The Bond Lawyer

THE JOURNAL OF THE NATIONAL ASSOCIATION OF BOND LAWYERS // VOLUME 48 NUMBER 4 // 2024

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Content

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Editor's Notes

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Welcome to the Volume 48 No. 4 of *The Bond Lawyer*.

In this Edition

In this edition, in addition to summarizing something of a barrage of revenue procedures recently announced, Tony Martini provides a look back at the tax developments in 2024 and a look forward to 2025 and the potential for additional tax legislation. Tony notes the continuing efforts on NABL's part to monitor, educate, and advocate on these matters, including the upcoming Town Hall on the 119th Congress that NABL's Governmental Affairs Committee will be offering exclusively to NABL members on January 16. The registration link is included in Tony's column.

Drew Kintzinger reports in this edition on recent SEC enforcement activity, including the annual report of enforcement activity. He also provides a summary of the recent speeches and other matters from the Office of Municipal Securities Director Dave Sanchez, as well as guidance from staff of OMS and the Public Finance Abuse Unit regarding what charter schools should know about municipal advisor regulation.

Third Installment of Municipal Securities Retrospective

Our journey through the historical development of federal securities regulation of the municipal market continues with the third installment from Paul Maco, Rick Weber, and Drew Kintzinger. While most focus today is on the continuing disclosure requirements of SEC Rule 15c2-12, the first iteration of the rule dealt primarily with underwriters' responsibilities and primary offering documents (and the reason behind the "deemed final" certification). The 1988 SEC proposing release highlights what is the foundation of an underwriter's responsibility to "test the key representations" in an offering document. This, like many of the Rule 15c2-12 proposing (and adopting) releases since, offers insight into the meaning behind the language of the rule and why we do some of the things we do today. Many thanks again to Paul, Rick, and Drew.

Blind Pools Retrospective

David Cholst and Cliff Gerber are back in this edition with a tax retrospective on blind pool transactions. Blind pools gained a bit of notoriety in the 1980's and 1990's and

David and Cliff break down the issues for us and provide some insight into some of the things tax practitioners were dealing with during this period. They note, of course, that not all pooled financings are "blind" and not all blind pooled financings are notorious. Thank you to David and Cliff.

More Commentary on Municipal Securities Market Reform

Kent Hiteshew continues his commentary on means to improve the municipal market, this time with David Dubrow[1]. In a two-part article published in *ProMarket*[2] Hiteshew and Dubrow provide a brief history of municipal securities regulation and pitch the evolution of disclosure regulation to a structure more akin to corporate finance (albeit without pre-sale registration and filing). The authors note that the significant federal legislation in the municipal market in relative recent history came on the heels of notable historic events, namely, the New York City fiscal crisis and the Washington Public Power Supply System default. They postulate the following:

> "…there has been virtually no relevant federal legislation enacted or SEC regulations issued in the wake of the far larger investor losses experienced by municipal investors after the historic Detroit and Puerto Rico bankruptcies of the last decade. In fact, with the exception of a single broker-dealer affiliate's closed-end bond funds, there have been virtually no SEC enforcement actions brought against any of the Detroit or Puerto Rico parties. Accordingly, it may be an appropriate time to revisit the unique exemption from uniform disclosure standards of the Securities Acts that continues to plague the municipal bond market."[3]

What struck me about their premise is that it seems to suggest more uniform disclosure would have, somehow, prevented investor losses. In the Southern vernacular, "that dog won't hunt." I do not see how any amount of disclosure, primary or ongoing, would have prevented the losses suffered by investors, unless the primary offering disclosure was so deficient that "full" disclosure would have resulted in the bonds never being issued (and not purchased). Ongoing disclosure about potential credit deterioration might have affected secondary market liquidity and pricing, but if the bonds were fixed

[1] See the previous discussion in *The Bond Lawyer,* Vol. 48 Number 2, from June 2024.
[2] https://www.promarket.org/2024/10/22/decades-of-regulatory-exemptions-have-been-to-the-detriment-of-the-municipal-bond-market/ and https://www.promarket.org/2024/10/23/the-case-for-modernizing-municipal-bond-disclosure-transparency/. *ProMarket* is published by the J. Stigler Center for the Study of the Economy and the State at the University of Chicago Booth School of Business.
[3] https://www.promarket.org/2024/10/23/the-case-for-modernizing-municipal-bond-disclosure-transparency/

rate without a tender right, someone would have been left holding the bonds at the time of default and loss even if disclosure went above and beyond.

The authors suggest guidelines for the SEC to consider an expansion of SEC Rule 15c2-12 "to prescribe uniform disclosure standards for primary offerings beyond the rudimentary materiality standard." Those guidelines include (1) use of "plain English," (2) inclusion of executive summaries, (3) inclusion of a risk factor section, (4) inclusion of specific historical financial information and trends for governmental issuers (but not conduit borrowers?), (5) use of generally accepted accounting principles in audited financial statements, (6) more disclosure regarding defined benefit pension obligations (beyond GASB requirements), (7) subjecting conduit borrower disclosure to the same standard as if there was no securities registration exemption, and (8) appraisals and expert reports could not be "pre-reviewed" by the [conduit] borrower[4].

Discussion regarding "uniform" disclosure guidelines is not susceptible to a one-size-fits-all proposition (which I believe the SEC staff has acknowledged time and time again). The municipal market with respect to governmental bonds is diverse because of underlying state law governance and no uniform disclosure regime will change that. Any set of guidelines would have to be fluid enough to be malleable to the many, many nuances of municipal bond offerings, which will then require the "rudimentary materiality standard" to be the driver. Think of how many variances there are just in the general obligation bond segment, alone.[5] If what the authors are really looking for is the homogenization of the municipal market, such that all municipal bonds will fit neatly into fewer categories to facilitate comparison among issuers and bond issues, to thereby increase liquidity and transparency in pricing, it will take a lot more than uniform disclosure principles. Additionally, perhaps revisions to Chapter 9 of the U.S. Bankruptcy Code should be considered or model state laws developed regarding perfection of security interests in revenues (property tax or other revenues and security), both of which would go much further to protect investors from potential losses in municipal bankruptcy.

My personal observation, as limited as that may be, is that disclosure practices in the governmental space and certain market segments generally have improved significantly over the past 30 years (since the 1994 Interpretive Release), due in part, to the concerted efforts of NABL members (through various committee projects and educational programs), the Government Finance Officers Association (through its series

[4] I assume the authors meant this guideline to apply only to conduit borrowers and not to apply to engineering and feasibility reports in governmental deals which necessarily should be reviewed by other parties to test the reasonableness of the conclusions.
[5] See the NABL Report on General Obligation Bonds. https://www.nabl.org/wp-content/uploads/2023/02/20140831-NABL-Report-on-General-Obligation-Bond-Considerations.pdf

of best practices and educational programs), and, of course, SEC activity (interpretive guidance, educational outreach, regulatory actions, and enforcement). Are there segments in the governmental space (either geographical or by market segment) that may be viewed as lagging behind? Perhaps, and, if so, let's identify those areas and help "raise the bar."

Plain English—Say What?

The reference to "plain English" in the Hiteshew/Dubrow article took me back to the late 1990's when the corporate rule on plain English was adopted for certain corporate filings[6] and technically only required for the cover page, summary statement, and risk factor section. There was discussion at the time and some encouragement for the municipal market to embrace plain English, however, the wind did not last long in those sails. There were, and still are, some issuers and conduit borrowers who have embraced the streamlined summary-style cover page for disclosure documents but the covers for many (most?) disclosure documents seem to be a condensed summary of the entire book and, for more complicated deals, the font size has to be reduced significantly to fit all the information on one page. Relatively few issuers and conduit borrowers have embraced the plain English approach beyond the cover but there are some. When the corporate rule was promulgated, it was accompanied by the "Plain English Handbook" which had this to say about covers:

> "A cover page should be an introduction, an inviting entryway into your document, giving investors some key facts about your offering, but not telling everything all at once. If it looks dense and overgrown with thorny details, no one will want to pick it up and start reading. If it looks like a legal document written by lawyers and for lawyers, many investors will not even attempt to read it."

(I can hear your eyes rolling.)

The handbook includes many suggestions for employing the plain English approach including selection of typefaces (use serif, as opposed to non-serif), font size (10-12 pt type unless you are targeting an elderly investor audience, in which case use larger), "design" concepts, justification tips (justified left, ragged right), tips for emphasis (don't use all caps, use italics or bold face type), and on and on.

There is some merit, maybe a lot, to making disclosure documents more "readable." However, we bond practitioners are creatures of habit and bound to principles of efficiency and expediency. Translated, that means we don't usually have the time to convert a document to plain English and our clients generally will not pay us to do it.

[6] https://www.sec.gov/rules-regulations/1998/01/plain-english-disclosure

That said, perhaps we can take a step or two in the direction of plain English, and maybe start with the document cover. A few examples of disclosure documents utilizing plain English concepts either on the cover alone or throughout are linked in the footnote.[7] And, there is likely an AI program out there than can help with this.

