

# NATIONAL ASSOCIATION OF BOND LAWYERS

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## Underwriting: Behind the Scenes

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### I. Overview of a Bond Transaction

#### A. Financing Participants

1. *Bond Counsel* – Attorneys retained by the issuer/obligated person to give an expert and objective legal opinion with respect to the authorization, validity and enforceability of bonds and other subjects, particularly the federal and state tax income treatment of interest on the bonds
2. *Credit Enhancer* – Bond insurer, commercial bank or other financial institution issuing an insurance policy or a supporting letter of credit in order to improve an issue's credit rating; distinguish from a liquidity facility which is a letter of credit, standby purchase agreement or other arrangement used to provide liquidity to purchase securities, commonly in the case of variable rate demand obligations that have been tendered to the issuer or remarking agent but cannot be immediately remarketed
3. *Credit Enhancer's Counsel* – Attorneys representing the credit enhancer
4. *Disclosure Counsel* – Attorneys representing the issuer/obligated person serving as the principal drafters of an issuer's/obligated person's disclosure document; may provide 10b5 opinion to issuer/obligated person, credit enhancer, and underwriters
5. *Issuer* – A state, political subdivision, agency, authority of the state or the United States or an agency or instrumentality of the United States that borrows money through the sale of bonds or notes
6. *Issuer's Counsel* – Attorneys representing the issuer that may provide an opinion on the creation and legal status of the issuer and its officials and any material litigation related to the issuer and its finances

7. *Municipal Advisor* – Person who advises an issuer/borrower (obligated person) on financial matters pertinent to an issue, such as structure, timing, marketing, fairness of pricing, terms, credit enhancement, and bond ratings; municipal advisor may also be designated as an independent registered municipal advisor (IRMA), which designation permits an underwriter to provide advice to an issuer or obligated person with respect to municipal financial products or the issuance of municipal securities without being deemed to be a municipal advisor
8. *Obligated Person* - A person legally committed to support payment of all or a part of an issue of municipal securities, other than certain unrelated providers of credit enhancement. Obligated persons are generally borrowers who are participants in a conduit bond financing.
9. *Underwriter* – Broker, dealer or bank dealer which purchases a new issue of municipal securities for resale; may also include syndicate or selling group members
10. *Obligated Person/Borrower's Counsel* – Attorneys representing the borrower or obligated person
11. *Paying Agent/Registrar* – Entity responsible for transmitting payments to bondholders and maintaining records of the registered owners of the bonds
12. *Rating Agency* – Organization which provides publicly available ratings of the credit qualities of securities. The most commonly known rating agencies are Standard & Poor's, Moody's, Fitch, and Kroll.
13. *Trustee* – Financial institution which acts in a fiduciary capacity for the benefit of bondholders in enforcing the terms of the bonds, which are generally set forth in a Trust Indenture; also frequently acts in a fiduciary capacity in managing bond proceeds
14. *Trustee's Counsel* – Attorneys representing the trustee
15. *Underwriter's Counsel* – Attorneys representing the underwriter in connection with the purchase of a new issue of municipal securities

**B. Investors**

Investors have specific preferences for maturity length, credit rating, and bond structure, and varying levels of price sensitivity. Typical municipal bond purchasers include:

1. Retail Investors – Individuals; "Mom & pop"
2. Professional Retail (Bank Trust Departments (On behalf of customers) (Investment Advisors, Separately Managed Accounts (SMAs), etc.)

3. Institutional Investors
  - a. Bond Funds
  - b. Insurance Companies
  - c. Arbitrage Accounts
  - d. Bank Trust Departments
  - e. Investment Advisers
  - f. Bank Portfolios

C. **Restricted Investors** – Usually institutional investors, often on riskier transactions or private placements

- a. Accredited Investors – A person with either (a) a net worth over \$1 million, excluding primary residence (individually or with spouse or partner) or (b) income over \$200,000 (individually) or \$300,000 (with spouse or partner) in each of the prior two years, and reasonably expects the same for the current year.
- b. Qualified Institutional Buyers (“QIB”) - A purchaser of securities that is deemed financially sophisticated and is legally recognized by securities market regulators to need less protection from issuers than most public investors. [Rule 144A](#) requires an institution to manage at least \$100 million in securities from issuers not affiliated with the institution to be considered a QIB. If the institution is a bank or savings and loans thrift they must have a net worth of at least \$25 million. If the institution is a registered dealer acting for its own account it must in the aggregate own and invest on a discretionary basis at least \$10 million of securities of issuers not affiliated with the dealer.

