of the contract, specific performance would not be awarded so as to require the authority’s operation of the facility because the purchaser would be able to obtain replacement RECs from another source. The contract does not entitle the purchaser to any electric energy generated by the facility and does not give the purchaser any rights with respect to how the facility is to be operated or maintained.

The Service first determined that the output contract regulations under Treas. Reg. § 1.141-7 do not apply. The Service acknowledged that the RECs are measured based on the quantity of renewable energy generated, but the RECs do not entitle the purchaser to any capacity of the generator and do not affect the nameplate capacity of the facility or the sale of power to others. Turning to the general private business analysis related to legal entitlements, the Service concluded.
that there are none created by the contracts with the purchaser. The liquidated damages in the
event of non-delivery of the RECs were not viewed by the Service as rising to level of control
over the facility or its operations. Further, based on the representation that it is unlikely that the
purchaser would be awarded specific performance for the authority’s nonperformance under
the contract, the purchaser could not use its legal or equitable remedies to force the authority to
operate the facility at any level. Therefore, the purchaser has no direct or indirect control over
the operation of or any legal entitlement to the facility.

Fortunately the Service was able to reach a favorable result in this case, as RECs are likely
to arise with respect to several bond-financed property with the push for renewable energy.
If the conclusion had gone the other way, it would present difficult private business use mea-
surement questions.

Catastrophic Insurance Fund. The Service again dealt with a fund set up by a state to pro-
vide supplemental insurance for losses suffered due to a catastrophic event in PLR 201043001
(dated July 19, 2010, and released October 29, 2010). The issuer of bonds had asked for a ruling
that bonds issued to pay claims of an association established by an act of the state legislature
would not violate the private business tests.

The association provides insurance to persons otherwise unable to obtain catastrophe insur-
ance from a private insurer. The association sells both commercial policies and residential poli-
cies, which differ as to coverage due to the different types of property involved. The policies are
rated separately as a result of the differences. The Service analyzed the use of proceeds under
the legislative history to the Tax Reform Act of 1986, which distinguished between use of pro-
ceeds to pay for services rendered to a government arising from general government operations
(purchasing computers for government employee use from a private vendor) and indirect non-
governmental use when a government contracts with a private business to supply that business
with a service (electric energy) on a basis different from that on which the service is provided
to the general public. Looking to the ultimate use of proceeds, the Service found that claim
amounts paid to policyholders are owned outright by the policyholders and policyholders are not
restricted in any way in their use. The proceeds are not used for working capital expenditures of
the government but are paid in respect of a contractually purchased right of the policyholder.
Therefore, similar to the electric energy example, the proceeds must be tracked to the ultimate
use. The Service concluded that the issuer cannot take advantage of the general public use
exception because of differences between the commercial and residential policies. The Service
concludes that the bonds meet the private business use test.

On the private payment or security test, the bonds fare better. The so-called Category B
bonds are secured by premium surcharges on all policyholders who reside or have operations in,
or whose insured property is located in a catastrophe area. State law does not provide require-
ments for the surcharge, but proposed rules provide for a flat percentage applicable to all poli-
cies. Assuming the proposed rules relating to the surcharge are followed and that the surcharge
is for the purpose of raising governmental revenues, the Service concluded the surcharge is a tax
of general applicability and not a private payment. The Category B bonds have additional secu-
ritv in the form of, and the Category C bonds are secured solely by, an assessment charged to all
licensed property insurers in the state. The Service concluded that the assessments are also a tax
of general applicability and not a private payment. Therefore, the private payment and security
test is “failed” and the bonds are not private activity bonds under the private business test. The
Service quickly disposed of the private loan test, finding no characteristics of a loan or repayment obligation, so the bonds are not private activity bonds.

**Output Contract Transition Rules.** PLR 201114003 (dated December 7, 2010, and released April 8, 2011) deals with a transitional rule for output requirements contracts under Treas. Reg. § 1.141-7. The transition rule, found in Treas. Reg. § 1.141-15(f)(1), exempts output contracts entered into before September 19, 2002. Amendments entered into on or after that date will negate transition treatment only if the amendments result in a change in the parties to the contract or increase the amount of requirements covered by the contract by reason of an extension of the contract term or a change in the method for determining such requirements. Under the transition rule, exercise of a legally enforceable right, including exercise of a renewal option, is not treated as an amendment.

With this analytical framework in mind, the Service determined that the deferral of the effective date of a renewal option in an existing requirements contract entered into prior to the transition date in exchange for the release of certain members from the requirements contract in order to transition some members over to a contract with a private company was not an amendment of the transitioned contract. In particular, the Service determined that deferral of the ability to terminate the contract is not an amendment that increases the requirements covered by the contract by reason of an extension of the term. Because the right to terminate continued to be available, the Service concluded that the deferral did not alter the basic right. The ruling did not discuss the effect of the change in certain of the parties served through the contract, perhaps because this resulted in an overall decrease in the requirements.

**CCRC Replacement Proceeds.** Quite a stir was caused on August 21, 2007, by the disclosure on EMMA by the Montana Facility Finance Authority that the tax exemption of bonds issued to finance the Mission Ridge retirement community was being challenged by the Service. The filing included the notice from the Service that set forth the Service’s position that entrance fees collected with respect to the facility were replacement proceeds subject to yield restriction and rebate.

In a technical advice memorandum, published as TAM 201118012 (dated January 19, 2011 and released by the Service in redacted form on May 6, 2011), the Office of Chief Counsel, to the relief of the retirement industry, concluded that the entrance fees were not replacement proceeds.

The TAM looked both at the terms of the various bond documents and, to a limited extent, actual balances and uses of the entrance fees to reach the conclusion that, even though there was a nexus between the entrance fees (and other revenues) and the bonds, there was no reasonable assurance that entrance fees would be available to pay debt service on the bonds if the conduit borrower encountered financial difficulties. This was certainly the conclusion that various counsel had argued was the appropriate one in the context of retirement homes and entrance fees, but there is perhaps a little bit of an nuance to that analysis in the ruling itself.

To review the facts, residents were required to pay an entrance fee before they could occupy their unit. The borrower was not required to refund a resident’s entrance fee until the resident left the facility and the vacant unit was re-occupied by a resident paying a new entrance fee. The borrower could waive these restrictions on refunds in its discretion in a hardship case. The borrower was not required to hold the entrance fees in trust in order to guarantee any required refund payment, as is the case in some jurisdictions. Therefore, the borrower was free to use the entrance fees and any investment earnings for its own purposes. If the entrance fees had been required to be held in trust, it is unlikely that the tax issue would have come up on audit.
The bond indenture granted the trustee a priority security interest in revenues of the borrower, including the entrance fees. The entrance fees were not in a segregated fund and the trustee did not take physical possession of the entrance fees or the commingled accounts of which the entrance fees were a part. The TAM indicates that the borrower uses cash, including entrance fees, to pay operating deficits, replacement costs, and other capital needs. In fact, at the end of the year, the amount of cash that the borrower had invested was approximately half of the total amount of entrance fee revenue the borrower had received.

The Service relied on Treas. Reg. § 1.148-1(c), which provides in general that amounts are replacement proceeds of an issue if the amounts have a sufficiently direct nexus to the issue and includes pledged funds, negative pledges, and other indirect pledges. The Service also looked to Revenue Ruling 78-348 (1978-2 CB 95), which provides that, for purposes of determining whether certain collateral constitutes replacement proceeds, a pledge need not be cast in a particular form and bondholders need not take actual or constructive possession of the collateral. Revenue Ruling 78-348 contains the classic “mantra” used by bond counsel that replacement proceeds are created only if there is a reasonable assurance that the collateral will be available if needed to pay debt service if the issuer encounters financial difficulty. The Service found that the entrance fees had a nexus, based on the fact that they were included in the revenues pledged to repayment of the bonds. However, the Service determined that there was no reasonable assurance the entrance fees would be available to pay debt service because there were no other facts, such as provisions in the indenture or other financing documents (including financial covenants that require the maintenance of certain asset levels), from which such reasonable assurance could be inferred. Further, the entrance fees were commingled with other revenues, and there were no limits on the ability to spend these moneys. But, moving beyond the document provisions, the Service stated that the end of the year “investment balance” was approximately one-half of the entrance fees collected, so it was reasonable to conclude that funds were transferred to operating accounts to cover operating expenses. This fact was the basis for the conclusion that the borrower was able to spend entrance fees without interference of the trustee and bondholders and that amounts could be spent on operating expenses prior to any payment to bondholders. Therefore, there were no facts to suggest that the bondholders could have relied on the level of cash available at closing being maintained while the bonds were outstanding.

Counsel to continuing care facilities and a variety of other traditional revenue bonds with general revenue pledges, such as bonds issued for universities, had been concerned that the initial position of the IRS agent could lead to a host of other special revenue sources included with a general revenue pledge being deemed replacement proceeds. The TAM seems to preserve the analytical framework applied for decades, but the use of actual bank balances to confirm the reasonable assurance analysis, rather than relying solely on the document provisions, may keep a few counsel awake at night.

Political Subdivision/On Behalf of Issuer Status. PLR 201104020 reached a result as to status as a political subdivision or on behalf of issuer that has puzzled many practitioners. Under the facts of the ruling, an authority formed to acquire and operate piers, terminals, and warehouse facilities within the limits of a city was governed by a seven-member board. The board consisted of the City Manager, the president of the City Council, a representative of the state Department of Transportation, and four residents of the city elected to the board by a majority of the voters. The City Council had no powers to remove board members other than through
its power to remove the City Manager and president of the Council from the positions that made them ex officio board members.

The authority has the power of eminent domain with respect to real property within the boundaries of the city but only with the consent of at least a majority of the City Council. The authority may charge fees for parking, docking, and storage facilities but does not have the taxing power. The authority is authorized to issue bonds. Upon a dissolution of the board, all authority property reverts to the city.

The Service looked first at whether the authority was a political subdivision. The result here was not surprising, as it was consistent with analysis of similar entities that had only the sovereign power of eminent domain, and in this case the exercise of that power is limited by the requirement to obtain city consent. With respect to the on behalf of analysis, the Service reviewed the factors in Revenue Ruling 57-187 and concluded that the authority failed because the majority of the board members were not controlled by the city. This conclusion turns on the fact that the Service apparently did not believe that a vote of the electorate of the city represented control by the city because as a mechanical matter, Revenue Ruling 57-187 only described appointment and removal by a governing body, which itself was an elected body. Logically it seems as though an elected board member should represent the highest form of control by a government, regardless of whether the City Council could remove them from the board, but this approach was apparently not considered by the Service.

Demolition of Facility. PLR 201110007 (dated November 30, 2010, and released March 11, 2011) is one in a long line of private letter rulings dealing with bond-financed facilities that have been left idle, abandoned, and/or demolished. In this case, bond proceeds were used to finance pollution control facilities, the installation of which was required to ensure the conduit borrower’s compliance with applicable federal and state environmental regulations. Tax-exempt bonds were issued and refinanced under the transitional rules of the Tax Reform Act of 1986 for pollution control facilities. After issuance of refunding bonds, the borrower entered into a consent decree to settle a lawsuit related to environmental law violations. The combination of the termination of a fuel supply contract and the requirement to pay the costs of installing enhanced pollution control equipment required under the consent decree caused the borrower to discontinue operations. After attempts to sell the facilities were unsuccessful, the facilities were decommissioned and demolished, and the borrower represented that scrap value, net of decommissioning costs, would be less than zero.

The Service ruled that the demolition would not result in a change in use that would cause interest on the bonds to be taxable or result in a loss of interest expense deduction on the conduit loan under Section 150(b) of the Code. The Service based its ruling on the fact that the consent decree prevented the facilities from being used as expected when bonds were issued and thus apparently was viewed as not being a deliberate action on the part of the borrower. Further, the demolition prevented the facilities from being used for any other use that might be a nonconforming use other than as scrap with no value.

Extension to File Volume Cap Carryforward. The Service released a ruling dealing with an extension of time to file a carryforward election ruling that was fairly novel, as late filing requests go. Under the facts of PLR 201103038 (dated September 27, 2010, and released January 21, 2011), the State allocating agency had apparently inadvertently included a portion of the bonus volume cap for housing bonds awarded under the Housing Act of 2008 on its regular private
activity bond volume cap carryforward election on Form 8328 and failed to include that same amount in the separate carryforward form used for the bonus cap. As you may recall, the Treasury Inspector General had expressed concerns that the Service was not appropriately tracking the private activity bond volume cap. Thus, this ruling deals with errors in tracking or recording volume cap for purposes of filing the form, rather than the failure to file a carryforward form in a timely fashion. Nonetheless, the Service concluded that the forms had been prepared and filed in good faith and could be corrected.

Waiver of Unrestricted Investments. The Service dealt with another request for an extension of time to make an election in PLR 201116015 (dated November 23, 2010, and released April 22, 211). In this case, the issuer was seeking to extend the time for making an election to waive the right to invest net sale proceeds of a new money issue during the three-year temporary period in order to blend investment yields with unspent proceeds of a prior issue. The bond issue in question had both a new money component and an advance refunding. At the time of issuance of the bonds, the issuer had erroneously concluded that there were no unspent proceeds of the refunding that would be treated as transferred proceeds. The unspent proceeds were not discovered until a later date by the issuer’s rebate analyst. If the election had been made at issuance, the issuer could have blended the investment of new money sale proceeds and transferred proceeds to calculate the rebate and yield reduction payments.