Déjà Vu All Over Again

In 2017, there were some NABL members who suggested NABL was asleep at the switch when the Tax Cut and Jobs Act of 2017 was enacted which ended advance refundings. That wasn't true, of course, but sometimes perception is reality, particularly, if one only looks at the result. So, with a new administration taking office in January, and the promise to extend the 2017 tax cuts and perhaps further reduce corporate tax rates, the exemption for municipal bonds is likely to again be considered a means to pay for the extension and/or further corporate tax rate reduction. All NABL members should take some time to visit the advocacy section of the NABL website for ideas of how you can be part of the effort to educate Congress on the importance of tax-exempt financing for our clients. You may not know any member of Congress personally, but you are a constituent of at least three members, whether you have ever met or voted for any of them. Let's all do our part. Here's the link: https://www.nabl.org/advocate/

And now, please enjoy the rest of this edition of *The Bond Lawyer*.

[7] https://emma.msrb.org/P21544687-P21193840-P21612756.pdf (cover and throughout)
https://emma.msrb.org/P21534814-P21186391-P21604267.pdf (cover)
https://emma.msrb.org/P21790773-P21374711-P21813830.pdf (cover)

Federal Securities Law

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The last quarter of the calendar year brings a steady flow of SEC enforcement actions involving municipal securities. The fall months also bring noteworthy published speeches and one Bulletin from the SEC's Office of Municipal Securities. In late November, the SEC, along with the MSRB and FINRA, sponsored a newsworthy Joint Compliance Outreach Event for municipal advisors and municipal securities dealers. A constant theme across much of this guidance are activities of municipal advisors—or those who are advising on municipal bond issuances without registering as a municipal advisor.

Enforcement

Division of Enforcement Results for Fiscal 2024. On November 22, 2024, the Commission released its enforcement results for fiscal year 2024 (ending September 30). Generally, numbers of enforcement actions were down, and the level of financial remedies obtained were the highest on record. The announcement emphasizes throughout that self-remediation, self-reporting, and cooperation often led to lower or no financial penalties, including certain municipal broker-dealers and municipal advisors. The Public Finance Abuse Unit reported no new civil actions commenced in federal district court during Fiscal 2024 and 14 new administrative proceedings affecting 16 named parties during the same period. This number includes the twelve off-channel settlements with municipal advisors announced on September 17, 2024. The one mention of the municipal market that the Enforcement Division makes in its report on the past fiscal year is that its recordkeeping "off channel" cases against more than 70 firms "include[es] the Commission's first cases charging recordkeeping violations against municipal advisors." Overall, the Public Finance Abuse Unit accounted for 2% of all enforcement proceedings initiated in Fiscal 2024.

The final quarter of calendar year 2024 included important developments in one disclosure case and in a cluster of municipal advisor cases:

<u>Disclosure—City of Rochester Judgement</u>. On October 16, 2024, Judge Elizabeth Wolford, federal district court judge for the Western District of New York, entered final judgement with respect to the City of Rochester and its former finance director (the "City Defendants"). In 2022, the SEC announced charges against the City and its former finance director (as well as against the City School District's former CFO and the City's municipal advisors) alleging the parties misled investors in a $119 million bond offering. The SEC alleged the bond offering documents included outdated financial information about the school district and did not indicate the school district was experiencing financial distress due to overspending on teacher salaries. Specifically, the SEC alleged the City's former finance director was aware of the school district's increased financial distress but made no effort to inquire further about the school district's financial condition prior to the bond offering and also failed to inform investors of the risks that the overspending on salaries posed to the school district's finances. In the final judgement, the City Defendants were enjoined from future violations of Section 10(b) and Rule 10b-5 under the 1934 Act and hof Section 17(a) of the Securities Act of 1933. The former City finance director was barred from any future municipal securities activities. Notably, no monetary penalties were assessed against either the City or the former finance director. Certain causes of action against the municipal advisor and its principals remain subject to final resolution and judgement order.

<u>Municipal Advisor Actions</u>. In the successive months of September, October, and November, the SEC obtained one final judicial order in a litigation proceeding and announced two settled administrative actions regarding municipal advisory activities. In ***Securities and Exchange Commission v. Choice Advisors, LLC and Matthias O'Meara*, No. 3:21-cv-01669-JO-MSB (S.D. Cal. filed Sept. 24, 2021)** the U.S. District Court for the Southern District of California entered final judgement against a municipal advisor firm and one of its principals, permanently enjoining the defendants from future violations of securities law and assessing disgorgement and civil penalties against both firm and individual. In 2021, the SEC alleged the defendants had entered into impermissible fee-splitting arrangements with an underwriter to bond offerings in which their municipal advisory clients were borrowers. The SEC alleged the principal worked on different sides of the same transaction, simultaneously serving as both a municipal advisor as well as registered representative to the underwriter. Neither the defendant firm nor principal were registered municipal advisors with either the SEC or MSRB. In addition, the SEC alleged that the defendants breached their fiduciary obligations by failing to disclose the conflicts created by their unregistered status and the principal's dual role.

In ***In the Matter of Hamlin Capital Advisors, LLC and Michael Ferrell Braun, Securities Exchange Act of 1934 Release No. 101424 (October 24, 2024)***, a no admit/no deny settled administrative order, the SEC similarly focused on failure to disclose material conflicts of interest and breach of fiduciary duty by a municipal advisory firm and its associated Managing Director. The SEC alleged the firm and its Managing Director advised charter school clients on bond offerings in which an affiliate entity of the advisor firm purchased all or a substantial portion of the bonds. In addition, the SEC allegedthe affiliate entity in turn acted as compensated bondholder representative. The SEC viewed this affiliate relationship and dual role as creating a material conflict of interest which was not timely disclosed to charter school borrowers. The cease and desist order censured both firm and individual for violations of the Exchange Act for violating MSRB rules and for violating its fiduciary duty to client schools. Civil penalties were assessed against both firm and individual.

In ***In the Matter of Level Field Charter Partners, LLC and David Endom, Securities Exchange Act of 1934 Release No. 101762 (November 26, 2024)***, another no admit/no deny administrative settlement, the SEC alleged that a consulting advisor firm and one of its partners provided municipal advisory services to four charter schools in connection with bond offerings, including advice on the structure, timing, and terms of the offerings, among other advisory activities in connection is the bond issues. The SEC alleged that the firm and partner failed to register as municipal advisors and failed to disclose their registration status to their charter school clients. Remedies included censure, cease and desist orders against both firm and individual, disgorgement and civil penalty against the firm and civil penalty against the individual partner.

These three actions—following the August 27, 2024, administrative action for unregistered municipal advisory activities in ***In the Matter of Tensquare, LLC and Karl Jentoft*** (reported in the September issue of this publication)—send a signal that the SEC is keeping a "laser focus" on the roles and activities of advisory and consulting firms that "touch" municipal securities offerings, particularly in the charter school space. It is also an announced priority of the SEC's Division of Examinations to audit registrations (or lack thereof) and advisory activities in the municipal advisor sector. As discussed below, the Office of Municipal Securities is proactively speaking to the market on this concern in a formal bulletin, in officially published speeches at www.sec.gov and in conference outreach events.

Guidance from the Office of Municipal Securities

Fall conference season brought speeches, officially footnoted and published at www.sec.gov, by Dave A. Sanchez, Director of the Office of Municipal Securities. A prefatory word about speeches: Yes, they are not a formal interpretive release by the Commission or even a "Staff Legal Bulletin" like the February 2020 bulletin on the applicability of antifraud provisions to municipal issuer and obligated person statements in the secondary market.

However, the speeches offer valuable insights into the current thinking of regulators at OMS and the Public Finance Abuse Unit in the Enforcement Division. Wearing this writer's tax hat, the 103 bar has often relied on regulator speeches at NABL conferences for an indication of where the IRS's thinking is on regulations and rulings. Similarly, the posted and footnoted speeches—and occasional bulletin—are the most direct guidance the municipal securities bar may be receiving from SEC Staff, given how preoccupied the Commission has been with topics of cryptocurrency, corporate climate change rules, and asset backed securities rules. The speeches are substantive and merit attention, even a close reading.

On September 26, Dave Sanchez delivered remarks to the California Debt and Investment Advisory Commission titled "***Responsibilities of Regulated Entities to Municipal Issuers***" (*https://www.sec.gov/newsroom/speeches-statements/remarks-california-debt-investment-advisory-commission-municipal-debt-essentials-seminar*). This published speech offers perhaps the best history of municipal advisor regulation from its inception in Dodd-Frank (2010) to present. It explains the complicated rule interplay between the SEC and the MSRB in this space. It explains the legal foundation of the fiduciary duty and the duty of care and duty of loyalty inherent in the fiduciary duty. It can be expected that the SEC may soon expand the duty of care to cover disclosure obligations of municipal advisors who participate in the preparation of issuer offering documents in municipal bond issues. There is some appropriate market "press back" on the comments in this speech regarding the SEC's belief that negotiated sales inexplicably remain the dominant method of sale when competitive sales may result in interest cost savings to issuers. However, the speech is one of the best statements of the law in the field of municipal advisor regulation.