D. **Typical Steps in a Transaction**

1. Assemble financing team
2. Evaluate capital needs and cash flow capacity (and design, construction, or plan, if applicable) – Usually handled by the municipal advisor and chief financial officer along with an engineer and/or architect.
3. Develop a financing plan and schedule
  - a. Type of sale

- i. Negotiated, competitive, private placement or direct purchase by a bank
    - ii. Considerations
      - A. Type of issuer/obligated person
      - B. Legal authority – State statute, by-laws, restrictive agreements, and etc
      - C. Project type
      - D. Security/Resources for repayment
      - E. Credit
      - F. Financing Structure (i.e., tax status, fixed or variable rate)
      - G. Market
  - b. Structure
    - i. Source of repayment (limited or unlimited taxes, revenues, fees, lease payments, etc.)
    - ii. Amortization schedule
    - iii. Serial vs. term bonds (current interest, zero coupon or capital appreciation bonds, put bonds, etc.)
    - iv. Bond covenants (rate maintenance, coverage ratios, additional bonds tests, limitations on future taxes, non-impairment provisions, etc.)
4. Draft documents
- a. Authorizing resolutions/ordinances
  - b. Trust Indentures/Agreements
  - c. Preliminary Official Statement/Official Statement (or Limited Public Offering Memorandum for limited public offerings and Private Placement Memorandum for private placements)
  - d. Feasibility studies/Engineering reports

- e. Bond Purchase Agreement/Contract of Purchase
  - f. Preliminary Blue Sky/Final Blue Sky Memorandum
  - g. Notices to bondholders/insurance companies/trustee?
  - h. Agreement Among Underwriters
    - i. Securities Industry and Financial Markets Association (“SIFMA”) Master Form
    - ii. SIFMA Data Base
    - iii. Schedule for each transaction
  - i. Selling Group Agreement
  - j. Accountants
    - i. Agreed Upon Procedures - a standard a company or client outlines when it hires an external party to perform an audit on a specific test or business process. The procedures, which are called audit standards, are designed and agreed upon by the entity conducting the audit, as well as any appropriate third parties
    - ii. Consent to use audit in Official Statement or otherwise
  - k. Escrow Agreement (for refundings)
5. Ratings Process (if obtaining credit rating)
- a. Selection of Rating Agencies
  - b. Issuer/obligated person completes rating agency questionnaire and financial information submittals
  - c. Ratings Presentation
  - d. Obtain ratings
6. Credit Enhancements
- a. Credit ratings (Moody's; S&P; Fitch; Kroll, etc.) Nationally Recognized Statistical Ratings Organization (NRSRO)
  - b. Bond insurance (Assured; BAM, etc.)
  - c. Letter of credit (LOC)

- d. Bond Guaranty or Debt Service Reserve Fund
- 7. Due Diligence (including checking on past Rule 15c2-12 continuing disclosure compliance) - Underwriter may utilize counsel but may not delegate this responsibility. Also, may include review of issuer formation documents and issuer approvals.
- 8. Marketing (Generally)
  - a. Distribution of Preliminary Official Statement (typically including rating)
  - b. Investor “Road Shows”
- 9. Comply with MSRB Rules

Municipal Securities Rulemaking Board (MSRB) - self-regulatory organization (SRO) subject to oversight by the SEC that is charged with primary rulemaking authority over municipal securities dealers and municipal advisors in connection with their municipal securities and municipal advisory activities.

- a. Municipal Advisors - Rule G-23
  - i. *Purpose* - Establishes ethical and disclosure requirements for broker-dealers who act as municipal advisors (“Municipal Advisors”). Rule G-23 does not apply to dealers providing financial advisory services to conduit borrowers.
  - ii. *Municipal Advisory Relationship* - Covers financial advisory or consultant services with respect to the issuance of municipal securities, including advice re: structure, timing, terms or similar matters.
  - iii. *Excludes Underwriters* – Giving Proper Intention. Municipal Advisory relationship shall not exist when underwriter renders advice in connection with a transaction in which the underwriter is performing underwriting services if the broker-dealer clearly identifies itself in writing as the underwriter and not as a Municipal Advisor from the earliest stages of its relationship with the issuer with respect to that issue, it will be considered to be acting as an underwriter. Other disclosures must be given.
  - iv. *Writing Requirement* - Municipal Advisors must have written agreement.

