

NATIONAL ASSOCIATION OF BOND LAWYERS
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Underwriter’s Counsel Roundtable (Intermediate)

Chair:

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Panelists:

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This panel will review the duties, responsibilities and potential liability for underwriters in public offerings of municipal securities and the role of underwriter’s counsel in representing underwriters. The panel will also include a discussion of best practices in evaluating and documenting the transaction from the outset through closing.

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 validity of bonds and other subjects, particularly the federal 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 serving as the principal drafters of an issuer’s disclosure document; may provide 10b5 opinion to issuer and underwriters
5. *Issuer* – A state, political subdivision, agency, authority 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

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, 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
9. *Underwriter* – Broker, dealer or bank dealer which purchases a new issue of municipal securities for resale
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
13. *Trustee* – Financial institution which acts in a fiduciary capacity for the benefit of bondholders in enforcing the terms of the bonds
14. *Trustee's Counsel* – Attorneys representing the trustee
15. *Underwriter* – Broker, dealer or bank dealer which purchases a new issue of municipal securities for resale
16. *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
 - a. Individuals
 - b. Bank Trust Departments (On behalf of customers) – see below
 - c. Investment Advisers (Professional Retail) – see below
2. Institutional Investors

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

C. Typical Steps in a Transaction

- 1. Assemble team
- 2. Evaluate capital needs and cash flow capacity
- 3. Develop a financing plan and schedule
 - a. Type of sale
 - i. Negotiated, competitive, private placement vs. direct purchase by a bank
 - ii. Considerations
 - A. Type of issuer/obligated person
 - B. Legal authority
 - C. Credit/reserves for repayment
 - D. Project type
 - E. Financing Structure
 - F. 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, etc.)
 - iv. Bond covenants (additional bonds tests, limitations on future taxes, non-impairment provisions, etc.)
- 4. Credit Enhancements
 - a. Credit ratings
 - b. Bond insurance
 - c. Letter of credit (LOC)
- 5. Due Diligence (including checking on past Rule 15c2-12 continuing disclosure compliance) - Underwriter may utilize counsel but may not delegate this responsibility
- 6. Draft documents
 - a. Authorizing resolutions/ordinances
 - b. Feasibility studies/ Engineering reports
 - c. Trust Indentures/Agreements
 - d. Notices to bondholders/insurance companies/trustee
 - e. Preliminary Official Statement/Official Statement
 - f. Preliminary Blue Sky/Final Blue Sky Memorandum
 - g. Bond Purchase Agreement/Contract of Purchase
 - h. Agreement Among Underwriters
 - i. New SIFMA Master Form
 - ii. SIFMA Data Base
 - iii. Schedule for each transaction
 - i. Selling Group Agreement
 - j. Accountants
 - i. Agreed Upon Procedures
 - ii. Consent to use audit
- 7. Marketing

8. Comply with MSRB Rules

Municipal Securities Rulemaking Board (MSRB) is a non-governmental, self-regulatory organization (SRO) 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”).
- ii. *Municipal Advisory Relationship* - Covers Municipal Advisors or consultant services with respect to the issuance of municipal securities, including advice re: structure, timing, terms or similar matters.
- iii. *Excludes Underwriters* - Municipal Advisors relationship shall not exist when underwriter renders advice in connection with a transaction in which the underwriter is performing underwriting services. A broker-dealer that clearly identifies itself in writing as an underwriter and not as a Municipal Advisor from the earliest stages of its relationship with the issuer with respect to that issue 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 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 it 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 made 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

- 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 yield level 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. 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
- c. Securities obligations are different than in competitive or negotiated sale

B. **Elements of a Pricing**

1. *Coupon* - Annual interest rate payable to the bondholder
2. *Discount Bonds* – Coupon is less than yield
3. *Maturity* - Date on which principal payments are due
3. *Par Bonds* – Coupon equals yield
4. *Premium Bonds* – Coupon is greater than yield
5. *Price* - Total amount paid by the issuer for the bonds
6. *Principal/Par Amount* - Face value of a bond to be paid back to the bondholder on the maturity date
7. *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

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. *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. Syndicate vs. selling group
 - b. Senior manager vs. co-managers
3. Create allocation policy
4. Establish priority of orders
5. Pre-pricing
6. Order period

7. Bond pricing
8. Award bonds
9. 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.
 - i. No direct relationship with the issuer/obligated person
 - ii. Related entity to broker dealer
 - A. Distribution agreement
2. Compensation/Spread – 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. *Expenses* – The costs of operating the syndicate for which the senior manager may be reimbursed.

- 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.
- iii. *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 member of the syndicate, the seller is entitled to the full takedown (also called the “total takedown”). 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.
- iv. *Risk or Residual* – The amount of profit or spread left in a 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
- v. *Payment* – Generally taken from the purchase price

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 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 orders top priority, followed by designated orders and member orders.

- a. *Retail Order* – Any order by customers other than institutional customers; “retail” is not defined by the MSRB.
- 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 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.
- 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 Issuer Price

- a. Hold-the-price
- b. Super premium/deep discount
- c. Priced to maturity (tax vs. marketing)

C. **Potential Pricing Considerations**

1. Yield curve
2. Bond structure
3. Supply
4. Economic indicators
5. Market psychology
6. Market technicalities

7. Credit
8. Tax statute
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. Issuer/Obligated Person approves release of the bonds at proposed interest rates
 - c. Order period begins – investor feedback
 - d. Repricing – Adjustment of interest rates, if necessary
 - e. Bond counsel and underwriter check that sales fit within legal parameters
 - f. Confirmation of insurer premium and verification (if refunding)
 - g. Bond Counsel/ Underwriter’s Counsel finalize bond purchase agreement
 - h. Issuer, Obligated Person and Underwriter sign bond purchase agreement
 - i. Underwriter tickets the transaction

E. Pre-Closing and Closing

1. Pre-closing Considerations of Underwriter
 - a. Form G-32
 - 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. Cost of issuance
 - ii. Flow of funds
- 2. Closing Considerations of Underwriter
 - a. Receipt of deliverables under bond purchase agreement
 - i. 10b5 certificates
 - ii. Transaction documents
 - iii. Opinions
 - iv. Evidence of credit enhancement
 - 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
 - b. Contact Depository Trust Corporation