In a second set of California remarks delivered at the California Bond Buyer Conference, also formally footnoted and published at www.sec.gov, Mr. Sanchez offered his views on "***Joint Powers Authorities and Other Topics for Market Participants***" (https://www.sec.gov/newsroom/speeches-statements/sanchez-remarks-california-bond-buyer-conference-102424). While the remarks focus on the public versus private control concerns that accompany some joint powers agencies, and also return to the topic of negotiated sale versus competitive sale pricing, the speech provides direct guidance on the topic of climate and environmental risks disclosure and the antifraud provisions. For example, Mr. Sanchez notes that in the context of evaluation of disclosure under the antifraud provisions, a "silo effect" in large issuer organizations that inhibit sharing of information may lead to failure to disclose material information. He also notes instances where municipal issuers in the same geographic region, and presumably with the same climate and environmental risks, are not disclosing the same information as material environmental and climate disclosure items. He does defer to "facts and circumstances" and notes that there is no legal requirement to consider what other issuers are disclosing. However, he advises that when assessing materiality of disclosure, an issuer or obligated person may find it "helpful" to consider the disclosures of other similarly impacted municipal issuers and obligated persons. This is not new law, but simply a restatement of the importance to an issuer of being aware of the "total mix" of information in the market under the U.S. Supreme Court's ***Basic v. Levinson*** doctrine when offering securities. Mr. Sanchez observes:

> Municipal analysts and market participants have observed an absence of adherence to municipal market best practices for climate and environmental disclosure by municipal issuers. Market participants have also raised concerns about municipal issuers downplaying or omitting material facts related to climate or environmental risks due to political pressure or for fear of the market's negative consequences. Because municipal securities are issued with longer terms, analysts and credit ratings agencies have raised concerns regarding the effects of climate and environmental risks on demographic shifts, insurability of property, livability and property value changes, and the credit risks those changes pose.

The speech offers direct Staff views on the state of disclosure practices with respect to environmental and climate risks.

In November, in a "last reviewed or updated" version dated November 15, 2024, the Office of Municipal Securities and the Division of Enforcement, Public Finance Abuse Unit, issued an ***Informational Bulletin: What Charter Schools Should Know About Municipal Advisor Regulation***." (https://www.sec.gov/about/divisions-offices/office-municipal-securities/informational-bulletin-charter-schools-110524). The Bulletin states that the contents represent the views of the staff of OMS and the PFA Unit and that the Bulletin is not a statement of the Commission. The Bulletin is a general, informational "follow-on" from the Enforcement actions and speeches discussed above.

Compliance Outreach Conference

On November 20-21, the SEC/MSRB/FINRA conducted a well-attended (220 present, 774 virtual/hybrid participants) Compliance Outreach Event for Municipal Advisors and Municipal Dealers. Speaker panels had several representatives from the NABL municipal securities bar. Several panel discussions were relevant to underwriter's counsels, disclosure counsels and bond counsels, including discussions of disclosure obligations of municipal advisors and the interactions between municipal advisors, underwriter's counsel and disclosure counsel; legal aspects of representing the roles and duties of co-managers; current views on fiduciary duty and duty of care; and current examination and enforcement priorities. A good summary of legal issues raised at the conference and addressed to all municipal market participants can be found in the closing remarks from the Office of Municipal Securities https://www.sec.gov/newsroom/speeches-statements/remarks-2024-joint-compliance-outreach-program-municipal-market-participants.

That is a "wrap" on a busy fall season for municipal securities. Happy Holidays to all!

Federal Tax Law: The Tax Microphone

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Looking Back; Looking Forward

I've been writing this quarterly column for several years now. Every year, as I take up my pen at year's end to write my Fall piece, I find myself reflecting on what's gone on in the preceding year and on what's to come in the New Year. This time around it's the same. Over the past year, we haven't seen any earth-shaking legislative or administrative tax law developments that have affected the municipal market. There's been a reasonable amount of lawyerly ferment about the regulatory implementation of the tax credit regime under Section 6417 of the Internal Revenue Code. I've written about that in a couple of my recent columns. We've also been seeing an uptick in staffing at TEB as the IRS continues to stand up resources to surge audits of tax-exempt debt issues. I've seen a fair bit of that first-hand over the last twelve months. But mostly, the developments we've witnessed in the tax law sphere have been pretty small bore. Just one example: we've seen the IRS expand the mandate for electronic filing of requests on Form 8038-CP for direct-pay subsidies on tax-advantaged debt instruments like build America bonds. That's enough said about that; if you are interested in the latest directive on this topic you can see what the IRS has to say at https://www.irs.gov/tax-exempt-bonds/recent-updates-concerning-8038-cp-processing-including-e-file.

Consequently, I find that I'm thinking more about the big picture at the end of 2024 and looking ahead, out toward the horizon. We all know what happened in our national election in November. The 119th Congress, which will convene in January 2025, will feature a closely-divided Senate and an even more narrowly-divided House of Representative, each under Republican leadership, nominally perhaps in the case of the House. And we will see a ground shift in the executive branch of our federal government; I'll characterize it here as the second coming of the second Grover

Cleveland administration for you history buffs, and I'll leave it at that. As we all know, the incoming administration has broadcast a good deal about tax cuts and about reducing and eliminating governmental regulations.

As a corollary of this, we can expect to hear talk in Congress about extending the provisions of the Tax Cuts and Jobs Act of 2017, either by repealing or (more likely) deferring the sunset provisions in that legislative package. We also may see efforts to unwind a number of the tax law changes championed by the current administration and enacted in the Infrastructure Investment and Jobs Act of 2021 and in the Inflation Reduction Act of 2022. Although it's nothing but speculation on my part, it seems possible that those in charge of developing tax policy in 2025 might look at repealing Code Section 6417. They might even decide that the new exempt facility categories for qualified broadband projects and qualified carbon dioxide capture projects should be jettisoned! Imagine! Rescinding most or all of the $80 billion in increased funding for the IRS that was approved in 2022 almost certainly will be front and center in 2025. We should know a lot more about this within the first 100 days after January 20.

What's more, I note that an ex-Congressman and former auctioneer from Missouri by the name of Billy Long has been tapped by the next administration to take over as Commissioner of the IRS. Reports indicate that, in his time in Congress, Mr. Long (who never was a member of the House Ways and Means Committee) co-sponsored several bills to abolish the IRS outright. One could be excused for thinking that it would be great for the municipal market if the IRS were out of the picture, but I wouldn't be so sure—these same bills Billy Long co-sponsored would have abolished the federal income tax, the estate and gift taxes, as well as federal payroll taxes, and replaced them with a national sales tax to be administered "primarily by the States" (see, e.g., H.R. 25, a bill introduced in the 1st session of the 114th Congress). That wouldn't have been so great for the municipal market, to put it mildly. Finally, I'm also mindful of the talk about enhancing the efficiency of the federal government and the prospect of cutting $2 trillion of annual spending in a federal budget that currently does not have $2 trillion in "discretionary" spending. No one can know today what all of this portends, but I'm probably not alone in feeling that 2025 has the potential to be something other than business as usual.

So what should we bond lawyers do? For me, the formula will be to stick to the knitting. I'm no expert in any of this, but with a narrowly-divided Congress on tap for 2025 and 2026, I wouldn't be surprised to see that much of this big-picture talk about tax policy tapers itself into a much more constrained frame of reference, focusing on achievable tax cuts and extensions of the 2017 tax act sunsets. That would imply related conversations about the search for "pay-fors" to offset the tax expenditures favored by the new administration in its quest for tax and spending cuts. And that's where we come in, because we shouldn't be surprised if some of the pay-fors that are identified involve proposals to repeal some of the authorities under Sections 103 and 141 through 150 of the Code that power the tax-exempt bond market.

As a group, we bond lawyers have a remarkable fund of experience and insight to explain to policymakers how and why tax-exempt bonds energize the economy, how they provide affordable funding for so much of the public and private infrastructure that Americans rely on every day to go to work and do their jobs, how they bolster investment in hospitals and scientific research, how they offer pathways to college and to home ownership. For many years, NABL has done great educating policymakers about these points. The work really never ends, but it seems to me there's never been a better time to redouble these efforts.

I feel fortunate to know that NABL's leadership is investing time and resources right now carry on with this outreach. I encourage my fellow NABL members to find ways to participate in and contribute to these efforts. So, in closing on this topic, I'll call readers' attention to the Town Hall on the 199th Congress that NABL's Governmental Affairs Committee will be offering exclusively to our membership on Thursday, January 16. You can register for the Town Hall at https://imis.nabl.org/NABL/Event_Display.aspx?WebsiteKey=e308e0e0-03d7-4b36-a8d5-8010273964d9&EventKey=GACADV25&_zs=jET77&_zl=OBtJ4. I hope you'll join me there, and I hope you'll consider teaming up with your fellow NABL members to advocate for tax-exempt bonds in 2025.

With that, let's turn to a couple of developments on the tax front that emerged in the Fall of 2024.

Revenue Procedure 2024-37

On September 18, 2024, the IRS released Revenue Procedure 2024-37, publishing updated guidance on the procedures and timing requirements for the filing of requests for recoveries of overpayments made with respect to the rebate requirement of Code Section 148(f), as well as overpayments of penalties in lieu of rebate under Code Section 148(f)(4)(C) and yield reduction payments (YRPs) under Treasury Regulations Section 1.148-5(c). Under Rev. Proc. 2024-37, these recovery requests, which must be filed using IRS Form 8038-R, are generally required to be submitted no later than two years after (i) the date 60 days after the final computation of the bond issue to which the payment relates or (ii) the date the payment was made, if the payment was made more than 60 days after the final computation date.