- v. *Prohibition on Underwriting Services* - No broker-dealer that has a financial advisory relationship with the issuer “with respect to the issuance of municipal securities” may acquire all or part of such issue, or act as placement agent.
  - vi. *Prohibition on Remarketing Activities* - No broker-dealer with a financial advisory relationship, may act as a remarketing agent with respect to the issue; except, if it resigns, then after one-year it may act as successor remarketing agent.
- b. Underwriters - MSRB Rule G-17; Interpretive Notice
- i. *Rule G-17 General Purpose* - Precludes dealers and municipal advisors, in the conduct of municipal securities or municipal advisory activities, from engaging in any deceptive, dishonest, or unfair practice with any person. Also establishes a general duty to deal fairly with all persons (including, among others, issuers of municipal securities).
  - ii. *2012 Interpretive Notice* - Primary change is the requirement of additional disclosures, consisting generally of: (i) disclosures concerning the underwriter’s role, (ii) disclosures concerning the underwriter’s compensation, (iii) disclosures concerning material conflicts of interests, and (iv) disclosures concerning complex municipal securities financings.
  - iii. *Specific Disclosures:*
    - A. The underwriter’s primary role is to purchase securities with a view to distribute in an arm’s-length commercial transaction with the issuer, and it has financial and other interests that differ from those of the issuer;
    - B. Unlike a Municipal Advisor, the underwriter does not have a fiduciary duty to the issuer under the federal securities laws and is, therefore, not required by federal law to act in the best interests of the issuer without regard to its own financial, or other, interests;
    - C. The underwriter has a duty to purchase securities from the issuer at a fair and reasonable price, but must balance that duty with its duty to sell municipal

securities to investors at prices that are fair and reasonable;

- D. The underwriter will review the official statement for the issuer's securities in accordance with and as part of its responsibilities to investors under the federal securities laws, as applied to the facts and circumstances of the transaction;
  - E. The underwriter must disclose whether underwriting compensation will be contingent on the closing of a transaction, and that compensation that is contingent on the closing of a transaction or the size of a transaction presents a conflict of interest because it may encourage the underwriter to recommend a transaction that is unnecessary, or to recommend that the size of the transaction be larger than is necessary; and
  - F. Must disclose other potential conflicts of interest.
- iv. *Complex Transactions* - Underwriter must provide additional disclosures for "complex municipal securities financings" if the underwriter recommends the transaction to the issuer.
  - v. *Timing* - Issuer relationship must be disclosed in the earliest stages of the underwriter's relationship with the issuer with respect to an issue (e.g., in a response to a request for proposals or in promotional materials provided to an issuer).

## II. Bond Structuring and Sizing

### A. Types of Sale

#### 1. Public Offering

- a. *Competitive Sale – Note: Competitive sale lead-up and pricing differs fairly dramatically from a negotiated sale, including many of the subtopics in this outline*
  - i. Bonds are advertised for sale (notice of sale)
  - ii. Bidding parameters are set
  - iii. Any broker-dealer or bank may bid at the designated date and time



- iv. Bonds are awarded to the bidder offering the lowest True Interest Cost (“TIC”) or Net Interest Cost (“NIC”). NIC does not take into account the time value of money (as would be done in other calculation methods, such as TIC).
- v. Selling syndicate
- b. Negotiated Sale
  - i. Terms of the bonds and of the sale are negotiated with the issuer/ obligated person
  - ii. Issuer/obligated person and underwriter agree upon a coupon, call and yield at which the underwriter will offer bonds to potential investors for each specific bond that is offered across the yield curve
  - iii. Initial interest scale may be adjusted depending on investor demand
  - iv. Underwriter may commit to underwrite balance of any unsold bonds, if necessary
  - v. Issuer, obligated person and underwriter enter into a bond purchase agreement.

2. Private Placement

- a. Bonds are sold to one or a few investors at negotiated terms
- b. Placement agent finds investors (generally, accredited investors and/or qualified institutional buyers)
- c. Securities obligations are different than in competitive or negotiated sale (i.e. SEC Rule 15c2-12 requirements do not apply and generally no bond rating; for bank private placements, bonds generally registered in the name of the bank and not issued in a book entry system through DTC and generally will not have a CUSIP)

**B. Elements of a Pricing**

- 1. *Coupon* - Annual interest rate payable to the bondholder
- 2. *Maturity* - Date on which principal payments are due
- 3. *Discount Bonds* – Coupon is less than yield
- 4. *Par Bonds* – Coupon equals yield