The Service concluded that the issuer had acted reasonably and in good faith and granted a 45-day period for making the election, which essentially appeared to involve a piece of paper that the issuer would retain with the ruling in its files. It is not uncommon to unearth unspent proceeds or find that amounts are more or less than amounts the trustee thought it had when the issue was being sized, but typically these involve small amounts and do not warrant letter rulings.

Food for Thought
You know you need to take more time off when you stand in security lines at foreign airports (which presumably do not use tax-exempt bond financing) and wonder if the Vodofone ads on the brightly colored security bins or the Johnnie Walker ads on the idle screens at checkout counters would be treated as private business use under the recent advertising contract private letter ruling.
The first anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”)\(^1\) is fast approaching. While broad in scope, Dodd-Frank left much of the detail of its implementation to agency rulemaking. As the SEC points out, Dodd-Frank “contains more than 90 provisions overall that require SEC rulemaking, as well as dozens of additional provisions that give the SEC discretionary rulemaking authority.”\(^2\) Of the mandatory rulemaking provisions, the Commission “has proposed or adopted rules for about two-thirds of them.”\(^3\) The SEC maintains a “Dodd-Frank Spotlight Home,” providing updates on rulemaking actions to date and those scheduled for future dates.\(^4\) As an example, under the heading “Dates to be Determined,” it identifies activities “deferred due to budget uncertainty.” At this location, all the activities listed—which involve the creation and staffing of four new offices and one committee called for by Dodd-Frank—“are currently being reassessed in light of the FY 2011 budget.” Among the four new offices in regulatory limbo is the Office of Municipal Securities, for which, the site notes, “[f]unctions continue to be assigned to staff within the Division of Trading and Markets.” Other sections requiring rulemaking activities relating to the municipal market have, for the most part, proceeded according to schedule, as described below. The Bond Buyer reports that the SEC has written to the heads of the House and Senate Appropriations subcommittees asking permission to reprogram fiscal 2011 funds so that the Commission can begin to create the new Office of Municipal Securities and other offices mandated by Dodd-Frank.\(^5\)

**Asset-Backed Securities**

As noted previously in *The Bond Lawyer*,\(^6\) §941 added a definition of Asset-Backed Security (“ABS”) to the Securities Exchange Act of 1934 as new §3(a)(77), a definition that appears to cover a variety of structures in the municipal market. New Exchange Act §15G, also added by Dodd-Frank §941, requires securitizers of asset-backed securities to retain not less than five percent of the credit risks of the assets underlying the securities. There was, however, an important exemption in the rule proposal issued March 31, 2011 by the SEC together with the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, and the Department of Housing and Urban

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1 Pub. L. No. 111-203
3 Id.
4 http://www.sec.gov/spotlight/dodd-frank.shtml
5 SEC Plans New Office for Munis, The Bond Buyer June 24, 2011.
6 Summer/Fall 2010, pp 18-21.
Development. General Exemptions Section 21(a)(3) and (4) would exempt “any asset backed security that is a security issued or guaranteed by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of a State or territory that is exempt from the registration requirements of the Securities Act of 1933 by reason of section 3(a)(2) of that Act” as well as any “asset-backed security that meets the definition of a qualified scholarship funding bond, as set forth in section 150(d)(2) of the Internal Revenue Code of 1986….”

In January, the SEC approved final rules required by Dodd-Frank § 943 with respect to initial and periodic disclosure regarding the use of representations and warranties in the market for asset-backed securities. The disclosure requirements apply to issuers of municipal ABS. However, municipal ABS are provided an additional three-year phase-in period, and the required disclosure can be provided on EMMA, the Municipal Securities Rulemaking Board’s centralized public database for information about municipal securities issuers and offerings.

**Municipal Advisors**

As described in last fall’s column, Dodd-Frank extends federal regulatory authority to cover municipal advisors, that is, those non-broker dealer advisors to issuers of municipal securities and obligated persons commonly called financial advisors, as well as other previously unregulated parties. On September 1, 2010, the SEC adopted Rule 15Ba2-6T, an “interim final temporary rule,” establishing a means for municipal advisors, as defined in Dodd-Frank, “to satisfy temporarily the requirement that they register with the Commission by October 1, 2010.” Municipal advisors are also required to register with the MSRB and to have done so prior to December 31, 2010.

MSRB Rule A-12 provides in part: “Prior to effecting any transaction in or inducing or attempting to induce the purchase or sale of any municipal security, or engaging in municipal advisory activities, a broker, dealer, municipal securities dealer, or municipal advisor shall pay to the Board an initial fee of $100, accompanied by a written statement setting forth the name, address and Securities and Exchange Commission registration number of the broker, dealer, municipal securities dealer, or municipal advisor on whose behalf such fee is paid.”

The question of who is a municipal advisor is answered for the moment by the interim final temporary rule and the limited guidance offered in the adopting release. Congress offered no direct guidance in Dodd-Frank beyond the words of the statute itself, recited in the adopting release for the interim final temporary rule. After release of the interim final temporary rule, few seemed concerned about the reach of this new regulatory authority. The extent to which the

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9 Summer/Fall at 14.
12 Release No. 34-62824, supra.
SEC might go in interpreting the term “municipal advisor,” and who would have to register as a consequence, did not become clear until December 2010, with the Commission’s release containing proposed permanent rules and forms for registration of municipal advisors.13

An inkling of the trouble in store might be found upon comparison of the defined terms Congress used in the federal securities laws for “municipal advisor,” “broker,” “dealer,” and “investment adviser.” The Exchange Act defines a municipal advisor as: “a person (who is not a municipal entity or an employee of a municipal entity) that— (i) 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 structure, timing, terms, and other similar matters concerning such financial products or issues; or (ii) undertakes a solicitation of a municipal entity.”14 The Exchange Act then continues to describe who is included and not included in the definition.

In contrast, the Exchange Act defines a broker as “any person engaged in the business of effecting transactions in securities for the account of others”15 and a dealer as: “any person engaged in the business of buying and selling securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person’s own account through a broker or otherwise.”16

Likewise, the Investment Advisers Act defines an investment adviser as “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.”17 Missing from the definition of municipal advisor is the language (1) “engaged in the business” found in the definitions of broker and dealer, and (2) “who for compensation, engages in the business,” in the case of investment adviser. Commentators have pointed out that “courts have read ‘engaged in the business’ as connoting a certain regularity of participation in purchasing or selling activities rather than a few isolated transactions,” thus permitting exclusion of various types of conduct from the definitions.18

Does the absence of such phrasing open the door to expansive application of the new regulatory authority? The SEC apparently thinks so. The Proposed Permanent Rules states: “In defining the term “municipal advisor” in Exchange Act Section 15B(e)(4), Congress did not distinguish between those municipal advisors who are compensated for providing advice and those who are not compensated for providing advice. Thus, consistent with Congress’s definition of the term “municipal advisor,” the Commission does not believe the issue of whether a municipal

15 Exchange Act §3(a)(4).
16 Exchange Act §3(a)(5).
17 Investment Advisers Act of 1940 §202(a)(11).
18 See Colby and Schwartz, What is a Broker-Dealer, and notes 45 and 190 therein in Broker-Dealer Regulation, Vol. 1, (PLI, 2010).
advisor is compensated for providing municipal advice should factor into the determination of
whether the municipal advisor must register with the Commission.”19

In line with a package delivered in the heart of the holiday season, the Proposed Permanent
Rules released in December 2011 had something for everyone. In addition to financial advisors,
guaranteed investment contract brokers, third-party marketers, placement agents, solicitors, find-
ers, and swap advisors that come within the express terms of the statutory definition of mu-
nicipal advisor (which the Proposed Permanent Rules adopt), the registration requirement, the
release points out, may cover certain:

- **Accountants** engaging in municipal advisory activities other than preparation of
  financial statements, auditing financial statements, or issuing letters for underwriters for
  or on behalf of a municipal entity or obligated person.20

- **Appointed members of governing bodies of a municipal entity** who are not
  employees of the municipal entity excluded from the definition of municipal advisor in
  the Exchange Act.21 The SEC includes within this statutory exclusion “any person
  serving as an elected member of the governing body of the municipal entity to the
  extent that person is acting within the scope of his or her role as an elected member of
  the governing body of the municipal entity” and “appointed members of a
  governing body to the extent such appointed members are **ex officio** members of the
  governing body by virtue of holding an elective office.”22 “This would include persons
  appointed to fill the remainder of the term for an elective office.”23 Such persons
  coming within the exclusion are not municipal advisors under the Proposed Permanent
  Rules. Controversially, the SEC believes that appointed members of a governing body
  of a municipal entity that are not elected **ex officio** members should be included in the
  definition of a municipal advisor.24 Persons required to register as a municipal advisor
  may include, for example, appointed members of any entity falling within the statutory
  definition of “municipal entity”25 or specifically identified in the Proposed Permanent
  Rules, such as state agencies, college and university systems, authorities, charter schools,
pension funds, and college savings plans. Although the Proposed Rules do not expressly
  state that such members would only be a municipal advisor to the extent such person
  “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” or “undertakes
a solicitation of a municipal entity,” such a limitation may be reasonably drawn from the
statutory definition of municipal advisor.26 The Proposed Permanent Rules define such

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19 76 FR 832.
22 Proposed Permanent Rules at 40-41.
23 Proposed Permanent Rules, n. 142
24 Proposed Permanent Rules at 51.
25 Exchange Act §15B(e)(8).
activities as “municipal advisory activities.” Under such a reading such appointed members of municipal entities would be required to register under the Proposed Permanent Rules only if they engage in municipal advisory activities with such municipal entities. It would be helpful if the Proposed Permanent Rules said this simply and clearly, but they do not.

• **Attorneys** engaging in municipal advisory activities other than those of a traditional legal nature or legal advice to a client of the attorney that is a municipal entity or obligated person.

• **Banks**, including commercial banks subject to regulation by various federal and state regulators, depending on their role with respect to investment strategies for municipal entities, may also engage in activities that would subject them to registration as municipal advisors, such as acting as trustees with respect to an issuance of municipal securities or providing advice with respect to municipal financial products. The Proposed Permanent Rules (1) point out “that Congress included in the statutory definition of ‘municipal advisor’ a limited number of exclusions from the definition, and such exclusions did not include banks in any capacity” and (2) seek comment on potential exclusions.

• **Broker-dealers acting as placement agents for a private equity fund** soliciting a municipal entity (including pension funds) and obligated persons to invest in the fund.

• **Brokers, Dealers, or Municipal Securities Dealers Serving as an Underwriter** engaging in municipal advisory activities while acting in a capacity other than as an underwriter on behalf of a municipal entity or obligated person. The Proposed Rules would consider an underwriter or placement agent to be a municipal advisor if it solicits a municipal entity to invest in a security or advises a municipal entity with respect to the investment of proceeds of municipal securities or the advisability of a municipal derivative.

• **Commodity Trading Advisors** or persons associated with the registered commodity trading advisor engages in municipal advisory activities other than advice related to swaps (as defined in Section 1a(47) of the Commodity Exchange Act (7 U.S.C. 1a(47)) and Section 3(a)(69) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(69)), including any rules and regulations thereunder).