Additional procedures are provided for the processing of these recovery requests, including in cases in which the request is rejected for failure to furnish all of the information required by Form 8038-R, in cases in which the request is denied on the merits and for the pursuit of appeals within the IRS with respect to claim denials. Rev. Proc. 2024-37 modifies and supersedes Revenue Procedure 2008-37, as modified by Revenue Procedure 2017-50, and it supersedes the latter Revenue Procedure in its entirety. Rev. Proc. 2024-37 applies to rebate, penalty-in-lieu of rebate and YRP recovery requests filed on and after October 18, 2024. A copy of Revenue Procedure 2024-37 can be found at https://www.irs.gov/pub/irs-drop/rp-24-37.pdf.

Revenue Procedure 2024-38

On September 25, 2024, the IRS promulgated Revenue Procedure 2024-38 to provide guidance on the effect on the income requirements under Code Section 142(d) of the alternative income eligibility requirements set forth in a Department of Housing and Urban Development (HUD) notice entitled “Section 8 Housing Choice Vouchers: Revised Implementation of the HUD-Veterans Affairs Supportive Housing Program” published in the Federal Register on August 13, 2024 (89 F.R. 65769). As you know, Section 142(d) describes the requirements for tax-exempt bond financings for “qualified residential rental projects” including the low- and moderate-income set aside requirements that pertain to such projects.

As the Revenue Procedure explains, the HUD-VASH notice, which is designed to offer rental housing assistance with integrated case management and clinical services, aims to assist homeless veterans and, to that end, seeks to ensure that homeless veterans are not excluded from the benefits of the HUD-VASH program as a result of their Veterans Affairs (VA) disability benefits. To achieve this goal, HUD exercised its authority to waive the income eligibility requirements of Section 3(b) of the United States Housing Act of 1937, a provision of law that applies for purposes of determining lower income family eligibility based on area median income standards for purposes including Section 8 voucher programs.

Rev. Proc. 2024-38 aligns the IRS with the objectives of the HUD-VASH program in this context, providing that, for purposes of testing the initial and ongoing low- and moderate-income set-aside requirements of Code Section 142(d)(2) and (d)(3), all VA service-related disability benefits are excluded from income for tenants who, as of the date of income determination, are approved to receive or are currently receiving assistance under the HUD–VASH program and to whom the HUD–VASH income eligibility waiver applies. The income exclusion provided in the Revenue Procedure applies to income determinations made with respect to bonds issued on or after October 24, 2024 to finance qualified residential rental projects; according to the Revenue Procedure, it can also be applied to bonds issued prior to that date for the same purpose, notwithstanding that Treasury Regulations Section 1.103-8(b)(8)(v) requires that the method for determining low or moderate income in effect on the date of issuance of bonds financing qualified residential rental projects is determinative for such issue, regardless of subsequent changes in law.

Rev. Proc. 2024-38 also provides the same exclusion criteria for purposes of the income requirements set forth in Code Section 42, relating to the low income housing tax credit. A copy of Revenue Procedure 2024-38 can be found at https://www.irs.gov/pub/irs-drop/rp-24-38.pdf.

Revenue Procedure 2024-39

On October 11, 2024, the IRS published Revenue Procedure 2024-39, granting certain “applicable entities” making direct subsidy payment elections under Code Section 6417 an automatic six-month extension to file their original or superseding returns Form 990-T. In order to qualify for the automatic extension, an “applicable entity” must (1) have had a filing obligation under Code Section 6011 or Code Section 6033(a); (2) not have otherwise received an extension of time to file a return; (3) be filing the Form 990-T to make a Code Section 6417 election for a tax year ending on and after December 31, 2023 and on or before November 30, 2024; and (4) meet all other requirements for making a Code Section 6417 election, including without limitation the pre-filing registration requirement prescribed by the Treasury Regulations under Code Section 6417. Assuming the preceding conditions are met, under the terms of the Revenue Procedure, this automatic extension applies to “applicable entities” even if they did not file a timely extension on Form 8868 with respect to the deadline for filing their 990-T returns.

Readers will know that state and local governmental units are one of the principal classes that intended to benefit from the direct-pay subsidy offered through Code Section 6417. And, as has been pointed out previously in this column, state and local governmental units typically will not have any institutional experience filing Form

990-T, as they must, to claim their Code Section 6417 subsidies, because, until the enactment of this tax credit provision in 2022, Form 990-T had been reserved for nonprofit entities described in Code Section 501(a) to make returns of the income on their unrelated trade or business activities. Historically, these filing requirements have been, by and large, entirely foreign to state and local governmental units, and to their staffs. The IRS recognizes this in the Revenue Procedure, and so is granting filing deadline relief in the first year that Code Section 6417 elections are available.

One question I have is whether this same logic should apply, and the same deadline relief granted, to a state or local governmental unit that does not happen to be making an eligible capital investment shortly before the first year that Code Section 6417 elections are available. Perhaps that governmental unit will only be making such an investment a year or two later. For the staff of that governmental unit, Form 990-T will look no less strange, and the filing deadlines and procedures for requesting a Form 990-T extension no less alien. Because of this, my reaction is that the relief afforded in Rev. Proc. 2024-39, limited as it is to the first Form 990-T filing season following the advent of the program for administering Code Section 6417, falls short of the mark. Instead, I think the relief should have been framed to extend an automatic 6-month extension to any "applicable entity" <u>filing a Form 990-T for the first time to capture a Code Section 6417 credit</u>, whether or not the filing pertains to a taxable year ending before December 1, 2024. Perhaps the regulators can be persuaded to address this point in supplemental guidance down the road.

Rev. Proc. 2024-39 also offers procedures for any unfortunate "applicable entity" that receives a notice advising that its Code Section 6417 election is "ineffective" notwithstanding that it was timely filed on Form 990-T pursuant to the provisions of the Revenue Procedure. Apparently, the IRS here is anticipating that its right hand (<u>i.e.</u>, the branch whose responsibility it is to spit out the letters telling taxpayers that their filings are late) will not know what its left hand (<u>i.e.</u>, the IRS Office of Passthroughs & Special Entities, which produced Rev. Proc. 2024-39) has been doing. An "applicable entity" that receives an errant "ineffective" filing notice is advised to call an IRS toll-free phone number and to the person at the other end of the line that it's "entitled to an automatic extension of time to file under Rev. Proc. 2024-39." What could possibly go wrong?

Finally, under Section 4 of the Revenue Procedure, an "applicable entity" that is eligible for the automatic extension relief may make its Code Section 6417 election on a paper-filed Form 990-T, rather than via an electronic Form 990-T filing, as otherwise mandated by the IRS. The paper filing goes must bear the notation, "Paper Filed under

Revenue Procedure 2024-39" at the top of the return, and it must be mailed to the Department of the Treasury, Internal Revenue Service Center, Ogden, UT 84201-0027.

A copy of Revenue Procedure 2024-39 can be found at https://www.irs.gov/pub/irs-drop/rp-24-39.pdf.

Revenue Procedure 2024-40

Last but not least in the parade of Revenue Procedures this time around is Rev. Proc. 2024-40, which dropped on October 23, 2024. This is the annual soup-to-nuts announcement of inflation adjustments for the coming year affecting all manner of Internal Revenue Code provisions. Included are a couple of inflation-related chestnuts affecting those of us who inhabit the tax-exempt bond world, as follows:

1. <u>Private Activity Bond Volume Cap</u>: For calendar year 2025, the amounts used to calculate the "State ceiling" for purposes of determining the total amount of annual private activity bond volume cap available in a State under Code Section 146(d) will be the greater of (a) $130 multiplied by the State's population or (b) $388,780,000.

2. <u>Loan Limits on Bonds for First-Time Farmers</u>: For calendar year 2025, the loan limit amount on agricultural bonds for first-time farmers under Code Section 147(c)(2)(A) will be $667,500.

3. <u>General Arbitrage Rebate Rules</u>: For any "bond year" ending in 2025, the amount of the rebate computation under Code Section 1.148-3(d)(4) will be $2,120.

4. <u>Brokers' Fees on GICs and Yield-Restricted Defeasance Escrow Investments</u>: For calendar year 2025, under Treasury Regulations Section 1.148-5(e)(2)(iii)(B)(1), a broker's commission or similar fee for the acquisition of a guaranteed investment contract (GIC) or for investments purchased for a yield-restricted defeasance escrow will be treated as reasonable if (a) the amount of the fee that the bond issuer treats as a "qualified administrative cost" does not exceed the lesser of (i) $50,000 and (ii) 0.2% of the "computational base" (as defined in Treasury Regulations Section 1.148-5(e)(2)(iii)(B)(2)) or, if more, $5,000 and (b) for any issue, the bond issuer does not treat more than $141,000 in brokers' commissions or similar fees as qualified administrative costs for all GICs

and investments for yield-restricted defeasance escrows purchased with gross proceeds of the bond issue.

A copy of Revenue Procedure 2024-40 can be found at https://www.irs.gov/pub/irs-drop/rp-24-40.pdf.