5. *Premium Bonds* – Coupon is greater than yield
6. *Price* - Total amount paid by the issuer per \$1000 bond
7. *Principal/Par Amount* - Face value of a bond to be paid back to the bondholder on the maturity date
8. *Yield* - Net annual interest cost to the issuer, taking into account the discount or premium on the purchase price, the interest rate and the length of time the bond is held
9. *Call Option* – Issuer's option to redeem bonds prior to maturity

**C. Serial vs. Term Bonds**

1. *Serial Bonds* – Specific annual principal maturities scheduled annually over a period of years
2. *Term Bonds* – Mature on a specified date and commonly use sinking fund payments (payments of principal prior to final maturity)
3. *Interest Accrual* – Current Interest (interest paid semi-annually over time) vs. Capital Appreciation or Zero Coupon Bonds (interest compounded and paid at maturity)

**III. Marketing a Negotiated Bond Issue**

**A. Underwriting Process**

1. Create investor target plan
2. Develop syndicate with issuer and obligated person
  - a. Underwriting syndicate vs. selling group
  - b. Senior manager vs. co-managers
3. Determine liabilities
4. Establish priority of orders
5. Determine allocation policies for syndicate compensation
6. Pre-pricing
7. Order period
8. Bond pricing (Verbal award)

9. Award bonds (Written award)
10. Delivery of bonds (closing)

**B. Underwriting Terms**

1. Underwriting team
  - a. Sole Managed Underwriting
  - b. Syndicate – Group formed to purchase new issue. Agreement Among Underwriters – Determines liability and allocable share of liability for each underwriter.
  - c. Selling Group – Distinct municipal securities brokers and dealers that assist in the distribution of a new issue of securities that are NOT members of the underwriting syndicate, nor do they have liability as underwriters; selling group members are able to acquire securities from the underwriting syndicate at syndicate terms (i.e., less the total takedown), but do not share in syndicate profits nor share any liability for unsold balances (not presently common).
    - i. No direct relationship with the issuer/obligated person
    - ii. Related entity to broker dealer
- A. Distribution agreement
2. Compensation/Spread/Underwriter's Discount - Syndicate's compensation. With respect to a new issue of municipal securities, the differential between the price paid to the issuer for the new issue and the prices at which the securities are initially offered to the investing public; this is also termed the "gross spread," "gross underwriting spread" or "production." MSRB Rules provide various restrictions.
  - a. To the extent that the initial offering prices are subsequently lowered by the syndicate, the full amount of the spread may not be realized by the syndicate.
  - b. The spread is usually expressed in dollars or points per bond.
  - c. Historically, the spread has consisted of four components, although one or more components may not be present in any particular offering:
    - i. *Takedown* – (Sales Takedown) Normally the largest component of the spread, similar to a commission, which represents the income derived from the sale of the securities.

If bonds are sold by a broker-dealer that is not a member of the syndicate, such seller receives only that portion of the takedown known as the concession or dealer's allowance, with the balance (often termed the "additional takedown") retained by the syndicate.

- ii. *Management Fee* – The amount paid, if any, to the senior manager and/or co-manager for structuring the transaction and/or handling the affairs of the syndicate. (Also sometimes called Structuring Fee)
- iii. *Expenses* – The costs of operating the syndicate for which the senior manager may be reimbursed including costs such as DTC, CUSIP, IPREO, road show etc.
- iv. *Underwriter's Risk* – The amount of spread syndicate account after meeting all other expenses or deductions. A portion of the residual is paid to each underwriter within a syndicate on a pro rata basis according to the number of bonds each broker-dealer has committed to sell without regard to the actual sales by each member (not presently common).

### 3. Order Period

- a. In a competitive sale, if there are syndicate members, the order period is the period of time following the sale of a new issue during which non-priority orders submitted by syndicate members are allocated without consideration of time of submission. The length of the order period is usually determined by the senior manager.
- b. In a negotiated sale, the order period is the period of time established by the manager during which orders are accepted. The order period in a negotiated sale generally precedes the purchase of the issue by the underwriter from the issuer. At times, order periods are established at subsequent points in the life of a syndicate. Such subsequent order periods may occur when securities are repriced or market conditions change.
- c. In some offerings, a "retail order period" may be designated during which orders will be accepted solely for retail customers (or, in some cases, small orders for any type of customers). MSRB Rule G-11 amended to address certain retail order period requirements.