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27 Proposed Rule 15Ba1-1(e).
29 Proposed Rules at 8.
30 Proposed Rules at 42, 52-53.
31 Proposed Rules at 32.
33 Proposed Rules at 48.
34 Proposed Rule 15Ba1-1(d)(2)(iii).
• **Employees of Obligated Persons** are not excluded by the Exchange Act under the definition of “municipal advisor” as are municipal entities or employees of municipal entities.\(^{35}\) The Proposed Rules request comment on whether “employees of obligated persons be excluded from the definition of ‘municipal advisor’ to the extent they are providing advice to the obligated person, acting in its capacity as an obligated person, in connection with municipal financial products or the issuance of municipal securities.”\(^{36}\)

• **Engineers** engaging in municipal advisory activities other than providing engineering advice.\(^{37}\) For example, under the Proposed Rules, an engineer is engaging in municipal advisory activities and therefore is subject to registration when preparing feasibility studies including analysis beyond the engineering aspects of the project, cash flow modeling, or the provision of information and education relating to municipal financial products or the issuance of municipal securities, even if those activities are incidental to the provision of engineering advice.\(^{38}\)

• **Investment Advisors** or persons associated with such investment advisor not registered under the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.) (the “Advisers Act”)\(^{39}\) and investment advisers or persons associates with investment advisors registered under the Advisers Act engaging in municipal advisory activities other than providing investment advice that would subject such adviser or person associated with such adviser to the Advisers Act.\(^{40}\)

• **Solicitors of a Municipal Entity or Obligated Person** are included within the statutory definition of “municipal advisor.”\(^{41}\) Exchange Act Section 15B(e)(9) provides that the term “solicitation of a municipal entity or obligated person” means “a direct or indirect communication with a municipal entity or obligated person made by a person, for direct or indirect compensation, on behalf of a broker, dealer, municipal securities dealer, municipal advisor, or investment adviser (as defined in section 202 of the Investment Advisers Act of 1940 [15 U.S.C. 80b-2]) that does not control, is not controlled by, or is not under common control with the person undertaking such solicitation for the purpose of obtaining or retaining an engagement by a municipal entity or obligated person of a broker, dealer, municipal securities dealer, or municipal advisor for or in connection with municipal financial products, the issuance of municipal securities, or of an investment adviser to provide investment advisory services to or on behalf of a municipal entity.”\(^{42}\) As a result, unless an exclusion applies, any third-party solicitor that

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36 Proposed Rules at 51.
39 Exchange Act §15B(e)(4)(A). The statutory exclusion applies only to investment advisers registered under the Advisers Act and their associated persons.
42 Proposed Rules at 29.
seeks business on behalf of a broker, dealer, municipal securities dealer, municipal advisor or investment adviser from a municipal entity must register as a “municipal advisor.” The Proposed Rules state “a third-party solicitor that seeks business on behalf of an investment adviser from a municipal pension fund or a local government investment pool must register as a ‘municipal advisor.”43

Governing Body Members as Municipal Advisors?
The most controversial inclusion in the list of potential municipal advisors are appointed members of a governing body of a municipal entity. Some wonder how a member of an entity’s governing body could give advice to himself? Others question what evil the rulemaking attempted to cure. Still others are concerned about the apparent intrusion by the federal government into matters of governance left to the States and their political subdivisions. On these points, the Proposed Permanent Rules are silent. The objections of this group to potential inclusion among those to be regulated as municipal advisors do not overshadow the objections from others enumerated above. Over 800 comment letters have been filed with the SEC on this rulemaking, with many of them attacking the proposed inclusion of public officials as municipal advisors. Among them are the letters of eight United States Senators; eleven Members of the House of Representatives (including Reps. Frank and Bachus, who changed roles from last Congress to the current as chairman and ranking minority member of the House Financial Services Committee); six Governors; three Attorneys General; and numerous State Comptrollers and Treasurers. For perspective, the 1994 amendments to Rule 15c2-12 that put in place the continuing disclosure framework for the municipal market elicited “over 390 comment letter representing over 475 groups and individuals,” which the Commission broke down into 232 letters representing the views of 242 issuers and issuer associations, 52 letters representing the views of 57 brokers, dealers, and municipal securities dealers, and 8 letters representing the views of 8 investor associations, but apparently no members of Congress.44 On its Dodd-Frank Spotlight Home, the SEC indicates it will “adopt permanent rules for the registration of municipal advisors” between August and December 2011. Many individuals in many parts of the municipal marketplace await the rulemaking.

Supreme Court Update—“Making Statements” under Rule 10b-5
In the Winter/Spring 2010 edition of The Bond Lawyer, I called your attention to the March 10, 2010 majority opinion in Securities and Exchange Commission v. James Tambone and Robert Hussey, a case before the First Circuit.45 Tambone arose from the SEC’s efforts to curb market timing and presented the court with an issue of first impression, the meaning of the word “make.” Almost all bond lawyers and underwriters’ counsel will recall the oft-quoted language in Rule 10b-5 making it unlawful “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.” The majority in Tambone stated “this case presents the two-part question of whether a securities professional can be said to ‘make’ a statement, such that liabil-

43 Id.
44 Rel. No. 34-34961
45 (No. 07-1384, 1st Cir. Mar.10, 2010).
ity under Rule 10b-5(b) may attach, either by (i) using statements to sell securities, regardless of whether those statements were crafted entirely by others, or (ii) directing the offering and sale of securities on behalf of an underwriter, thus making an implied statement that he has a reasonable basis to believe that the key representations in the relevant prospectus are truthful and complete.

The answer given by the majority to each part of this two-part question was ‘no.’ The First Circuit rejected the SEC’s efforts to interpret the statute such “that one may make a statement within the purview of the rule by merely using or disseminating a statement without regard to the authorship of that statement or, in the alternative, that securities professionals who direct the offering and sale of shares on behalf of an underwriter impliedly make a statement, covered by the rule, to the effect that the disclosures in a prospectus are truthful and complete.”

On June 13, 2011, the date of submission of this column for publication, the United States Supreme Court released its decision in *Janus Capital Group, Inc., et al. v. First Derivative Traders*, also addressing market timing issues. The 5-4 decision in Janus substantially narrowed the existing interpretation of Rule 10b-5 to “the person or entity with the ultimate authority over the statement, including its content and whether and how to control it” exclusive of others who participate in its preparation and dissemination. Justice Thomas’s majority opinion was joined by Chief Justice Roberts and Justices Scalia, Kennedy, and Alito. Justice Breyer filed a contentious dissenting opinion, in which Justices Ginsburg, Sotomayor, and Kagan joined.

The syllabus explains that First Derivatives Traders, representing a class of shareholders in Janus Capital Group, Inc. (“JCG”), instituted a private action under Exchange Act Rule 10b-5 alleging, “inter alia, that JCG and its wholly owned subsidiary, petitioner Janus Capital Management LLC (“JCM”), made false statements in mutual fund prospectuses filed by Janus Investment Fund (the “Fund”)—for which JCM was the investment adviser and administrator—and that those statements affected the price of JCG’s stock. The District Court dismissed the complaint for failure to state a claim. The Fourth Circuit reversed, holding that First Derivative had sufficiently alleged that JCG and JCM, by participating in the writing and dissemination of the prospectuses, made the misleading statements contained in the documents.

Justice Thomas’s majority decision reduces the issue to a simple question: did the party “make” the misleading statement or omission? To be liable under Rule 10b-5, one must “make” an untrue statement of a material fact. The majority held that JCM did not make the alleged misstatements. Since the allegedly misleading prospectus was a document of, and legally controlled by, the Fund, and JCM was a legally separate entity serving as an advisor, JCM simply did not “make” the challenged statement. Justice Thomas begins his analysis by noting that “in analyzing whether JCM “made” the statements for purposes of Rule 10b–5, we are mindful that we must give “narrow dimensions . . . to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.”

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47 Id.
48 Id.
49 Id.
One “makes” a statement by stating it. When “make” is paired with a noun expressing the action of a verb, the resulting phrase is “approximately equivalent in sense” to that verb. 6 Oxford English Dictionary 66 (def. 59) (1933)(hereinafter OED); accord, Webster’s New International Dictionary 1485 (def. 43) (2d ed. 1934) (“Make followed by a noun with the indefinite article is often nearly equivalent to the verb intransitive corresponding to that noun”). For instance, “to make a proclamation” is the approximate equivalent of “to proclaim,” and “to make a promise” approximates “to promise.” See 6 OED 66 (def. 59). The phrase at issue in Rule 10b–5, “[t]o make any . . . statement,” is thus the approximate equivalent of “to state.” For purposes of Rule 10b–5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it. Without control, a person or entity can merely suggest what to say, not “make” a statement in its own right. One who prepares or publishes a statement on behalf of another is not its maker. And in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it is attributed. This rule might best be exemplified by the relationship between a speechwriter and a speaker. Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes credit—or blame—for what is ultimately said.

Justice Thomas asserts that his holding follows from Central Bank of Denver, N. A. v. First Interstate Bank of Denver, N. A., 511 U. S. 164 (1994) and from the recent holding in Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 552 U. S. 148, 165 (2008). In Central Bank, the Court held that the private right of action under Rule 10b-5 does not extend to suits against aiders and abettors. “Such suits,” Justice Thomas explains, “—against entities that contribute ‘substantial assistance’ to the making of a statement but do not actually make it – may be brought by the SEC…but not by private parties.” After Central Bank, even the SEC’s authority to pursue aiders and abettors was in doubt until Congress added §20(f) to the Exchange Act. In the interim, the SEC pushed to expand the scope of who could be considered a “primary violator,” as did the plaintiffs’ bar both in the interim and afterwards, with supporting amicus briefs filed by the SEC. Justice Thomas continues: “[i]f persons or entities without control over the content of a statement could be considered primary violators who ‘made’ the statement, then aiders and abettors would be almost nonexistent.” In a footnote he adds: “for Central Bank to have any meaning, there must be some distinction between those who are primarily liable (and thus may be pursued in private suits) and those who are secondarily liable (and thus may not be pursued in private suits). We draw a clear line between the two – the maker is the person or entity with ultimate authority over a statement and others are not.”

In Stoneridge, the Court “held that dismissal of the complaint was proper because the public could not have relied on the entities’ undisclosed deceptive acts.” Justice Thomas points out that “[s]ignificantly, in reaching that conclusion we emphasized that ‘nothing [the defendants] did made it necessary or inevitable for [the company] to record the transactions as it did.’ This emphasis suggests the rule we adopt today: that the maker of a statement is the entity with authority over the content of the statement and whether and how to communicate it. Without such authority, it is not ‘necessary or inevitable’ that any falsehood will be contained in the statement.”

Following its discussion of Central Bank and Stoneridge, the majority opinion states: “We see no reason to treat participating in the drafting of a false statement differently from engaging
in deceptive transactions, when each is merely an undisclosed act preceding the decision of an independent entity to make a public statement.”

In dissent, Justice Breyer asserts that parties other than the legally controlling entity can indeed make statements under Rule 10b-5, contests the conclusion that the majority is following Central Bank, and argues that the majority’s bright line ruling may create situations where no one can be held liable for misleading statements. He continues:

The possibility of guilty management and innocent board is the 13th stroke of the new rule’s clock. What is to happen when guilty management writes a prospectus (for the board) containing materially false statements and fools both board and public into believing they are true? Apparently under the majority’s rule, in such circumstances no one could be found to have “made” a materially false statement—even though under the common law the managers would likely have been guilty or liable (in analogous circumstances) for doing so as principals (and not as aiders and abettors).

and:

Indeed, under the majority’s rule it seems unlikely that the SEC itself in such circumstances could exercise the authority Congress has granted it to pursue primary violators who “make” false statements or the authority that Congress has specifically provided to prosecute aiders and abettors to securities violations.

Private actions in the municipal market under the antifraud provisions are far fewer in number than those brought by the SEC, in large part because the SEC does not have to show economic loss. Nevertheless, such actions are brought from time to time. The majority’s bright line drawn for primary liability under Rule 10b-5 should be of some comfort to lawyers and others who participate in the preparation and dissemination of disclosure. Whether or not it extends to SEC actions, as Justice Breyer fears, remains to be seen. Others with more time available to analyze this decision will add much in the months ahead to the spare observations above. I encourage you to read the opinion yourself, available on the Supreme Court website at the URL provided above in note 46.
Introduction
Is disclosure on the underlying obligor necessary when variable rate demand obligations ("VRDOs") are secured by a letter of credit? Obligations of this type have been in use in the municipal market since the early 1980s. After more than 30 years of experience, a clear answer to this question might be expected. Yet, even after the exemption for VRDOs was removed by the Securities and Exchange Commission (the “SEC”) from Rule 15c2-12 by the amendments that became effective in December 2010, uncertainty remains.

Why isn’t the answer clear? This article will explore the reasons. It will discuss the structure of the 2010 amendments and the rationale offered by the SEC for the removal of the exemption. It will also explore the structure of VRDOs and the credit substitution theory for VRDOs secured by letters of credit. At the end of the discussion some practical approaches will be discussed that might be used to reconcile the disclosure responsibilities of market participants with the risk protection and expectations of investors in VRDOs. It is too ambitious to expect this article to provide a clear answer to the basic question. A more realistic goal would be to improve the framework for analysis of this issue. It is likely to remain a subject of intense debate and discussion.

The responsibility for VRDO disclosure rests primarily with the entity for whose benefit VRDOs are issued, the entity that receives the proceeds of the offering and is obligated to pay. The lawyers and underwriters who assist these obligors in their access to the VRDO market must advise the obligors and may also have some responsibility of their own. Ultimately, these other participants will have to decide whether they will assist in the financing in light of the decisions made by the obligor.2

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1 SEC Municipal Securities Disclosure Rule, 17 C.F.R. § 240.15c2-12 (2011); Amendment to Municipal Securities Disclosure, Exchange Act Release No. 34-62184A, 2010 SEC LEXIS 1862 (June 10, 2010) [hereinafter the “Release”]. The amendments were promulgated as part of the Release, which contains important interpretive statements about the reason for the amendments and their intended effect. When this discussion refers to the amendments, it means the actual language of the amendments to the Rule. When this discussion refers to the Release, it means the accompanying release with the interpretive comments about the amendments.

2 For a good discussion about the disclosure responsibilities of the various parties in a tax-exempt bond financing, see NATIONAL ASSOCIATION OF BOND LAWYERS, AM. BAR ASS’N SECTION OF STATE AND LOCAL GOVERNMENT LAW ET AL., DISCLOSURE ROLES OF COUNSEL IN STATE AND LOCAL GOVERNMENT SECURITIES OFFERINGS (3d ed. 2009).
Background
The first step toward a better framework for analysis is a common understanding of basic concepts and terminology involved. The following are key concepts and terminology important to an understanding of this issue.