Treasury Releases 2024-2025 Priority Guidance Plan; TE/GE FY2025 Program Letter

On October 3, 2023, the Treasury Department and the IRS announced the release of their 2024-5024 Priority Guidance Plan, including, as usual, a litany of guidance projects relating to the tax-exempt bond market that the regulators tell us they are allocating resources to on a “priority” basis. The listing for 2024-2025 is as follows:

1. Guidance under Code Section 142, as amended by the Infrastructure Investment and Jobs Act.

2. Revenue procedure providing guidance on the use of average area purchase prices and median income figures for purposes of Code Section 143.

3. Regulations under Code Sections 148 and 150 on refunding bonds.

4. Revenue procedure on the recovery of rebate under Code Section 148.

5. Regulations under Code Section 149 to update requirements for certain tax-exempt bond information returns.

6. Final regulations on bond reissuance under Code Section 150. Proposed regulations were published on December 31, 2018.

If you were to go back to the Fall 2023 issue of *The Bond Lawyer*, you’d be reminded that this list is exactly the same as the list that was appeared in the 2023-2024 Priority Guidance Plan, except that one other item on last year’s list, regarding guidance under Code Sections 144(b) and 150 for qualified student loan bonds has been struck off, presumably because of the release of IRS Notice 2024-32 in March of this year. You’d also recall that I offered some pointed commentary about how static this list appears to be year over year. I won’t recapitulate that commentary here, but my viewpoint hasn't changed. Perhaps a taxing authority like the IRS, with budgetary enhancements on the order of $80 billion over the past couple of years (see above), should give some thought to investing more of its considerable resources in providing substantive guidance to the markets, rather than just staffing up taxpayer examinations. Maybe I'm missing something. Readers can draw their own conclusions.

On a somewhat related note, in early October, the Commissioners of IRS Tax Exempt and Government Entities (TE/GE) released their program letter for fiscal year 2025. Principally addressed to IRS staff ("the work you do"), the letter outlines priorities for TE/GE for the coming year within the framework of the broader strategic plan the IRS has published for fiscal years 2023 through 2031. These priorities appear to be in line with what we've heard from TE/GE representatives at recent NABL seminars, reiterating for example a commitment to support effective processing at the pre-filing and filing stages for "elective payment elections of clean energy credits" such as those provided in Sections 6417 and 6418 of the Code. Interestingly, the letter reports that newly-hired TE/GE staff currently make up more than 50% of the total TE/GE workforce. The letter also states in a couple of places that TE/GE's leadership intends to focus on examinations of tax-exempt hospitals; I'm not sure what to make of this, exactly, but there it is. Diehard IRS watchers may want to take a look at the full print of the FY2025 program letter, which can be found at https://www.irs.gov/pub/irs-prior/p5313--2023.pdf.

* * * * *

Here's wishing all of the readers of *The Bond Lawyer* the very best for 2025; may you have a healthy and a prosperous New Year!

Federal Regulation of the Municipal Securities Market:

A (Not so) Brief History and Retrospective (Part 3)

By Andrew R. Kintzinger[1], Paul S. Maco[2], and Fredric A. Weber[3]

In the first article of this series,[4] we described the prosecution of unregistered broker-dealers, known as "Bond Daddies," by the Securities and Exchange Commission (SEC) for defrauding unsophisticated investors, including returning Vietnam P.O.W.s, through sales of nearly worthless municipal bonds, and that these abuses resulted in adoption of 1975 municipal securities reform legislation (1975 Amendments). The 1975 Amendments created the Municipal Securities Rulemaking Board (MSRB) and required registration of municipal securities dealers with the SEC and MSRB and compliance with MSRB rules adopted for that purpose. The 1975 Amendments also expanded the SEC's broker-dealer antifraud statutes, Exchange Act Sections 15(c)(1) and (2), by adding "municipal securities dealers" to the brokers and dealers already covered, and directed that "the Commission shall, for the purposes of this paragraph, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent," and amended the definition of "person" in Section 3(a)(9) by adding "government, or political subdivision, agency, or instrumentality of a government," to remove any doubt that Section 10(b) and Rule 10b-5 applied to state and local governments. We noted that, in considering the legislation, Congressional committees said they were unaware of abuses by municipal securities issuers that would warrant regulation of their conduct.

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[2] Paul S. Maco is a retired partner of Bracewell LLP and served as the founding Director of the SEC's Office of Municipal Securities and previously as a member of its Division of Enforcement assigned to reports on transactions in New York City securities in the 1970s. He is co-reporter of *Disclosure Roles of Counsel in State and Local Government Securities Offerings,* 2nd and 3d Editions, and co-editor of the 1st edition. He has been awarded the Frederick O. Kiel Distinguished Service Award and Carlson Prize by NABL.

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[4] *See* "Federal Regulation of the Municipal Securities Market: A (Not so) Brief History and Retrospective (Part 1)," *The Bond Lawyer,* Vol. 48, No. 3.

In the second article of this series,[5] we chronicled a series of events that would result in the first SEC regulation of transactions in municipal securities pursuant to the 1975 Amendments, as foreshadowed in an SEC Commissioner's speech to the SIA:

- the New York City and Washington Public Power Supply System (WPPSS) securities defaults, the first of which occurred on the heels of the 1975 Amendments, and the SEC investigations and reports, prepared on each, delivered to Congress and subsequently publicly released, documenting serious disclosure problems in the offerings of the related municipal securities and consequent significant investor harm in each;

- the national economic turmoil during the time between each report brought on by a combination of stagflation, an aggressive Federal Reserve response increasing the federal funds rate to a high of 20%, and resulting financial havoc experienced by savers, savings banks, and state and local governments;

- the financial markets innovations developed to adapt to rapidly changing markets; and

- the tax and SEC mutual fund regulations that increased participation of individual investors in the tax-exempt municipal bond market.

As reported in the last article in this series, on September 22, 1988, the same day the Commission released the WPPSS reports, it issued the proposed rulemaking, *Municipal Securities Disclosure*,[6] the "Proposing Release." In this, the third installment of our journey down memory lane, we discuss the process of the initial proposal and modified adoption of Rule 15c2-12. Practitioners today largely focus on the continuing disclosure provisions of Rule 15c2-12, but when initially promulgated in the aftermath of the WPPSS debacle, the rule focused on underwriters' responsibilities in municipal transactions. This regulatory first step and accompanying interpretation highlight the fundamental responsibilities of an underwriter to its customers and provides the foundation for subsequent amendments that effectively mandate continuing disclosure.

[5] *See* "Federal Regulation of the Municipal Securities Market: A (Not so) Brief History and Retrospective (Part 2)," *The Bond Lawyer,* Vol. 48, No. 4.

[6] Exchange Act Rel. No. 34-26100, File No. S7-20-88, 53 F.R. 3778 (Sept. 28, 1988).

In April 1987, the first edition of *Disclosure Roles of Counsel in State and Local Government Securities Offerings*[7] ("*Disclosure Roles*") was published,[8] 17 months before the WPPS Reports and Proposing Release. The timing was fortuitous. Aware that the SEC was working on rulemaking in response to Congressional concerns about the quality of disclosure in the municipal bond market, in the late fall of 1987 several members of *Disclosure Roles*' Editorial Committee, John M. Gardner, Stanley Keller, and one of the authors, Paul Maco, travelled to Washington, D.C. and met with Congressional and SEC staff. They shared copies of *Disclosure Roles* and encouraged its use as a resource for understanding the diversity of practice and opinion in the municipal securities markets. *Disclosure Roles*, as well as articles by Robert Doty and Robert S. Amdursky, are cited throughout the Proposing Release. *Disclosure Roles*' discussion of Rule 176, particularly under Part III C, Circumstances of the Transaction, and E, Appropriate Levels of Responsibilities, is reflected in the "flexible rather than absolute standard" approach taken in the Proposing Release, as well as the eight "factors … generally . . . relevant in determining the reasonableness of a municipal underwriter's basis for assessing the truthfulness of the key representations in final official statements."[9] Both Rule 15c2-12 and the Interpretation, as indicated by the citations of *Disclosure Roles*, were the result of extensive communication, beginning before the Proposing Release, among the Commission Staff, municipal issuers, and the municipal securities bar.

The 1988 Proposing Release

The Proposing Release had three components, identified in the "Summary" paragraph as:

- Proposed Rule 15c2-12 (the "Proposed Rule");

[7] American Bar Association, Section of Urban, State and Local Government Law, and National Association of Bond Lawyers, *Disclosure Roles of Counsel in State and Local Government Securities Offerings* (1987).

[8] *Disclosure Roles* was the product of a Project sponsored by the Subcommittee on Municipal and Governmental Obligations, Committee on Federal Regulation of Securities, Section of Corporation, Banking and Business Law, American Bar Association ("ABA Federal Securities"); Section of Urban, State, and Local Government Law. American Bar Association ("ABA Urban, State and Local"); and Committee on Federal Securities Law, National Association of Bond Lawyers ("NABL Committee"), and published by the Section of Urban, State, and Local Government Law, American Bar Association. The Project was conceived and established by Robern S. Amdursky, Chair of ABA Federal Securities and Frieda K. Wallison, the Chairman of NABL Committee. Robert. W. Doty was appointed as Reporter and Coordinator of the Project. John M. Gardner was appointed Co-Reporter and Chairman of an Editorial Committee together with Joseph H. Johnson, Stanley Keller, Paul Maco, and David S. Goodman.