- 4. **Priority of Orders** - The rules adopted by an underwriting syndicate specifying the priority to be given different types of orders received by the syndicate. MSRB rules require syndicates to adopt priority provisions in

writing and to make them available to all interested parties. For competitive underwritings, orders received prior to the sale (“pre-sale orders”) generally are given top priority. In some negotiated offerings, retail orders or other restrictions designated by the issuer are given priority. Once the order period begins for either negotiated or competitive underwritings, the most common priority provision gives group net or net designated orders top priority, followed by member orders.

- a. *Retail Order* – Any order by customers other than institutional customers; “retail” is not defined by the MSRB. Generally includes Professional Retail but not always.
- b. *Institutional Order* – Any order by banks, financial institutions, bond funds, insurance companies or other business organizations that possess or control considerable assets for large scale investing.
- c. *Group Net Order* – Any order that, if allocated, is allocated at the public offering price without deducting the concession or takedown. A group net order benefits all syndicate members according to their percentage participation (i.e., liability) in the account and consequently is normally accorded the highest priority of all orders received during the order period.
- d. *Designated (Member) Order* – Any order submitted by a syndicate member on behalf of a buyer on which all or a portion of the takedown is to be credited to certain members of the syndicate. The buyer directs the percentage of the total designation each member will receive. Generally two or more syndicate members will be designated to receive a portion of the takedown. In practice, Issuers will set guidelines for how the buyers may direct the takedown among the syndicate.
- e. *(Non-Designated) Member Order* – Any order submitted by a syndicate member where the securities would be confirmed to that member at syndicate terms (e.g., less the total takedown).

5. Calculation of Issue Price

- a. Hold-the-price or 10% of bonds sold at offering price
- b. Super premium/deep discount
- c. Priced to final optional redemption date (tax vs. marketing)

C. **Potential Pricing Considerations**

1. Yield curve

2. Bond structure
3. Supply and demand
4. Economic indicators
5. Market psychology
6. Market technicalities
7. Credit
8. Tax status
9. Redemption schedule

**D. Day of Sale**

1. Pre-pricing call
  - a. Issuer/Obligated Person, Municipal Advisor and Underwriter discuss
    - i. Market conditions
    - ii. Comparable transactions
    - iii. Proposed interest rates (coupons, yields)
  - b. Bond counsel and underwriter confirm that sales fit within legal parameters
  - c. Issuer/Obligated Person approves release of the bonds at proposed interest rates
  - d. Order period begins – investor feedback
  - e. Repricing – Adjustment of interest rates, if necessary
  - f. Confirmation of insurance premium and verification (if refunding)
  - g. Bond Counsel/ Underwriter's Counsel finalize bond purchase agreement
  - h. Issuer, (Obligated Person) and Underwriter execute bond purchase agreement – time restriction?
  - i. Underwriter tickets the transaction

## E. Pre-Closing and Closing

### 1. Pre-closing Considerations of Underwriter

- a. Form G-32- requires that any dealer (i.e., not just the underwriter) selling municipal securities to a customer during the issue's underwriting period must deliver the official statement in final form, if any, to the customer by settlement of the transaction
- b. Final OS
  - i. Dated to coincide with bond purchase agreement execution
  - ii. Distributed to investors within 7 business days of bond purchase agreement execution
- c. Closing Memo
  - i. Flow of funds
  - ii. Wiring instructions
  - iii. Costs of issuance

### 2. Closing Considerations of Underwriter

- a. Receipt of deliverables under bond purchase agreement
  - i. *10b5 certificates* – Antifraud certifications which give underwriter comfort that issuer did not “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” (See: <https://www.ecfr.gov/current/title-17/chapter-II/part-240/subpart-A/subject-group-ECFR71e2d22647918b0/section-240.10b-5>)
  - ii. *Transaction documents* – Examples include Trust Indenture, Loan Agreement, Continuing Disclosure Undertaking, transcript certificates, etc.
  - iii. *Opinions* – Examples include Bond Counsel Opinion, Underwriter’s Counsel Opinion, Issuer Opinion, Trustee Opinion, etc.
  - iv. *Evidence of credit enhancement* – Examples include bond insurance, letter of credit, etc.

- v. *Final Blue Sky memo* – Contains same information, or a letter confirming as of the closing date the information, contained in the Preliminary Blue Sky Memorandum delivered prior to the circulation of the Preliminary Official Statement
- a. Confirmation of wires – Fed wire reference numbers
- b. Close through Depository Trust Corporation (DTC)