Who is the Underlying Obligor?
In this article the term “underlying obligor” is used for the entity responsible for payment if the letter of credit bank does not pay. In one sense this entity might be thought of as the primary obligor, because it initiated the issuance of the VRDOs and is responsible for payment. The letter of credit is only the security for that payment. However, under the credit substitution theory discussed below, the bank payment obligation under a direct pay letter of credit is elevated to the primary credit, perhaps even the only credit, to which the investor looks for payment. The word “underlying” attempts to connote the secondary role played by the underlying obligor in the credit substitution theory.

The underlying obligor for VRDOs may be the actual issuer of the VRDOs. Governmental units can issue VRDOs and other types of tax-exempt debt directly for their own account. In this case the issuer itself is obligated to pay debt service and to purchase VRDOs tendered for purchase with its own funds. The underlying obligor for VRDOs may also be a conduit borrower that borrows the proceeds from the actual issuer of the bonds. In this case the actual issuer usually has no obligation for payment with its own funds. Rather, the conduit borrower is obligated by a loan agreement or similar agreement to make payments to the actual issuer for debt service and for the purchase of VRDOs tendered for purchase. Nonprofit, 501(c)(3) corporations, for-profit corporations, and other entities that are not governmental units can be conduit borrowers if they qualify as a beneficiary of tax-exempt financing. For purposes of this analysis, the difference between actual issuers of VRDOs and conduit borrowers is not important. The term “underlying obligor” is used for the entity that has responsibility for payment with its own funds.

Variable Rate Demand Obligations and Direct Pay Letters of Credit
VRDOs are debt obligations that have a variable interest rate reset each week. The rate is set by an independent party, usually referred to as a “remarketing agent.” The remarketing agent is required to set the rate at a level that will make the VRDOs trade at par. If the holder of a VRDO doesn’t like the current rate, or if the holder is concerned about credit risk, or if the holder simply wants to liquidate the investment, the holder has the right to tender the VRDO for repurchase on 7 days’ notice. There are also specified events that require a mandatory tender for repurchase. These events may include a change to another interest rate mode, a substitution of the letter of credit, the expiration of the letter of credit, or a default by the underlying obligor in

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3 It is also possible that VRDOs can be taxable. The analysis for taxable VRDOs would be the same.
4 For some VRDOs the rate is reset on a daily basis. The difference is not important for purposes of this discussion. The point is that the rate on VRDOs is reset frequently so that the VRDOs are always expected to trade at par.
its agreement with the bank providing the letter of credit. A VRDO tendered for purchase may be remarketed to a new investor, if one can be found.

A letter of credit that secures VRDOs is a direct pay letter of credit that obligates the issuing bank to pay debt service each time it is due and obligates the issuing bank to pay the purchase price of VRDOs tendered for purchase that cannot be remarkedeted. The bank’s funds are used for payment through a draw on the letter of credit, and the underlying obligor must reimburse the bank for the draws.5

The structural principles of VRDOs secured by a letter of credit are now well-established. If the VRDOs are rated, the rating agency reviews the structure to be sure it satisfies these principles. Debt service is paid directly from a draw on the letter of credit. If the purchase price of tendered VRDOs cannot be paid from remarketing proceeds, the purchase price is paid directly from a draw on the letter of credit. These structural principles insulate the holder of the VRDO from the risk that underlying obligor cannot pay, and they also insulate the holder from bankruptcy risks related to the credit of the underlying obligor, such as the risk of the automatic stay or the risk of an avoidable preference. These VRDOs are structured so that the investor can rely solely on the credit of the bank issuing the letter of credit and can disregard the credit of the underlying obligor. The underlying obligor is obligated to reimburse the bank for draws on the letter of credit, so that the bank, not the VRDO investor, takes the payment risk associated with the credit of the underlying obligor. This structure is sometimes referred to as a “credit substitution,” meaning the credit of the bank is substituted for the credit of the underlying obligor. It has been battle tested, and an underlying obligor is safe to assume that the legal structure works.6 Of course, it is possible that the bank could fail to pay on its letter of credit. If it does fail, the underlying obligor is still responsible for payment. This possibility is the reason for the central question addressed here: Does this possibility require that disclosure be made about the credit of the underlying obligor?

How far and how fast would a bank have to fall to make the 7-day tender option no longer an effective protection for the investor? The answer obviously depends to a great extent on the particular bank in question. At the time VRDOs are issued, the bank’s rating is likely to be at least in the “A” category for its long-term rating and in the highest category (“A-1/P-1”) for its short-term rating. Ratings below these levels usually do not provide cost-effective access to this market.7 It is a long way to fall from these rating levels to the point of failure – the inability to honor a draw on the letter of credit. A VRDO investor can be expected to have ample time to

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5 It is possible for VRDOs to be issued without credit enhancement—without a letter of credit. Unenhanced VRDOs are not part of this discussion. There is little room for doubt that unenhanced VRDOs require disclosure on the underlying obligor.

6 A series of cases beginning with the infamous In re Twist Cap, Inc., 1 B.R. 284 (M.D. Fl. 1979) resulted in a thorough analysis of the related bankruptcy issues, including preference and automatic stay provisions, and has generally confirmed the sanctity of letters of credit used in this context. See, e.g., In re Planes, Inc. 29 B.R. 370 (N.D. Ga. 1983); In re Air Conditioning, Inc. of Stuart 72 B.R. 657 (S.D. Fl. 1983). Based on this well-developed body of law, rating agencies have concluded that the risk of an adverse decision need not be factored into the risks for investors in VRDOs secured by direct pay letters of credit.

7 After the VRDOs are issued, the bank’s rating can deteriorate. We are talking here about the circumstances at the time of issuance.
decide whether and when to exercise its 7-day tender option. During the recent financial crisis, some banks unfortunately fell from those rating levels to the point where the FDIC stepped in or forced the bank to sell or merge. If those banks had letters of credit outstanding during the slide toward insolvency, the underlying obligor usually refinanced. If it did not, the bank ended up holding the VRDOs after the holders tendered. The lack of reports to the contrary indicate that the decline was never fast enough to preclude the use of the 7-day tender option. The investors were never left holding the bag. A failure rapid enough to remove the effective protection of the 7-day tender option would more likely be the result of a systemic failure of the banking industry as a whole. That possibility is even more remote than a single bank failure. If such a systemic failure occurs, the economy as a whole is likely to suffer the consequences. It may be fair for the underlying obligor to say that all bets are off at that point about its credit as well, and the underlying obligor may question whether its historical disclosure information is likely to be of any value to an investor under such circumstances. However, it is not persuasive, at least for purposes of analysis of disclosure responsibility under the securities laws, for an underlying obligor to decide the question on the basis that its disclosure information probably would not be useful anyway. It might. In any event, it's possible that a particular bank, or even the financial system as a whole, will suffer a catastrophic failure that would make the 7-day tender option no longer an effective protection.

**Payment Risk and Market Risk**

Investors in debt obligations take two basic risks. The first is the risk that the investor may not be paid when debt service is due. This first risk is referred to in this article as “payment risk.” The second risk relates to the market value of a debt obligation. The market value could decline if the credit of the obligor deteriorates. If the investor sells at a price below par, the investor suffers a loss. Of course, market value could also decline as a result of an increase in prevailing interest rates or as a result of a widening in credit spreads. Those factors are not credit-specific. They relate to general market conditions and have nothing to do with the disclosure issues under consideration here. On the other hand, a decrease in prevailing interest rates or a narrowing of credit spreads could lead to market loss resulting from credit deterioration of the obligor. If prevailing rates decrease or credit spreads narrow, the market value of the debt obligation should increase. The increase is not credit-specific. It is the result of general market conditions. However, if the debt obligation is paid early, the investor will lose the advantage of the increase in market value. This could happen, for example, if the obligor defaults and the debt is accelerated. So the credit of the obligor carries a risk that value will decline and a risk that the investor will be deprived of the advantage of an increase in market value by early payment. These risks are referred to in this article as “market risk.”

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8 The phrase “credit spread” refers to the difference in interest rates between issuers of similar debt obligations of differing creditworthiness. Typically, a credit spread is compared to a comparable U.S. Treasury obligation (or, in the case of municipal bonds, an index based on “AAA” municipal bonds). Thus, on a 10 year bond, a AA-rated borrower will pay a higher interest rate on its debt than the U.S. Government would on its debt. Likewise, a BBB-rated borrower’s interest cost to access the bond market would be higher than either of the other two borrowers. The difference in rate is intended to compensate the holder for the increased risk of non-payment or other default by less creditworthy borrowers.
Credit enhancement arguably insulates an investor from payment risk and market risk related to the credit of the underlying obligor. In the early days of the reign of bond insurance in the municipal market, this argument was sometimes used to justify the omission of disclosure on the underlying obligor in the offering document for fixed-rate bonds. If the credit enhancer is rated “AAA,” the investor should be able to rely solely on ability of the bond insurer to pay, and disclosure about the underlying obligor should be unnecessary, or so the argument went. One problem with this argument is that bond insurance never fully insulated the investor from market risk related to the credit of the underlying obligor. If the underlying obligor defaulted after interest rates declined, the bond insurer could cause the maturity of the bonds to be accelerated. This would deprive the investor of the increase in market value. For this reason alone the underlying obligor’s credit could be material to an investor. Experience from the recent crisis in the financial markets revealed a more fundamental flaw in this argument. In retrospect, after the bond insurance industry essentially crashed and burned in the last few years, this argument seems naïve. Without any tender option to liquidate their investment early, investors in insured, fixed-rate bonds could only watch and suffer as bond insurance was downgraded or became worthless and the value of their bonds followed. They were left with only the credit of the underlying obligor for the assessment of payment risk and market risk. Information about the credit of the underlying obligor became essential to these investors. In retrospect, it was always essential.

The SEC provided an early warning about such reliance on credit enhancement. In 1989, in the adopting release for Rule 15c2-12, the SEC made the following statement:

“In the Commission’s view, the presence of credit enhancement generally would not be a substitute for material disclosure concerning the primary obligor on municipal bonds.”

Total reliance on bond insurance was already the subject of debate when this statement was made, and some market participants had refused to adopt that approach even before the SEC spoke. This statement by the SEC and the discussion that followed effectively removed any remaining doubt on the point for fixed-rate bonds. To the extent that some might have clung to the total reliance approach, the recent experience with the bond insurance industry has made the transition to acceptance complete. Today the accepted practice is to provide primary market disclosure on the underlying obligor for insured, fixed-rate bonds.

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9 This assumes, of course, that the financing documents permit acceleration after default. Some financing documents do not, particularly financing documents for governmental units. Even when documents do permit acceleration, it is rare for a bond insurer to exercise that right on behalf of fixed-rate bondholders.  
10 Many bond insurers provided insurance or credit default swaps on subprime mortgage backed investments that soured in 2007 and 2008, when writedowns of the value of subprime-backed investments led to ratings downgrades of almost all of the major bond insurers. Without sufficient capital to pay claims or sufficient ratings to make their products attractive to potential customers, business withered along with the insurers’ claims paying ability. There are only a few viable insurers today; none are AAA-rated any longer.  
Did this statement by the SEC also apply to VRDOs secured by a letter of credit? If the investor has a 7-day tender option at par and the interest rate is reset every week, do the same concerns exist about payment risk and market risk? The statement by the SEC did not distinguish between long-term and short-term obligations, or between types of credit enhancement, or between obligations with a tender option and those without. There was another important distinction to consider. VRDOs were exempt from the continuing disclosure requirements of Rule 15c2-12; fixed-rate debt was not.12 Did that make a difference? Finally, the use of the word “generally” in this statement suggests that there are exceptions to the basic statement. What are those exceptions? These questions prompted market participants to consider the differences in VRDOs secured by a letter of credit in light of this statement.

VRDOs secured by letters of credit are structured to eliminate both payment risk and market risk, at least where the credit of the underlying obligor is concerned. The VRDO investor is always paid from a draw on the letter of credit, or from a successful remarketing, so the investor has no payment risk based on the credit of the underlying obligor. The interest rate on the VRDO is continually adjusted, on a weekly basis, to a level that would allow the VRDO to trade at par, so the VRDO investor can have confidence that the market value of the VRDO will not vary from par.13 If the investor feels threatened with respect to payment risk or market risk, including payment risk or market risk based on the credit of the bank, the investor can tender and be paid at par on 7 days’ notice. Of course, the potential flaw in the credit substitution theory was and is the credit of the bank. If the bank fails, the underlying obligor will be responsible for payment; the investor will be exposed to payment risk and market risk based on the credit of the underlying obligor. In one sense this is the same analysis for insured fixed-rate bonds. There is, however, a critical difference. The VRDO investor has a tender option at par. If the credit of the bank starts to deteriorate, the investor can tender on 7 days’ notice and be paid at par. Is this distinction enough, or does the possibility of bank failure under these circumstances (before the tender right can be exercised) require that disclosure be made about the credit of the underlying obligor?