[9] 53 F.R. 37789.

- Interpretation of the legal obligations of municipal underwriters (the "Interpretation");[10] and

- Request for comment on a Municipal Securities Rulemaking Board proposal "to establish a central repository to collect information concerning municipal securities" ("Central Repository").

As recounted in the last article in this series, more than 40 years ago, in 1983, after the decision by the Washington Supreme Court invalidated "take or pay" contracts by a number of public utilities in the Pacific Northwest, the Washington Public Power Supply System (WPPSS) defaulted on $2.25 billion of tax-exempt revenue bonds, the largest default in the history of the United States municipal securities markets. Also as recounted in the last article, a decade before the WPPSS default offering documents for New York City failed to disclose the City's financial deficit at the time, which was more than $5 billion (twice the amount of the WPPSS default). The Proposing Release noted the New York City and WPPSS bond defaults and related failures by municipal securities underwriters to adequately check disclosure and analyze accompanying risks.[11] They induced the SEC to issue the Interpretation.[12] The purpose of the Interpretation was to articulate and reemphasize the legal responsibilities imposed by the general antifraud provisions of the federal securities laws on underwriters participating in municipal securities offerings, no doubt to discourage repetition of these failures.

Underwriters needed an opportunity to review disclosure documents so that they could fulfill their obligations under the antifraud provisions of the federal securities laws and to assure that investors have more timely access to disclosure documents.[13] Prior to adoption of Rule 15c2-12, underwriters had difficulties in obtaining sufficient official statements for timely

[10] Interpretive releases are releases in which the SEC issues its interpretation of the securities laws and regulations. "These releases do not have the force of law, but they are very persuasive." Georgetown Law Library Securities Law (U.S. and International) Research Guide, available at https://guides.ll.georgetown.edu/c.php?g=365494&p=2811107.

[11] 53 F.R. 37779-37780.

[12] Fippinger and Pittman, *Disclosure Obligations of Underwriters of Municipal Securities*, 127, 128, n.8, 41 Bus. Lawyer, No. 1 (Nov. 1991), citing Chemical Bank v. Washington Public Power Supply Sys. 99 Wash. 2d. 772, 666 P.2d 329 (1983), aff'd, 102 Wash. 2d. 874, 691 P. 2d 524 (1984), cert,. denied, sub. Nom. Haberman v. Chemical Bank, 471 U.S. 1065 (1985), Chemical Bank v. Public Util. Dist. No. 1, 471 U.S. 1075 (1985). Robert A. Fippinger is a leading scholar/practitioner and author of the treatise, *The Securities Law of Public Finance*, and Edward Pittman, at the time the article was written, was Assistant Chief Counsel of the Commission's Division of Market Regulation. (One of the authors of this article, Paul S. Maco, and the late Lewis C. Horne, Jr. served as reviewers for the *Business Lawyer.*) Since its publication, the Fippinger and Pittman article has been highly regarded for its analysis of the original Rule 15c2-12 and the Interpretation, so their article is quoted frequently in this article.

[13] Fippinger and Pittman, at 138.

delivery to customers, as required by MSRB rules.[14] The purpose of the Proposed Rule was to create a formal process for disclosure in municipal offerings intended, among other things, to assure that investors will receive vetted disclosure documents in a timely manner.

As explained in the Proposing Release, dealers may not have had adequate access to complete descriptive information about an issuer's securities when trading in the secondary market. Lack of disclosure about important features of an issuer's securities had been a frequent complaint in MSRB arbitration proceedings and has resulted in pricing and trading inefficiencies. The MSRB proposed creation of a publicly accessible central repository of official statements and certain refunding documents. The purpose of the Central Repository was to improve the information available to both the primary and secondary market.[15]

A series of questions, both general and specific, on each of the three components were posed in the Proposing Release. The responses and outcomes are discussed under "Comments and the Final Rule" below.

The Interpretation[16]

After proposing the Proposed Rule, the Commission stated the core import of the Interpretation:

[14] 53 F.R. 37781-37782, n. 34, citing PSA Task Force Report, *Public Securities Association Municipal Securities Disclosure Task Force Report Initial Analysis of Current Disclosure Practices in the Municipal Securities Market* (June 1988) ("Task Force Report") at 21.

[15] 53 F.R. 37791.

[16] For clarity and perspective in reading this article, a brief reminder is provided of the provisions of the federal securities laws applicable, and not applicable, to municipal securities: The Securities Act of 1933 (Securities Act) does not apply to (a) certain classes of securities exempted by Section 3 of the Act and (b) certain transactions in securities exempted under Section 4 of the Act, except when expressly provided otherwise in the Act. Municipal securities are such an exempted class. However, Section 17(c) of the Securities Act expressly provides that the exemptions provided in Section 3 do not apply to the antifraud provisions of Section 17. Section 17 applies to "any person" and Section 2(a)(2) defines "person" to include "an individual" as well as "a government or political subdivision thereof," so Section 17 applies to state and local governments and their officials and employees. All other provisions of the Securities Act, such as Section 11, *Civil Liabilities on Account of False Registration Statements* (and the defenses made available under that section), do not apply to municipal securities. The exemption under Securities Act Section 3(a)(2) does not provide exemption under other federal securities laws, such as the Securities Exchange Act of 1934 (Exchange Act). So, for example, it does not exempt brokers, dealers, municipal securities dealers or municipal advisors from the provisions of the Exchange Act when participating in a transaction involving a municipal security. Underwriters and broker-dealers, including those involved in distribution but not underwriting, are subject to the antifraud provisions of Sections 10(b) and 15 of the Exchange Act as well as Section 15B and rules of the MSRB. The 1975 Amendments removed any basis for arguing that Exchange Act Section 10(b) and Rule 10b-5 do not apply to municipal issuers by amending the definition of "person" under Exchange Act Section 3(a)(9) to include "government, or political subdivision, agency or instrumentality of a government."

> In connection with Rule 15c2-12's requirements to obtain and review a near-final official statement, the Commission wishes to emphasize the obligation of a municipal underwriter to have a reasonable basis for recommending any municipal securities and its responsibility, in fulfilling that obligation, to review in a professional manner the accuracy of the offering statements with which it is associated.[17]

In the process of offering and selling municipal bonds in an underwriting, the underwriter makes a recommendation to its customer. At the foundation of the Interpretation is the doctrine known as the "know your securities rule." As Fippinger and Pittman explain, "[T]he interpretation emphasizes that the courts and the Commission have held that the general antifraud provisions of the federal securities laws require a broker-dealer to have a reasonable basis for the recommendations it makes to its customers. Although this doctrine, sometimes known as the 'know your securities rule,' is established primarily through case law, it is also an element of the rules of the self-regulatory organizations, including the MSRB."[18] The Interpretation references numerous cases amplifying this point, including the widely-cited decision by the Second Circuit, *Hanly v. SEC*.[19] In *Hanly* the court stated:

> [T]he standards ... are strict. [A salesman] cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusion based on such investigation.

As noted by Fippinger and Pittman, "[a]lthough much of the case law that has developed regarding the affirmative duties of brokers and dealers under the general antifraud provisions of the federal securities laws has evolved in the context of corporate securities transactions, it is clear similar duties apply to municipal securities brokers and dealers,[20] and "a number of Commission enforcement actions, generally in the context of egregious frauds, have stressed that the need for municipal underwriters to conduct a reasonable inquiry before recommending securities to their customers."[21]

[17] 53 F.R. 37787.

[18] Fippinger and Pittman at 130. In n. 18 to the text, the authors point out: The MSRB has interpreted rules G-17 and G-19 to require that a broker-dealer disclose all material facts known by it at the time of the transaction, and also to have reasonable grounds, based on its knowledge of the security, for recommending a transaction. *See, e.g.*, MSRB rule G-19, MSRB Manual (CCH) ¶ 3591, at 4866 (May 1991) (MSRB Interpretation).

[19] [15 F.2d 589, 597 (2d. Cir. 1969).

[20] Fippinger and Pittman at n. 21. They cite Thiele v. Shields, 131 F. Supp. 416, 419 (S.D.N.Y.); S.E.C. v. Charles A. Morris & Assocs. 386 F. Supp. 1327, 1332-33 (S.D. Tenn. 1973).

[21] Fippinger and Pittman at n. 22. They cite *In re* Blumfeld, Exchange Act Release No. 16, 437, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. 82,396 (Dec. 19, 1979), *In re* Walston & Co., Exchange Act

After articulating a broker-dealer's obligation, the Interpretation turns to responsibilities of a subset of broker-dealers, those of an underwriter:

> This obligation to have a reasonable basis for belief in the accuracy of statements directly made concerning the offering is underscored when a broker-dealer underwrites securities. . . . A municipal underwriter's obligation extends to having a reasonable basis for belief in the truth of key representations in an official statement prepared by the issuer.[22].