Before leaving the concept of payment risk and credit risk, it should be noted that the 7-day tender feature of VRDOs secured by a letter of credit distinguishes these obligations from other types of credit-enhanced debt as well as insured fixed-rate debt. Thus, insured auction rate bonds, insured index-rate floaters, and insured VRDOs with a standby purchase agreement all fail by comparison to this feature of VRDOs. Insured VRDOs with a standby purchase agreement come closest to the protection afforded by VRDOs secured by a letter of credit, but there is a critical difference. The bank’s obligation to purchase is never absolute. If the credit of the

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12 Assuming, of course, that the fixed rate debt was not sold in a limited placement, an exemption to the Rule discussed below.

13 In addition to the frequent mark-to-market of the interest rate, VRDOs are customarily subject to optional redemption at par on any date upon no more than 30 days’ notice and are subject to mandatory tender and purchase on any date upon no more than 20 days’ notice if the interest rate mode is converted, or certain other events occur at the option of the underlying obligor. The investor has no contractual right to hold VRDOs beyond these relatively short notice periods. Even if the interest rate was above the current market (i.e., was not being marked to market on a frequent basis), the right of the underlying obligor to pay the investor at par on short notice would effectively eliminate the ability of the investor to realize any value in trading the investment.
insurer failed, the bank could immediately terminate its obligation to purchase. In many cases the tender right also evaporated when the bank's obligation to buy ceased. In other cases the investor retained its tender right but became dependent upon the credit of the underlying obligor to purchase. At the end of the day, the investor in an insured VRDO could never be sure that its tender right could be exercised. This feature proved fatal to market acceptance when the bond insurance industry crashed. The structure with the best argument against disclosure about the credit of the underlying obligor remains the VRDO secured by a letter of credit.

The 7-day tender option has an important effect on risk allocation when market disturbance disrupts acceptance of VRDOs secured by a letter of credit. If the bank's credit deteriorates, or if the viability of the banking industry as a whole is in doubt, the investors can exercise their tender right. If the VRDOs cannot be remarketed, they must be held by the bank after a draw on the letter of credit to fund the purchase price. The underlying obligor is then left to restructure the debt. When the bank's obligation to hold expires, the underlying obligor must either restructure with the bank or refinance. This effectively shifts the risk of the bank's failure from the investors to the underlying obligor. If the underlying obligor has chosen to access the market without disclosure about the credit of the underlying obligor, this allocation of risk makes perfect sense. If the underlying obligor provided disclosure about its own credit, but the holders tendered anyway, the underlying obligor is in the same position. As discussed below, during the recent market crisis obligors of both types ended up in this position. The point is that the 7-day tender option shifts this risk in both cases, assuming, of course, that the bank remains viable long enough to honor the tender right.

It should be obvious by now that one inevitable conclusion of this article is that someone must evaluate the risk that a bank might fail before its letter of credit can be drawn upon in order to reach practical answers to the basic disclosure question posed here. More about that later.

The Meaning of “Disclosure on the Underlying Obligor”
What does “disclosure on the underlying obligor” mean in this context? For a primary offering of securities, disclosure in the official statement about the underlying obligor typically includes information about its organization and governance, its facilities and operations, its primary sources of revenue, operating statistics or data for past fiscal years, and sometimes for interim partial years as well, a summary of revenues and expenses for past fiscal years, and sometimes for interim partial years as well, the most recent audited financial statements, pending or threat-
ened litigation, and risk factors.\textsuperscript{14} This list is illustrative only. The information varies by industry and the particular obligor involved. The point is that the scope of information is expected to provide a complete picture that will permit the investor to make an informed investment decision based on the underlying obligor’s ability to pay. Disclosure of this type and extent is referred in this article as “primary market disclosure.” This type of primary market disclosure is the generally accepted standard for fixed-rate debt and for other types of debt dependent upon the underlying obligor for payment. The question here is whether it is also necessary for VR-DOs secured by a letter of credit.

Although Rule 15c2-12 has rules governing the required delivery of an official statement, the Rule says almost nothing about the required content of the official statement. The Rule basically assumes that the official statement will comply with the basic standards of the securities laws: it will include information necessary for a reasonable investor to make an informed investment decision, it will be correct in all material respects, and it will not fail to state a material fact required or necessary to be stated therein in order to make the statements made therein, in light of the circumstances under which they were made, not misleading.\textsuperscript{15}

\textsuperscript{14} The events and possibilities included in risk factors vary to a great degree, reflecting the drafter’s determination of what is relevant and what is a reasonable possibility. Good disclosure practice does not require that every possibility and its consequences must be described. Some judgment is always required to separate reasonable possibilities from the unreasonable. The people of Manson, Iowa will tell you that an asteroid could hit the Earth. It happened there long ago. See BILL BRYSON, A SHORT HISTORY OF NEARLY EVERYTHING 189–207 (2003) for a description of the event. The scientists who have studied geological evidence of this event will tell you that the likely result was total devastation of whatever life existed in the impact area, which was large indeed. Yet, official statements for debt offerings in Iowa and elsewhere in the United States do not spend time discussing this possibility. Not even the lawyers who draft the risk factor section for health care offerings have spent time on this possibility.

The United States government could default on its debt. It has quite a lot these days, and there are frequent statements in the news media by politicians and economists about the crushing burden being left for future generations. Congress must periodically exercise the political will to raise the debt limit. It is possible that Congress will balk, or that the citizens of the United States will force a balk, as the citizens of Iceland have done, or that the United States simply will not be able to meet its debts. It is possible. Official statements do not spend time on this possibility either.

The explanation must be that asteroids and default by the United States are generally believed to be so remote, or the consequences so dramatic and thorough, that it is not worth speculating about them. The risk we are discussing here about a bank’s failure is also remote, maybe or maybe not as remote as these examples. It doesn’t matter how we rank the possibilities in terms of probability. The point is that sheer possibility is not the measure of good disclosure. Some judgment is required. There is an element of reasonableness in the selection of possibilities.

Before leaving primary market disclosure, it should be noted that an official statement is always delivered in connection with the public offering of municipal securities. The official statement, at a minimum, will describe the pricing terms of the securities, the legal security for payment, and the essential terms of authorizing and security documents. VRDOs are no exception. The official statement for VRDOs secured by a letter of credit will also include information about the bank. This information is typically provided by the bank in summary form and cross-references to more detailed information in the regulatory filings of the bank or its parent holding company. The question here is not whether an official statement is delivered at all; the question is whether the official statement will include primary market disclosure about the underlying obligor.

Rule 15c2-12 also has rules governing the required delivery of continuing disclosure information after the securities have been issued. There are two types of continuing disclosure information required. One relates to certain events that may occur after the securities are issued. This is commonly referred to as “event disclosure.” This type of disclosure is discussed below. The extension of this type of disclosure to VRDOs should not be controversial.

The other type of continuing disclosure relates to required updating of certain information included in the original official statement. The underlying obligor is required to make annual filings that include annual financial information for each [underlying obligor] “for whom financial information or operating data is presented in the final official statement.” The continuing disclosure requirements also include filing of audited financial statements. The annual financial information to be provided, and the required timing of delivery for that information and the audit, is specified in the continuing disclosure agreement entered into when the securities are issued. The annual financial information typically includes at least the key operating data and the summary of revenues and expenses presented. In other words, it requires annual updating of specified portions of the primary market disclosure. Disclosure of this type (including the delivery of the audit) is referred to in this article as “annual financial disclosure.” This phrase is not meant to include event disclosure.

It should be noted from the language of the Rule quoted in the preceding paragraph that the Rule does not necessarily require annual financial disclosure for an underlying obligor. It depends on whether the final official statement presented similar information for the underlying obligor. This nuance of the Rule has major significance in the analysis later regarding the effect of the 2010 amendments and the statements made by the SEC in the Release.

At various points in this article the difference between primary market disclosure and annual financial disclosure is not important. When referring to both types of disclosure, or when the distinction is not important in the context, the phrase “disclosure on the underlying obligor” is sometimes used to avoid distraction or to economize.

16 17 C.F.R. § 240.15c2-12(b)(5)(i)(A) (emphasis added). The requirement that the continuing disclosure reflect the primary offering disclosure reflects a common sense decision by the SEC to rely on the decisions made by the financing team in the original offering as to materiality, since members of the team have well-developed responsibilities for such initial disclosures.

17 C.F.R. § 240.15c2-12(b)(5)(i)(B).
**The Differences in Underlying Obligors**

It is important to note that all underlying obligors are not situated similarly with respect to this issue. Some underlying obligors are frequent issuers of debt in the municipal market with experience in preparing an official statement and with existing continuing disclosure agreements that already require annual financial disclosure. In fact, many health care entities often have continuing disclosure agreements that require quarterly disclosure. For these obligors, disclosure about their own credit is not a substantial burden, and it certainly is not an impediment to access to the VRDO market. Depending on their credit rating, some of these obligors may even be able to access the VRDO market without a letter of credit. There are many variations within this class. These obligors will be referred to as “disclosure-ready obligors.”

Many underlying obligors simply are not disclosure ready. Some have never prepared an official statement or accessed the public market. They lack the experience and resources to do so with the required care and diligence necessary for a public offering. Some have operations or finances that are unusual and cannot be disclosed without a difficult presentation, accompanied by strenuous due diligence. There are many variations within this class, but the distinguishing characteristic is that market access with full disclosure on the underlying obligor is simply cost-prohibitive or impossible. For this class of obligors it’s not a question of willingness to disclose, it’s a question of ability to disclose at all, at least at a reasonable financial cost, or to disclose properly if disclosure is undertaken. These obligors are referred to as “obligors who cannot disclose.”

The following may be a useful example of an obligor who cannot disclose. A community wishes to develop a children’s museum. Interested citizens organize a nonprofit, 501(c)(3) corporation to develop, own, and operate the museum. The estimated cost is approximately $30 million. The city makes promises about funding, and a fundraising drive yields numerous corporate and individual pledges. A pro forma financial statement projects ticket and sponsor revenues that yield a modest operating margin. The combination of the projected modest operating margin, anticipated city support and anticipated donor support makes this project seem viable, at least in the eyes of the local community. A loan officer in the local branch of a potential letter of credit bank agrees and convinces his credit committee that the bank should provide financing for this project. The loan is too large for a “bank-qualified” direct tax-exempt loan, so the bank agrees to provide a letter of credit that will support a VRDO offering for the museum. Careful professionals attempting to assist this hypothetical museum project would consider good disclosure on the underlying credit to be difficult indeed. This is a complete start-up operation; it has no past operations or audit; it has projections that have not been vetted by independent review of a feasibility consultant; the city’s level of commitment and funding ability are hard to verify; the pledges are generally solid, but the viability of some pledges is still somewhat speculative; and there is no guaranteed maximum price contract or other comfort about the final budget. The museum may consider the cost of good primary market disclosure unbearable for this project. Should this museum be able to access the VRDO market with disclosure only about the bank’s credit?

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18 The SEC in the Release seemed to place significant emphasis on the fact that disclosure-ready obligors entered into continuing disclosure agreements on their variable rate financings in spite of the exemption in the Rule. Release, supra note 1, at *35, *52 n.100, *298.
Other underlying obligors may simply be unwilling to provide full disclosure about their credit because disclosure would harm their business prospects, violate essential business agreements, or violate a confidentiality agreement. The business reasons may be quite legitimate. The variations in this class are once again wide. This class of underlying obligors will be referred to as “obligors unwilling to disclose.”

The following may be a useful example of an underlying obligor unwilling to disclose. A company is engaged in research and development of an alternative energy source and needs financing for a facility to manufacture the prototype equipment. The process and equipment involved may be highly confidential at this stage of development. An attempt to describe the company’s business prospects without describing the process and equipment would be meaningless and to do so would only allow potential competitors to gain unfair use of the research and development to date. The energy company’s bank is willing to provide a letter of credit that will allow the energy company to finance the facilities with VRDOs. If this energy company is not willing to disclose about its own credit, should it be allowed to access the VRDO market with disclosure only about the bank’s credit?

In fact, many transactions like our museum project or our energy company project have already been done successfully in the VRDO market without any disclosure on the underlying obligor. When the letter of credit for these projects is substituted, or some other event occurs that may constitute a new “primary offering,” the participants in those transactions will be faced with a dilemma about the continuation of that financing without disclosure on the underlying obligor. There will be many more projects proposed in the future for obligors who cannot disclose or obligors unwilling to disclose. These projects clearly cannot access the public market for fixed-rate bonds, and their projects may be too large, or otherwise ineligible, for a direct tax-exempt loan from a bank. VRDOs may be one of the only alternatives available to these obligors for tax-exempt financing. Any analysis that might preclude them from the VRDO market must be undertaken with the potential consequences in mind. These consequences relate to legitimate, practical concerns—market access for worthy public projects. This analysis must lead to appropriate protection for investors against payment risk and market risk, and it must consider the likelihood of harm to investors and the likelihood that the SEC might disagree with the approach and initiate an enforcement action to express that disagreement, but it must also consider the effect on market access for underlying obligors that cannot disclose and underlying obligors unwilling to disclose. Unfortunately, there is little comfort or certainty to be found for this analysis. A good place to start is the 2010 amendments to Rule 15c2-12. Underlying obligors need to understand what those amendments tell us about this difficult issue.

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19 See infra at “The Definition of ‘Primary Offering’ and the Pillsbury Dilemma”.
Rule 15c2-12 and the 2010 Amendments
Rule 15c2-12, adopted in 1989 and materially extended in 1994, contains two basic requirements. First, the Rule requires delivery of an official statement in connection with a primary offering of bonds. Second, the Rule requires an agreement for (i) annual financial disclosure and (ii) event disclosure.

Event Disclosure
The requirements for annual financial disclosure were discussed above. The effect of the 2010 amendments on primary market disclosure and annual financial disclosure is the primary focus of this analysis. It should be noted, however, that the 2010 amendments also made changes in event disclosure. The list of events to be disclosed as part of the continuing disclosure obligation of underlying obligors was changed. The list now includes the following events with respect to the securities being offered:

1. Principal and interest payment delinquencies.
2. Non-payment related defaults, if material.
3. Unscheduled draws on debt service reserves reflecting financial difficulties.
4. Unscheduled draws on credit enhancements reflecting financial difficulties.
5. Substitution of credit or liquidity providers, or their failure to perform.
6. Adverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the security, or other material events affecting the tax status of the security.
7. Modifications to rights of security holders, if material.
8. Bond calls, if material, and tender offers.
10. Release, substitution, or sale of property securing repayment of the securities, if material.
11. Rating changes.
12. Bankruptcy, insolvency, receivership or similar event of the obligated person.
13. The consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material.
14. Appointment of a successor or additional trustee or the change of name of a trustee, if material.
15. Failure to provide required annual financial information, on or before the date specified in the continuing disclosure agreement.

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20 The original version of the Rule included only the official statement requirement. The Rule was amended in 1994 to add the continuing disclosure requirement and was amended in 2008 to make the MSRB the central location for all filing requirements.
21 17 C.F.R. § 240.15c2-12(b)(5)(i)(C).
Many of these events are clearly important to investors in VRDOs. It makes sense that the underlying obligor should be required to file notice of these events, or at least those related solely to the financial health of the underlying obligor. For example, a determination by the Internal Revenue Service that VRDOs are taxable would have a significant effect on an investor. Whether or not required by the Rule, underlying obligors would be expected to notify the market about such an event. Having the obligation formally imposed by the 2010 amendments should not be a burden and should not be controversial.

The Rule is Addressed to Underwriters, But Is Understood to Apply to Underlying Obligors
The Rule is an underwriter conduct rule that requires municipal underwriters to obtain a contract with the underlying obligor for delivery of an official statement and execution of a continuing disclosure agreement. That odd approach is the result of the Tower Amendment’s prohibition against direct regulation by the SEC of the issuers of municipal securities. The SEC can regulate broker-dealers (underwriters), however, so the Rule is imposed indirectly through requirements on the broker-dealers. Despite the odd approach, the Rule is generally understood and applied as a rule effectively governing the offering of securities by underlying obligors.

The Rule Governs Procedures for Disclosure, Not Content
The Rule is basically a procedural rule, not a substantive rule, in terms of the content of an official statement. In other words, the Rule determines when an official statement must be delivered; it does not impose specific requirements about the content of an official statement. The SEC has taken pains to make this point clear. Although this distinction is technically correct, it would also be correct to say that the amendments to the Rule, by implication, and the language of the accompanying Release have some important things to say about content. More about that below.

22 The Tower Amendment, part of the 1975 legislation creating the Municipal Securities Rulemaking Board (the “MSRB”), is part of the Securities Exchange Act of 1934 and prohibits the SEC and MSRB from requiring municipal issuers to make any filing with the SEC or MSRB in connection with any bond issuance. 15 U.S.C. § 78-4(d). The Dodd-Frank Act which was recently passed required the executive branch to undertake a study of whether the Tower Amendment should be repealed. This endeavor bears watching closely.

23 In its 1989 Release, the SEC stated, “Some commentators suggested that use of the term ‘complete’ in the Proposed Rule implied substantive disclosure obligations concerning the offering documents. The Rule was not intended to govern the content of the offering documents.” Adoption of Rule 15c2-12, Exchange Act Release No. 34-26985, 1989 SEC LEXIS 1173, at *22 n.31 (June 28, 1989) (emphasis added).

24 See infra pp. 12–16.
Exemptions Under the Rule

The Rule has exemptions. They are important for this discussion. Prior to the 2010 amendments, the primary exemptions could be summarized, or paraphrased, as follows:

1. **Limited placement exemption.** A primary offering of securities in denominations of $100,000 or more if the securities are sold to no more than 35 investors and there is a reasonable belief that:
   - (a) each purchaser has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the investment; and
   - (b) each purchaser is purchasing for only one account and not with a view to distributing the securities.

2. **Commercial paper exemption.** A primary offering of securities in denominations of $100,000 or more if the securities have a maturity of nine months or less.

3. **Variable rate demand obligation (VRDO) exemption.** A primary offering of securities in denominations of $100,000 or more if the holder has the option to tender the securities for purchase at par at least as frequently as every nine months.

The 2010 amendments removed the exemption for VRDOs. Just removing the exemption for VRDOs would have made them subject to both the official statement requirements and the continuing disclosure requirements of the Rule. However, a new paragraph (d)(5) was added to the exemption section of the Rule. Technically read, new (d)(5) says that there is no official statement delivery requirement for VRDOs, only a continuing disclosure requirement. This is an odd result, particularly in the context of this discussion. Could it mean that the SEC does not consider an official statement necessary for VRDOs? If that is correct, then has the SEC also concluded that disclosure on the underlying obligor is not necessary? A reader looking for a quick and clean “no” answer to our basic question might be tempted to seize on this aspect of the amendment structure. That would be a mistake. A close reading of the Release makes it clear that

25 For the actual exemption language, see 17 C.F.R. § 240.15c2-12(d)(1) (1994) (amended 2010). The Rule also has a partial exemption from the continuing disclosure requirement for small issuers. See section (d)(2).

26 Release, supra note 1, at *22.

27 17 C.F.R. § 240.15c2-12(d)(5) (“With the exception of paragraphs (b)(1) through (b)(4), this section shall apply to a primary offering of municipal securities in authorized denominations of $100,000 or more if such securities may, at the option of the holder thereof, be tendered to an issuer of such securities or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months until maturity, earlier redemption, or purchase by an issuer or its designated agent; provided, however, that paragraphs (b)(5) and (c) of this section shall not apply to such securities outstanding on November 30, 2010, for so long as they continuously remain in authorized denominations of $100,000 or more and may, at the option of the holder thereof, be tendered to an issuer of such securities or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months until maturity, earlier redemption, or purchase by an issuer or its designated agent.”).

28 In discussing the paperwork burden associated with its amendments to the Rule, the SEC stated, “As discussed above, the amendments are not eliminating the exemption for demand securities from paragraphs (b)(1) through (b)(4) of the Rule, which relate to primary offering disclosure. As a result, under the amendments, issuers of demand securities will not have a paperwork burden with respect to primary offering disclosures.” Release, supra note 1, at *214.
that the technical structure of the amendments is only a response to the “Pillsbury dilemma,” to be discussed next, and that this structure was not at all intended to provide such a simple answer.

The Definition of “Primary Offering” and the Pillsbury Dilemma
The “Pillsbury dilemma” relates to the definition of a “primary offering” under the Rule. This definition is important, because the official statement delivery requirement is triggered each time there is a primary offering. The actual definition of “primary offering” in the Rule is innocuous looking, maybe even a bit misleading. It states:

“(7) The term primary offering means an offering of municipal securities directly or indirectly by or on behalf of an issuer of such securities, including any remarketing of municipal securities.

(i) That is accompanied by a change in the authorized denomination of such securities from $100,000 or more to less than $100,000, or

(ii) That is accompanied by a change in the period during which such securities may be tendered to an issuer of such securities or its designated agent for redemption or purchase from a period of nine months or less to a period of more than nine months.”

A no action letter from the SEC in 1991 addressed to the Pillsbury law firm made it clear that the specifics in this definition regarding changes in denomination and interest rate mode in connection with a remarketing of bonds are illustrative only and do not define the universe of remarketings that are primary offerings subject to the Rule. The SEC indicated that a primary offering can occur whenever the securities pass through the hands of the underlying obligor, or its agent, and are remarketed. This interpretation puts emphasis on the introductory clause, which refers simply to “an offering” of securities.

The SEC’s interpretation was of little consequence for VRDOs before the 2010 amendments. Even if a primary offering did occur with each remarketing of the VRDOs, such an offering was exempt from the requirements of the Rule.

By removing the exemption for VRDOs, the 2010 amendments made this interpretation important. If the official statement requirement applies to VRDOs and a new primary offering occurs each time VRDOs are remarked, then an official statement and a new continuing disclosure agreement must be prepared for each remarketing. This would make it practically impossible to comply with the Rule and would effectively preclude the use of VRDOs. The SEC recognized this dilemma and responded by exempting VRDOs from the official statement requirements.

This approach was helpful for purposes of the official statement requirement, but it leaves open some questions for application of the continuing disclosure rule. Must an underwriter or remarketing agent require a new continuing disclosure agreement every time there is a remarketing? Surely not. Perhaps this issue could be finessed by having an agreement that survives and

29 17 C.F.R. § 240.15c2-12(f)(7).
remains in effect throughout the remarketing process, until the debt is retired. Surely that would
satisfy the intent of the Rule, so that re-execution and redelivery with each remarketing would be
unnecessary. One might also interpret primary offering to mean a primary offering occurs only
in connection with a remarketing that follows a mandatory tender. A mandatory tender usually occurs when the underlying obligor takes some affirmative steps with respect to the securi-
ties, such as changing the interest rate mode or substituting the letter of credit. The degree of
involvement of the underlying obligor when a mandatory tender occurs is far greater than the
underlying obligor’s involvement with a simple optional tender. This distinction is logical and
appealing in its simplicity, but so far there is little authority to rely on for this interpretation. Per-
haps the SEC will clarify this point in the future. In the meantime, the safer approach may be to
use a continuing disclosure agreement that specifically survives with each remarketing.

The Limited Grandfather Provision
The 2010 amendments do not apply to VRDOs that were already outstanding on November
30, 2010 (the day before the general effective date). This means that the exemption for those
VRDOs continues, but for how long is uncertain. The limited grandfather provision may only
defer the questions addressed here about disclosure. Although the Release contains encourag-
ing narrative to indicate that the limited grandfather provision remains effective as long as the
affected VRDOs are outstanding, the underlying obligor has at least two concerns in relying on
this provision.

First, it is possible that the understanding of “primary offering” could override the limited
grandfather provision. It might mean that the next optional tender and remarketing override, or
it might mean that the next mandatory tender and remarketing override. The mandatory tender
standard would make more sense, but, as already indicated, there is no real authority for that
distinction. The Release does not address this point.

Second, after the effective date, certainly when the next mandatory tender occurs, the under-
lying obligor and the underwriters and lawyers who assist the underlying obligor will have
to address the disclosure question in light of the concerns discussed here, whether or not the
exemption continues. If the need for disclosure about the underlying obligor is based on a need
to reduce the likelihood of fraud facilitated by inadequate disclosure, does a technical effective
date provision provide much comfort? Should the underlying obligor have no concern about
investors in pre-effective-date VRDOs? If the grandfathered VRDOs are outstanding for un-
derlying obligors like our museum or energy company, the parties will have to decide the more
basic question: can those VRDOs remain outstanding at all without disclosure on the underly-
ing obligor?

When the next mandatory tender occurs, the underlying obligor and those who assist also
will have to decide whether to execute a continuing disclosure agreement, an issue that seems
small by comparison. It may seem like the safe decision to execute the agreement and avoid any
argument about the effect of the limited grandfather provision, but once that path is taken the
scope of the disclosure obligation is likely to become an acute concern.

32 17 C.F.R. § 240.15c2-12(d)(5).
The Treatment of Commercial Paper

In the Release the SEC offered various reasons for the amendments, which are discussed in the next section. No explanation, however, was ever offered for the disparate treatment of commercial paper. Yet, there are important similarities between VRDOs and commercial paper secured by a letter of credit. Commercial paper can have a maturity of up to 270 days. There is no right to tender before maturity. When the commercial paper matures, it must be paid and retired. If new commercial paper can be sold, the proceeds of the new issue can be used to pay the principal of the maturing commercial paper. If not, the letter of credit is drawn upon and the holder of the maturing commercial paper is paid from that source instead. Like the holder of a VRDO, the holder of commercial paper can be assured that the structure will allow it to rely on the bank in all events for payment of debt service. The investor is insulated from payment risk and market risk related to the underlying obligor. Like VRDOs, the credit substitution theory seems to work well, unless the bank fails before the commercial paper matures. Unlike VRDOs, the investor is exposed to risk of the bank’s failure for up to 270 days, rather than the 7 days necessary to exercise a tender option for VRDOs. In a rapid meltdown of the financial system, this difference could be important.