The "key representation standard" is from *In re* Hamilton Grant & Co.,[23] a Commission order resolving administrative proceedings against an underwriter of an initial public offering of corporate securities and its principal by consent. As described in the Proposing Release:

> For example, in Hamilton Grant & Co., the Commission found that an underwriter had violated sections 17(a)(2) and (3) of the Securities Act where the underwriter had 'failed to make any substantial effort to obtain specific verification of management's key representations' and thus had 'no basis for a reasonable belief in the truthfulness of the key representations made in the registration statement and prospectus.'[24]

Release No. 8165, [1966-1967 Transfer Binder] (CCH) ¶ 77,474 (Sept 22, 1967). The Proposing Release provides extensive citations to caselaw supporting the text in nn, 72 – 77.

[22] 53. F.R. 3777-3778.

[23] Securities Exchange Act Release No. 24679 (July 7,1987), 38 SEC Docket 1346,1353; [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84, 146 (July 7,1987). See Fippinger and Pittman at n. 25 on page 131: "The term "key" rather than 'material,' representations has not been used extensively in the federal securities laws. In one instance cited by the Commission in the Interpretation, the Commission sanctioned an underwriter for failing to conduct a reasonable inquiry into the validity of an issuer's assertions that were 'key to the selling efforts' concerning contracts providing a major source of the issuer's revenues [citing *In re* Hamilton Grant]."

[24] 53. F.R. 3777-3778. As reported July 9, 1987 in the Washington Post under the headline "SEC Punishes Dealer for not Verifying Prospectus": Although the company's toy business had provided the bulk of revenue since the firm was founded in 1977, Hamilton Grant's Ross urged the company to emphasize its manufacture of devices used for remotely piloted vehicles (RPVs) in its registration statement describing the public offering, according to an SEC statement yesterday. Ross knew that the Israeli use of such drones in the Lebanon conflict in 1982 showed that they were useful battlefield weapons, according to the SEC. Moreover, Balsa Donde management had represented that it was the sole supplier of airframe components to the Israeli company that developed these drones, and that the U.S. Navy had recently placed a large order for the RPVs from the company. Both these representations were part of the company's registration statement and prospectus for investors, and the offering was an immediate success. In fact, however, Balsa Donde had recently lost its status as sole supplier, and the Navy contract was not as significant as the company implied, the SEC said. As a result, the commission in December forced the company to rescind the offering and give investors their money back. The commission said yesterday that Hamilton Grant violated securities laws "by failing to exercise anything approaching the degree of care reasonable under the circumstances to assure the substantial accuracy

The Interpretation adds, “both the Commission and the courts have indicated that municipal underwriters must exercise reasonable care to evaluate the accuracy of statements in issuer disclosure documents.”[25] It also acknowledges that underwriters, recognizing their responsibilities, for some time “generally have undertaken an investigation of the issuer’s disclosure in negotiated offerings of municipal securities.”[26] The Interpretation noted that, “[a]mong other things, depending upon the nature of the issuer, this has included meetings with municipal officials, visits to physical facilities, and an examination of the issuer’s records and current economic trends and forecasts that bear upon the ability of the issuer to repay its debt. In addition, underwriters usually require so-called ‘Rule 10b-5’ letters from their counsel with respect to municipal offerings."[27]

Despite progress in general practices, the Commission was not convinced that the practices were “recognized universally or followed in all negotiated offerings,” and for competitive offerings, both the New York City Final Report and the Supply System Staff Report found that due diligence was “extremely limited.”[28]

Factors Affecting the Scope of an Underwriters Investigation. In response, the Commission found it appropriate to further articulate a municipal underwriter’s obligations to the investing public in both negotiated and competitively bid offerings “to encourage meaningful review of issue disclosure”[29].

> In the Commission’s view, the reasonableness of a belief in the accuracy and completeness of the key representations in the final official statement, and the extent of a review of the issuer’s situation necessary to arrive at this belief, will depend upon all the circumstances. In both negotiated and competitively bid municipal offerings, the

of representations" made in the prospectus. Available at: https://www.washingtonpost.com/archive/business/1987/07/09/sec-punishes-dealer-for-not-verifying-prospectus/cade0506-9528-401b-b6df-59dd8151c715/.

[25] 53 F.R. 37788, n.77, citing, e.g., Walston & Co., supra note 76; Edward J. Blumenfeld, Securities Exchange Act Release No. 16437 (Dec. 19,1979), 18 SEC Docket 1379; Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981), cert, denied, 455 U.S. 936 (1982), and additional cases.

[26] *Id*., n. 79, stating in support: “The recent report by the American Bar Association and National Association of Bond Lawyers [*Disclosure Roles*] on the disclosure roles of counsel in municipal offerings acknowledged that: While issuer officials and underwriters are * * * exempt from civil liabilities under section 11 of the 1933 Act, both the SEC and private litigants have taken the position that a duty exists under the antifraud provisions similar to, although perhaps not so severe as, the investigating activities which form the statutory "due diligence” defense under Section 11. American Bar Association, Section of Urban, State and Local Government Law, and National Association of Bond Lawyers, Disclosure Roles of Counsel in State and Local Government Securities Offerings (1987), at 37.”

[27] 53 F.R. 37788, n. 79.

[28] 53 F.R. 37788-37789.

[29] 53 F.R. 37789.

Commission expects, at a minimum, that underwriters will review the issuer's disclosure documents in a professional manner for possible inaccuracies and omissions. [cit. om.] Beyond this baseline review, the Commission believes that a number of factors generally will be relevant in determining the reasonableness of a municipal underwriter's basis for assessing the truthfulness of the key representations in final official statements.[30]

In the Proposing Release, the Commission stated these factors include the following (although, in response to comments, it subsequently withdrew the asterisked factors):

- The extent to which the underwriter relied upon municipal officials, employees, experts, and other persons whose duties have given them knowledge of particular facts;[31]
- The type of underwriting arrangement (e.g., firm commitment or best efforts);*
- The role of the underwriter (manager, syndicate member, or selected dealer);
- The type of bonds being offered (general obligation, revenue, or private activity);
- The past familiarity of the underwriter with the issuer;
- The length of time to maturity of the bonds;
- The presence or absence of credit enhancements;* and
- Whether the bonds are competitively bid or are distributed in a negotiated offering.[32]

Negotiated Offerings. In negotiated municipal offerings, according to the Interpretation, where the underwriter is involved in the preparation of the official statement, "development of a reasonable basis for belief in the accuracy and completeness of the statements therein should involve an inquiry into the key representations in the official statement that is conducted in a professional manner, drawing on the underwriter's experience with the particular issuer, and other issuers, as well as its knowledge of the municipal markets. Sole reliance on the representations of the issuer would not suffice,"[33] particularly where an unseasoned issuer is involved.[34] However, recognizing the varying types of municipal debt and extent of municipal

[30] *Id*..

[31] The SEC cautioned, however, an underwriter may not merely rely upon formal representations by an issuer or its officials or employees regarding the general accuracy of disclosure. *Id*. n. 86.

[32] *Id*.

[33] *Id*., citing *Hamilton Grant & Co.*

[34] 53 F.R. 37789, citing *Charles E . Bailey & Co.*, 35 S.E.C. 33, 42 (1953).

disclosure practices, the Commission did not “delineate specific investigative requirements” but rather took note “that commentators already have suggested a variety of investigative procedures to be followed by underwriters in connection with negotiated municipal securities offerings.”[35]

Competitive Offerings.[36] After stating “the fact that an offering is underwritten on a competitive basis does not negate the responsibility that the underwriter perform a reasonable review,” the Commission acknowledged “that municipal underwriters may have little initial access to background information concerning securities that have been bid on a competitive basis.” As a result, the type of sale, competitive bid or negotiated sale, is a factor “to be considered in determining the reasonableness of the underwriters’ basis for assessing the truthfulness of key representations in final official statements.”[37]

The minimum standard of care recognized in the Interpretation for competitive offerings, Fippinger and Pittman observe, “is similar to the practice followed by most underwriters in formulating a bid. Specifically, in a competitive offering involving an ‘established municipal issuer,’ the underwriter satisfies its obligation to have a reasonable basis for belief in the accuracy of key representations in the issuer’s disclosure documents where: ‘it reviewed the official statement in a professional manner, and received from the issuer a detailed and credible explanation concerning any aspect of the official statement that appeared on its face, or on the basis of information available to the underwriter, to be inadequate.’”[38]

The Interpretation cautions that, “[i]n reviewing the issuer’s disclosure documents, therefore, underwriters bidding on competitive offerings should stay attuned to factors that suggest inaccuracies in the disclosure or signal that additional investigation is necessary. [*cit. om*.] If these factors appear, the underwriter should investigate the questionable disclosure and, if a problem is uncovered, pursue the inquiry until satisfied that correct disclosure has been made.”[39] The Interpretation also cautions that an underwriter in a competitive offering “may not ignore other information regarding the issuer that it has available.” The Interpretation notes that underwriters, in either competitive or negotiated offerings, may also, over time, “develop an

[35] 53 F.R. 37789*, citing* again *Disclosure Roles* at 74-98, and Doty, *The Disclosure Process and Securities Laws, State and Local Debt Financing* (D. Gelfand ed. 1986) at §§ 8-69, 8-71.