So why the different treatment? The exemption for commercial paper is untouched, while the exemption for VRDOs is removed. Without any discussion in the Release we are left to speculate. Perhaps the SEC felt that its hands were tied here because the registration rules for other securities contain a parallel exemption for commercial paper. It might be difficult to justify removal of an exemption for municipal securities that is parallel to an exemption for corporate debt. Or perhaps the difference relates to the short maturity of commercial paper. If each investor will be paid within 270 days from the investment date, it is not likely that the investor will ever need, or see, the benefit of continuing disclosure. This makes sense only if you assume the bank will never fail. If it fails within 270 days and the investor only had information about the bank, the investor may have a real need for information about the underlying obligor.

The continuing exemption may prompt a greater use of commercial paper in the future. Time will tell. But the difference between the treatment of commercial paper and VRDOs under the Rule will be of little comfort in the analysis for most market participants. The question remains: Is disclosure about the underlying obligor for commercial paper necessary, or can the official statement safely include only disclosure about the credit of the bank?

The Reasons for Change

The structure of the actual amendments provides little help in this analysis. Certainly the removal of the exemption implies that the SEC thought the exemption was no longer warranted, and that in and of itself could be important, but the structure of the amendments raises several questions that could tend to reduce the import of any such implication. Why are the official

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statement requirements not extended to VRDOs? Why the different treatment of commercial paper? Might these questions imply that the exemption was not important in this analysis after all? If you expect to find greater clarity in the interpretative statements of the Release, you might be disappointed, depending on your view of the expected or desired outcome of this analysis.

**Reduction of Fraud Facilitated by Inadequate Disclosure**

The Release offers a variety of reasons for the amendment. The most chilling is a general statement to the effect that the amendments are necessary to reduce the likelihood of fraud facilitated by inadequate disclosure.\(^\text{34}\) An example:

> “The Commission believes that investors and other municipal market participants today should be able to obtain continuing disclosure information regarding demand securities so that they can make more knowledgeable investment decisions and effectively manage and monitor their investments so as to reduce the likelihood of fraud facilitated by inadequate disclosure.”\(^\text{35}\)

One might be tempted to stop reading at this point and conclude that this statement is conclusive on its face with respect to the SEC’s view of this issue. There are other clues, however, to be gleaned from the Release that must be weighed to give this statement context in a complete analysis.

**Recent Market Turmoil**

The Release also contains a number of more specific reasons for change. The SEC states that recent events have suggested the need to reconsider the exemption.\(^\text{36}\) It suggests that the market for VRDOs was among the sectors most affected by the recent market turmoil, and, consequently, there is good reason to increase the availability of information about these securities to investors.\(^\text{37}\) These statements are, frankly, hard to fathom. During the recent market turmoil, VRDOs secured by letters of credit performed very well. The structure held up under intense scrutiny and doubt, including doubt about certain banks in particular and doubt about the banking industry as a whole. It is impossible to prove a negative like this, but diligent inquiry from a variety of reliable sources fails to produce a single example of a VRDO holder being left unpaid or unable to exercise its tender option. Certainly the SEC offers no such examples in the Release. It is true that rates on VRDOs spiked wildly during this period. The SIFMA index reached 7.96% on September 24, 2008. This produced a hardship for underlying obligors and arguably produced a windfall for investors who chose to continue to hold, but it was the “market rate” and the investors were paid. If investors chose not to hold, they tendered and were paid. Isn’t this exactly how the structure was intended to work? It is also true that after some VRDOs were tendered, they could not be remarketed. This produced hardship for underlying obligors that had to refinance out of the VRDOs. But, again, isn’t this exactly how the structure allocated the risk? The underlying obligor accepts the refinancing risk if it relies on the credit of the bank and the bank’s credit deteriorates. With this experience, one might have expected that

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\(^{35}\) Id. at *41 (emphasis added).

\(^{36}\) Id. at *16.

\(^{37}\) Id. at *33.
VRDOs would be counted as a reliable performer during an extremely difficult period, rather than a candidate for reform. Will they perform as well in a more severe crisis? Is it possible that next time a bank will fail before the 7-day tender option can be exercised? That question keeps nagging at this analysis. For the moment, however, one can only wonder why recent events are the catalyst for this change.

Increased Issuance and Trading Volumes
The SEC says that the changes were prompted by the increased issuance, trading volumes, and outstanding dollar amount of VRDOs. In other words, this is a growing market with a significant amount of VRDOs outstanding. Fair enough. But what does that indicate? Does it suggest that the market acceptance of VRDOs is very high and that VRDOs have proven to be a useful financing tool for underlying obligors? Probably so.

Although the success of the structure might indicate that it is working well, the Release indicates that the SEC has received comment letters from analysts and investors on the buy side of the market complaining about the exemption for VRDOs and the lack of disclosure available on underlying obligors. Certainly these commenting investors and analysts want more information, but that begs the question why. Is it because they fear losses based on inadequate information about the underlying obligor? Experience to date indicates that investors have been paid as scheduled and that investors have not suffered market loss. Under these circumstances, it is fair for underlying obligors that utilize VRDOs to question whether this interest in information might be prompted by other legitimate interests apart from payment risk or market risk. Perhaps these investment funds and analysts want to know what sectors of the economy are being supported by the VRDOs they buy. Perhaps their own investors have a preference for investment funds that support a particular sector, such as higher education and medical research. Perhaps this information would help identify types of VRDOs that are likely to remain outstanding longer than others. Reducing turnover in their portfolio might improve profitability. A better understanding of the reasons why investment funds want this information would help the analysis. If the reasons relate to concerns other than payment risk and market risk, then perhaps this is more of a cost/benefit analysis and the concerns can be addressed by market dynamics.

38 Id. at *29.
39 Id. at *33; Comment letters available at http://www.sec.gov/comments/s7-15-09/s71509.shtml.
40 Market dynamics can be an important force in shaping continuing disclosure obligations. Several years ago investors in health care bonds started asking for quarterly disclosure, as well as the annual disclosure required by the Rule. Some hospitals resisted at first, but it became clear that resistance carried a price in the marketing of the bonds. Today it is common for a health care provider to enter the market offering quarterly disclosure. This issue is being resolved by market dynamics, not a change in the Rule. There is still no requirements in the Rule for quarterly disclosure for any underlying obligor. This is a cost/benefit question for the underlying obligor.
Underlying obligors might also question whether the availability of information about underlying obligors will help pricing of VRDOs. Complete information on this point is not available, but some market participants believe that VRDOs of similar size with a letter of credit from the same bank tend to price the same, no matter what the underlying obligor may be and whether or not disclosure about the underlying obligor is available. If that belief is well-founded, it undermines the notion that such disclosure is material to investors. Underlying obligors may also question whether the availability of information about the underlying obligor will prevent tenders that are based on the bank’s credit rating. Good information is hard to find here as well. The Release suggests that an investor unable to obtain annual financial disclosure on the underlying obligor may have no option but to tender when the bank’s credit, or the market in general, is stressed. The Release indicates that this is not in the best interest of the investing public or the municipal securities market; without adequate information on the underlying obligor, it is difficult for the investor to determine whether to buy, hold, sell or put.\textsuperscript{41} Some underlying obligors who regularly provide continuing disclosure and maintain a high credit rating complained that their VRDOs were nevertheless tendered when the bank’s credit deteriorated or the market in general was stressed in the recent financial crisis. These beliefs and observations may or may not be valid observations or good indicators about the VRDO market. To improve the discussion, however, it would be helpful if reliable market data on these points could be developed.

Even if pricing of VRDOs stratifies based on availability of disclosure on the underlying obligor, and even if investors with access to such information are more willing to hold after a bank’s credit or the market in general is stressed, does that necessarily indicate that the failure to provide the information is tantamount to “fraud facilitated by inadequate disclosure”?\textsuperscript{42} This may be more of a cost-benefit analysis for underlying obligors, rather than a 10b-5 analysis.\textsuperscript{43} If the underlying obligor complies, it may get better pricing and fewer tenders. If it does not, it may pay a higher interest rate and may be forced to refinance or restructure the debt sooner. As noted above, the structure of VRDOs encourages both results. The interest rate is reset weekly to reflect market conditions, and the investor is free to determine whether and when to tender. The structure protects the investor from both payment risk and market risk. By doing so, it leaves the underlying obligor with the consequences. As noted so often during this discussion, however, these predictable consequences and this neat and clean ordering of risks breaks down if the bank fails to pay or cover a tender. Can the existence of the 7-day tender right be relied upon as the trump card in the analysis? Comments by the SEC on this point discourage such a conclusion.

\begin{footnotesize}
\textsuperscript{41} Release, \textit{supra} note 1, at *55.
\textsuperscript{42} Id. at *21.
\textsuperscript{43} Assuming the market does begin to differentiate underlying obligors who disclose, disclosure ready obligors would likely find the marginal cost of additional disclosure to be minimal when compared to the savings from receiving a lower interest rate. On the other hand, obligors who cannot disclose most likely would find the cost of disclosure is too high, unless the interest rate penalty charged by the market is exorbitant. This, of course, may lead to obligors who cannot disclose seeking other markets for financing.
\end{footnotesize}
The Demand Feature Does Not Obviate the Need for Continuing Disclosure

The SEC says: “The Commission does not believe that an investor’s ability to tender a demand security for repurchase obviates the need for continuing disclosures.”44 This statement, taken alone, is alarming. Granted, it is made in a context where the Release makes its point that an investor may have the right to tender at par, but without such information the investor may be left with no option but to tender when in doubt. Various other attempts might be made to explain away its existence, but the statement is there and must be an important part of the analysis.

It should also be noted that in the Release the SEC reminds us, as it did in 1989, that in its view the existence of credit enhancement is not a substitute for information about the underlying obligor.45 The Release also states that “the Commission believes that information regarding [underlying obligors] is material to investors in credit enhanced offerings and therefore should be included in the official statements.”46 As for the 7-day tender right, the SEC reminds us that it is possible for banks issuing letters of credit to default or be downgraded and that “[t]he possibility of such occurrences supports the likelihood that investors would consider information concerning the underlying obligor important to making investment decisions.”47 These interpretive statements in the Release certainly lead to the conclusion that the SEC believes disclosure on the underlying obligor is necessary.

The Invitation to Disclose or Not

Before leaping to the conclusion that the Release is unequivocal on the basic question under consideration, some other statements in the Release deserve attention. At several points the Release states that the scope of the continuing disclosure requirement is dependent upon the structure of the original official statement. In other words, if the original official statement does not include primary market disclosure on the underlying obligor, instead relying on the credit substitution theory, then the continuing disclosure information need not include annual financial disclosure on the underlying obligor. For example, the SEC says:

Regarding the concern that any new disclosure burdens may induce some [underlying obligors] to withdraw from the tax-exempt municipal market because they do not prepare annual filings in the ordinary course of business, the Commission notes that, for purposes of the Rule, annual filings are required only to the extent provided in the final official statements.48

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44 Release, supra note 1, at *55.
45 Id. at *51.
46 Id.
47 Id. at *51-52.
48 Id. at *41.
Similarly, the SEC addresses concerns that some small entities might withdraw from the tax-exempt market because disclosure of their financial information would provide competitors with information that might put them at a competitive disadvantage, or certain small underlying obligors might have to prepare costly audited financial statements. The SEC’s response to these concerns is:

As discussed above, the undertakings contemplated by the amendments (and Rule 15c2-12 in general) require annual financial information only to the extent provided in the final official statement...”49

This theme is repeated in numerous other places in the Release.50 These statements suggest that disclosure on the underlying credit can be a matter of choice that is reflected in the decision what to include in the official statement.

It is fair to say that the Release provides both strong implications that disclosure on the underlying obligor is necessary and an invitation to avoid disclosure on the underlying obligor by preparing a final official statement that does not include that type of information. It is also fair to say that the SEC seems to be quite deliberate in both respects. How can these signals that seem to conflict be reconciled?

Why the SEC Cannot Save Underlying Obligors From this Dilemma

The SEC cannot save the municipal market from this dilemma, at least not in Rule 15c2-12. It cannot tell us that disclosure on the underlying obligor is unnecessary because the possibility that the bank may fail before the tender right is exercised is sufficiently remote. The SEC has been consistent in its insistence that it does not approve the content or substance of disclosure.51 Even if it was willing to provide such approval, Rule 15c2-12 is not the proper context. This is a procedural rule, not a substantive rule. It tells us when disclosure is necessary; it does not tell us what disclosure is necessary.

There is another, more important, reason why the SEC cannot save the market from this dilemma. It is undeniably true that a bank could fail before investors exercise their 7-day tender option. It might be remote as a possibility, but it is possible. Why should the SEC resolve the question whether it is remote enough to be disregarded? That determination is left to the market participants, which is probably where it belongs, whether we like it or not. It certainly is fair to say that if the bank does fail before investors can exercise their 7-day tender option, information about the underlying obligor could become important. It is certainly also true that some important voices on the buy side of this market have made strong requests for removal of the exemption and additional information through continuing disclosure. Finally, it is predictable that if a bank did fail in this manner and investors were harmed after such insistence from the buy side, the SEC would be called upon to explain why it had ignored these requests. When investors make those types of demands and a bank’s failure is a possibility, it is unreasonable to hope or expect that the primary market regulator will take a different stance.

49 Id. at *287 n.547 (emphasis added).
50 Id. at *41, *43 n.83, *45 n.86.
Viewed in this light, the amendments and Release might be interpreted as an attempt to strike a balance. The SEC has issued its warning about what is possible and what the consequences could be if the unthinkable happens—a bank fails before the 7-day tender option can be exercised. It has also left the door open for underlying obligors to make a judgment about the likelihood of that happening. If measured as sufficiently remote, the final official statement need not provide primary market disclosure on the underlying credit, and thus neither will the continuing disclosure agreement require annual financial information on the underlying credit. But the underlying obligor takes the risk. If such a judgment is made and it turns out to be wrong, the underlying obligor, and perhaps the other market participants that assisted in the underlying obligor’s access to the market, may be faced with the possibility of a private right of action under 10b-5.

Practical Responses to the Dilemma
Where does all this analysis leave the underlying obligor? The situation is certainly confusing. Measuring disclosure responsibility through judgment about the likelihood of a bank’s failure is an uncomfortable process. Doing so in the wake of the SEC’s statements in the Release is even less comfortable. But our museum and our energy company, as well as disclosure-ready obligors, must make decisions. The following are some approaches that underlying obligors might take to navigate through this minefield.

The Full Disclosure Approach
The underlying obligor can include primary market disclosure in the official statement and agree to provide annual financial disclosure. This is an easy solution for a disclosure-ready obligor. It could be more difficult and costly, perhaps even practically impossible, for obligors such as our museum and energy company.

This approach assures compliance with the most conservative interpretation possible of the Rule and the SEC’s statements in the Release. It avoids the difficult task of weighing the likelihood of the bank’s failure. It complies with all requests from the buy side of the market. It might even result in a better interest rate than the other options, and, if the bank falters, it might even prevent premature or unnecessary tenders.

The disclosure-ready obligor might also try a variation of the full disclosure option. It might omit primary market disclosure, but agree in its continuing disclosure agreement to provide the same annual financial disclosure that it is providing for its outstanding fixed rate bonds. The latest filing of annual financial disclosure information could be adopted by reference in the official statement for the VRDOs. This might save the incremental cost of updating the primary market disclosure from the most recent fixed-rate financing and it might avoid some due diligence costs, such as updating discussion of financial performance and review work from auditors. It will get the disclosure-ready obligor into the VRDO market faster.

52 If the underlying obligor is doing a fixed rate issue at the same time, the primary market disclosure for the fixed rate issue can be used for the VRDOs.
Leaving out the primary market disclosure raises some interesting questions. If it had been supplied, wouldn’t it have been stale in a relatively short period anyway? For health care obligors that provide quarterly disclosure, the primary market disclosure becomes stale 90-180 days after the VRDOs are issued. For disclosure-ready obligors who provide annual financial information, the primary market disclosure becomes stale within a year, if not sooner. VRDOs can be tendered and remarketed immediately after issuance and throughout the full term of the VRDOs, so the primary market disclosure is of little value after the next filing under the continuing disclosure agreement, and it becomes even less so as time goes by. Annual financial disclosure seems to be the most important disclosure tool for VRDOs. In addition, the possibility that the bank would fail right out of the gate, before the next continuing disclosure filing is made, seems to be the most remote possibility of all.

When a disclosure-ready obligor uses this alternative approach, adopting by reference its existing continuing disclosure filings, it may be appropriate to include a section in the official statement that discusses any recent developments that might be material under the circumstances. Of course, both of these variations on the full disclosure approach require appropriate due diligence for the information presented or adopted by reference. This will vary with the circumstances, but a standard 10b-5 certificate from the underlying obligor is the starting point for the due diligence effort.

The Commercial Paper Option
The underlying obligor could issue commercial paper rather than VRDOs. The underlying obligor might also choose to omit primary market disclosure in the official statement and not agree to provide annual financial disclosure. Remember, because commercial paper is exempt under the Rule, there is no regulatory requirement that the underlying obligor enter into a continuing disclosure agreement or provide any annual financial disclosure.

This underlying obligor takes advantage of an exemption that has always been in the Rule. As noted above, this exemption was not repealed, even though commercial paper is similar in many respects to VRDOs. An exemption under the Rule, however, is not the same as an exemption from basic disclosure responsibilities under the securities laws. The underlying obligor still has potential 10b-5 liability for material misstatements and omissions. By taking this approach the underlying obligor relies on the credit substitution theory. The underlying obligor concludes, in effect, that the bank’s failure is sufficiently remote to justify this disclosure approach. By purchasing the commercial paper, the investor accepts this analysis, a conclusion customarily made clear by a statement in the offering document that the investor is relying exclusively on the bank credit.

This approach seems marginally better than the full credit substitution approach described below, because this underlying obligor has the added benefit of an exemption from the Rule. Still, we have repeatedly returned to that troublesome question whether the bank’s failure is sufficiently remote to justify omission of disclosure on the underlying credit. The form of the debt – commercial paper rather than VRDOs – doesn’t really answer that question.
The Limited Placement Option

The underlying obligor might offer the VRDOs only to money market funds, or other qualified institutional buyers, limiting the number of purchasers to 35. This type of offering might be called a “private placement” or a “limited public offering,” but the interpretive release from the original promulgation of the Rule uses the term “limited placement” to describe this exception to the Rule, so that term is used here as well.

The underlying obligor might also choose to omit primary market disclosure in the official statement (or limited placement memorandum) and not agree to provide annual financial disclosure. Remember, because a limited placement is exempt under the Rule, there is no regulatory requirement that the underlying obligor enter into a continuing disclosure agreement or provide any annual financial disclosure.

By limiting the buyers to money market funds or other qualified institutional buyers, the underlying obligor attempts to establish compliance with the limited placement requirement that all buyers have the requisite knowledge and skill and that they are buying for only one account. The underlying obligor may include a reference to this limitation in the official statement, and in its agreements with underwriter and the remarketing agent the underlying obligor may also obtain representations that the VRDOs will be sold or remarketed only in accordance with these limitations.

The discussion in the Release about the meaning of the term “primary offering” may actually help the underlying obligor in its effort to fit under the limited placement exemption. The 35-investor limitation has always been troublesome in some respects. Does it apply only to the initial offering, or does it include subsequent purchasers as well? If it does include subsequent purchasers, and the VRDOs are expected to be remarketed from time to time, how can you be sure that the number of investors stays under 35? VRDOs are typically offered only to a small number of institutional investors, usually money market funds, so this limitation might not be much of a concern in the initial offering. Also, many of the investors in this market tend to buy and hold, so it might be reasonable to expect that the likelihood of exceeding this limitation is small. In any event, the understanding of the term “primary offering” affords some additional protection. If every remarketing is a primary offering, then this limitation could never be surpassed unless the number of buyers for any remarketing exceeded 35. If a primary offering occurs only when a remarketing follows a mandatory tender, then the count should start over with each mandatory tender. The “Pillsbury dilemma” turns out to be of some benefit in this part of the analysis.

53 Rule 144A defines “qualified institutional buyer” to mean, in short, certain enumerated entities that own or invest at least $100 million of securities of non-affiliated companies, certain securities dealers, certain investment companies which own at least $100 million in securities and banks and savings and loans. 17 C.F.R. § 230.144A(a)(1).
54 In this context, underwriters and remarketing agents may seek, or require, written certification from prospective customers that they are indeed qualified buyers as a condition precedent to a sale or remarketing. An agreement between the underlying obligor and underwriter or remarketing agent may include such a requirement. The official statement may also include a statement to the effect that each purchaser’s acceptance of delivery will constitute an acknowledgement that it meets these qualifications.
55 Release, supra note 1, at *28 (“Some investors, such as mutual funds, appear to hold VRDOs for long periods of time . . . .”).
The underlying obligor may also include a warning in the official statement that no disclosure is being provided on the underlying obligor and that the investor is expected to rely solely on the credit of the bank for purposes of its purchase of these VRDOs. The underlying obligor might carry this one step further, telling the investor that it, not the underlying obligor, is assuming the risk that the bank will fail before its 7-day tender option can be exercised.

This underlying obligor takes advantage of an exemption that has always been in the Rule. Like the underlying obligor in the commercial paper approach, this underlying obligor also places reliance on the credit substitution theory. The underlying obligor concludes, in effect, that the bank’s failure is sufficiently remote to justify this disclosure approach. There may be an important difference, however, in the use of the limited placement approach. The qualified institutional buyers may be expected to understand the credit substitution theory and the risk that the bank may fail. These buyers can also be expected to carefully monitor the credit of the bank, so the chance that they may be left without an effective tender option is even more limited. Finally, the warning in the official statement may serve to shift the risk of the bank’s failure to the buyer.

There may be a price, however. The limited placement structure may be perceived by investors as an undesirable limitation on the liquidity of their investment, and the investors may expect to be compensated for the attempted risk shifting. The investors may also be disappointed that they will not receive the annual financial disclosure or the primary market disclosure. The result of these concerns may be that the investors require a higher interest rate for VRDOs bought in a limited placement.

This is perhaps the best approach for the museum and the energy company, for underlying obligors who cannot disclose and underlying obligors unwilling to disclose. If the pricing premium, assuming there is one, is not too high, the cost of this approach may be far less than the full disclosure approach. And past experience suggests that such cost is quite modest and that this approach is a reasonable one fully acceptable to both borrower and lender.

The Full Credit Substitution Approach

The underlying obligor may choose to issue VRDOs without primary market disclosure in the official statement. The underlying obligor’s continuing disclosure agreement may obligate it to provide event disclosure, as it must because there is no exemption from the Rule, but the agreement may provide that no annual financial disclosure will be provided because information of that type was not included in the official statement.

This underlying obligor relies heavily on the credit substitution theory. It may also be relying on the seeming invitation to do so in the Release, but in the process it dismisses the warnings to the contrary by the SEC in the Release. This underlying obligor makes a judgment that the risk of the bank’s failure is sufficiently remote that there is no reason to fear any 10b-5 liability to the investors. If the bank avoids a failure so severe that the investors are deprived of an effective tender option, this underlying obligor’s judgment will be validated. In the process the underlying obligor also avoids the cost and time of preparing primary market disclosure and annual financial disclosure.

This underlying obligor may also attempt to shift the risk of the bank’s failure to the investors, using a warning in the official statement similar to that described above for the limited placement approach. Indeed offering documents for VRDOs routinely provide such a warning. Unlike the limited placement approach, however, this underlying obligor will have no reason to
believe that only money market funds or other qualified institutional buyers will end up owning these VRDOs. For investors without the knowledge and skill necessary to evaluate this risk, the attempt at risk-shifting may not be successful. It certainly is less likely to be successful in this context. However, the customary issuance of VRDOs in minimum denominations of $100,000 and the customary clear disclosure of the use of the credit substitution theory may well provide meaningful protection to the underlying obligor and its financial team even in dealing with individual investors.

Potential investors may not be receptive to this approach. Some might charge a higher interest rate. Some may even resist to the point of refusing to buy. It is also possible that these VRDOs will trade the same as the VRDOs issued under the full disclosure approach. Time will tell.

There may be another concern. Investors who never suffer because the credit substitution theory works as expected do not have any basis for a private right of action under 10b-5. They have suffered no loss. That limitation does not apply to an enforcement action by the SEC, which can use its enforcement powers under the Reform Act to bring an action based on the failure to disclose, whether or not there is any demonstrated loss to investors. Is it possible that the SEC would do so in response to this approach, after issuing a warning in the Release about the need for disclosure?

There are reasons to hope that the SEC would not bring such an enforcement action. Its own statements in the Release suggesting that annual financial disclosure is only necessary if such information is included in the official statement undermine justification for such action. It is also fair to point out that this approach has been used for many years without an enforcement action, and, under those circumstances, the SEC is not likely to take such action against an underlying obligor without additional guidance. Of course, there is also the point that no investors have been harmed by this structure. But an underlying obligor must weigh this possibility nevertheless. In fact, underlying obligors who rely upon the limited placement option or the commercial paper option must weigh the same possibility.

Although the disclosure responsibility on these issues rests primarily with the underlying obligor, the underwriters and lawyers who assist underlying obligors in their access to the VRDO market will have to advise underlying obligors about the risks of the approaches they might consider. They will have to also consider their own responsibility in the analysis, including the possibility of an enforcement action by the SEC.

As stated in the opening paragraph, the debate and discussion of these issues is likely to be with us for years to come. Events in the market, clarification from the buy side about its needs and expectations, or additional guidance from the SEC might help clarify the choices. In the meantime, our museum and our energy company have to make responsible, practical choices, and they need good advice. This analysis, it is hoped, has provided a better framework for the advice.

56 See Latigo Ventures v. Laventhol & Horwath, 876 F.2d 1322, 1325 (7th Cir. 1989) (“[I]nvestors cannot complain about a fraud that did not cause them harm.”); Feldman v. Pioneer Petroleum, Inc., 813 F.2d 296, 302 (10th Cir. 1987) (“Failure to show actual damages is a fatal defect in a Rule 10b-5 cause of action.”); Newton v. Merrill Lynch, 259 F.3d 154, 178 (3d Cir. 2001) (“Failure to allege or prove actual damages will result in dismissal of any 10b-5 claim.”) (quoting 2 T. HAZEN, LAW OF SECURITIES REGULATION 533 (3d ed. 1995)).