[36] As Fippinger and Pittman note “[i]n light of the arguments presented in the WPPSS enforcement investigation, the Commission devoted the largest portion of the Interpretation to dispel the notion that an underwriter in a competitive offering has no responsibility for the accuracy of the disclosure documents.” Fippinger and Pittman at 134.

[37] 53 F.R. 37789.

[38] Fippinger and Pittman at 134, citing release at 37790.

[39] 53 F.R. 37789.

independent reservoir of knowledge of an issuer," including "in trading of other bonds of the issuer in the secondary market" and through their research departments.[40]

Syndicate Members. The SEC stated that the required professional inquiry should be performed by the managing underwriter and need not be repeated by mere syndicate members. They, however, should be satisfied that the managing underwriter made a professional inquiry and therefore had a reasonable basis for its recommendation. In addition, whether involved in a negotiated or competitive offering, all syndicate members should familiarize themselves with the disclosure and notify the managing underwriter of any facts that suggest an inaccuracy or warrant further investigation.[41]

Financial Advisors. While the Interpretation was directed at underwriters, it included a controversial footnote that purported to impose the same duties on financial advisors when they participate in competitive offerings of municipal securities, have access to issuer data and participate in drafting the offering document, citing only a secondary source as authority.[42]

Proposed Rule 15c2-12

As initially proposed, Rule 15c2-12 would have read as follows:[43]

> (a) As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any broker, dealer, or municipal securities dealer to act as underwriter in an offering of municipal securities with an aggregate offering price in excess of $10,000,000 unless it complies with the requirements of paragraphs (b) through (e) of this section.
>
> (b) The broker, dealer, or municipal securities dealer shall, prior to the time it bids for or purchases securities of the issuer, directly or through its designated agents, obtain and review an official statement that is complete, except for the omission of the following information: The offering price, interest rate, selling compensation, amount of proceeds, delivery dates, other terms of securities depending on such factors, and the identity of the underwriter.
>
> (c) The broker, dealer, or municipal securities dealer shall send promptly by first class mail or other equally prompt means to any person, on request, a single copy of any preliminary official statement prepared by the issuer for dissemination to potential bidders or purchasers.

[40] *Id.*

[41] *Id.* n. 87.

[42] 53 F.R. 37790, n. 92.

[43] 53 F.R. 37792.

(d) The broker, dealer, or municipal securities dealer shall contract with the issuer or its designated agents to obtain, within two business days after any final agreement to purchase or sell the securities, copies of a final official statement in sufficient quantities to comply with paragraph (e) of this section and the rules of the Municipal Securities Rulemaking Board.

(e) The broker, dealer, or municipal securities dealer, in a timely manner, shall send to any person, on request, a single copy of the final official statement.

(f) For the purposes of this section—

(1) The term "final official statement" means a document prepared by the issuer or its representatives setting forth, among other matters, information concerning the issuer and the proposed issue of securities that is final as of the date of the final agreement to purchase or sell municipal securities for, or on behalf of, an issuer or underwriter.

(2) The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with the distribution of, any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission, concession or allowance from an underwriter, broker, dealer, or municipal securities dealer not in excess of the usual and customary distributors' or sellers' commission, concession or allowance.

The threshold of $10 million in paragraph (a) of the Proposed Rule was chosen based on 1987 data provided by the Public Securities Association (PSA) and the MSRB showing that, while only about 25% of long-term debt offerings (1,743) exceeded $10 million, they raised approximately 86% (over $89 billion) of the money borrowed annually by municipal issuers.[44] The Commission requested comment whether some other threshold would be warranted for the rule as a whole or for particular provisions. The Commission also asked "whether any rule that is adopted should contain some type of 'private placement exemption."[45]

The proposed requirement of paragraph (b) of the Proposed Rule to "obtain and review an official statement that is complete," except for "offering price, interest rate, selling compensation, amount of proceeds, delivery dates, other terms of securities depending on such factors, and the identity of the underwriter," was "designed to assure that underwriters receive and avail themselves of the opportunity to review an official statement that contains complete disclosure about the issuer and the basic structure of the financing, before becoming obligated

[44] 53 F.R. 37782.

[45] *Id.*

to purchase a large issue of municipal securities for resale to the public."[46] As explained by the Proposing Release, "Paragraph (b) would prevent the underwriter from submitting a bid in a competitive offering, or from committing to buy securities in a negotiated offering, until it has received and reviewed an official statement that is deemed final by the issuer, except for pricing, underwriting, and certain other specified information."[47] As such, paragraph (b) was "designed to prevent fraud by providing the underwriter with information about the issue sufficient to determine, before becoming obligated to purchase the securities, whether changes to the disclosed information are needed and should be obtained before the bid is submitted."[48]

"The purpose of paragraph (c)," the Proposing Release explains, "is to provide potential investors with access to any preliminary official statement prepared by the issuer for dissemination to potential bidders or purchasers at a time when it may be of use to investors in their investment decision."[49] The Proposing Release noted that preliminary official statements are frequently used as selling documents, large investors often receive them when solicited, and "some institutional investors will not agree to purchase securities in an offering without receiving a preliminary official statement."[50] Due to the lack of uniform practice among underwriters in providing offering documents to retail investors, and " [b]ecause sales efforts may be conducted in competitive offerings prior to the time that an underwriter is awarded a bid, and investors may not have access to a final disclosure document for an extended period of time following their commitment to purchase the securities, the Commission believes that confusion concerning the offering terms and the potential for misleading sales representations would be reduced if investors had the ability to obtain information contained in the preliminary official statement."[51]

The purpose of proposed paragraph (d) of the Proposed Rule, which would require underwriters to contract to obtain "copies of a final official statement in sufficient quantities within two days of a final agreement to purchase the offered securities," was, explained by the Commission, "to facilitate the prompt distribution of disclosure documents so that investors will have a reference document to guard against misrepresentations that may occur in the selling process. In addition, this paragraph would provide investors and dealers in the secondary market with static information concerning the terms of the issued securities."[52]

[46] 53 F.R. 37783.

[47] 53 F.R. 37784.

[48] *Id.*.

[49] *Id.*

[50] *Id.*

[51] *Id.* In n. 49, the Commission notes: "of course, where key representations made in the preliminary official statement are known to the underwriter to be no longer accurate, the underwriter would have to notify investors prior to the time that they make an investment decision and would have to provide copies of the amended final official statement."

[52] *Id.*

The purpose of paragraph (e) of the Proposed Rule, requiring underwriters to provide a copy of the final official statement on request, was, as explained by the Commission, "to make the underwriter responsible for transmission of information to analysts, rating agencies, industry news services, and individuals who wish to analyze particular municipal securities offerings."[53]

The Proposed Rule contained two definitions. The definition of "final official statement" in subparagraph (f)(1), was based on the definition of official statement in MSRB rule G-32.[54] The definition of "underwriter" in subparagraph (f)(2), explained the Commission, "parallels the definition in section 2(11) of the Securities Act." [55]

In the Proposing Release, the Commission requested comments on both definitions as well as on the provisions of each paragraph.

As Fippinger and Pittman explain, "[t]he Commission cited the need to provide underwriters with an opportunity to review disclosure documents so that they may fulfill their obligations under the antifraud provisions of the federal securities laws and to assure that investors have more timely access to disclosure documents as reasons for adoption of the Rule."[56] As the PSA Task Force Report's "empirical evidence" and MSRB rule filings with the SEC indicated, underwriters had difficulties in obtaining sufficient official statements for timely delivery to customers, as required by MSRB rules. The Proposed Rule would also ameliorate that problem.[57]

Creation of a Central Repository

As important as the underwriters' ability to review official statements is investor access to them. In addition to delivery of hard copy disclosure, a central repository for disclosure documents to make them accessible to all investors would advance that goal. The third topic for comment in the Proposing Release was an MSRB proposal for creation of a central repository.

As explained in the Proposing Release, "[i]n an effort to improve the quality of disclosure available to both the primary and secondary market, the MSRB recently has proposed the creation of a central repository of official statements and certain refunding documents. . . . As envisioned by the MSRB, participation in the repository by municipal issuers would be mandatory, and information concerning new issues would be made available to interested persons, for a fee, shortly after filing with the repository by the issuer." The Commission requested comment on whether a repository should be established and, if so, whether it should

[53] 53 F.R. 37785.

[54] 53 F.R. 37786.

[55] *Id.*

[56] Fippinger and Pittman at 138.

[57] 53 F.R. 37782.

be provided by the MSRB or the private sector and whether submissions should be mandated or voluntary.

Comments and the Final Rule

The Proposing Release directed that comments on the Proposed Rule, the Interpretation, and the MSRB proposal to establish a central repository be submitted to the Commission by December 27, 1988.

In SEC Rel. No. 34-26985, dated June 28, 1989,[58] adopting Final Rule 15c2-12 (the "Adopting Release"), the Commission noted that it received "over sixty letters from all segments of the industry, including issuers, underwriters, institutional investors, bond counsel, analysts, financial advisors, insurance providers, disclosure services, the MSRB and state securities regulators."[59] Based on the comments received, which are referenced and cited frequently throughout the body and footnotes of the Adopting Release, the Commission adopted a Final Rule that modified the Proposed Rule and also amended portions of the Interpretation. The Commission moved from Proposed Rule to the Final Rule over a short comment period (95 days) and a relatively short time frame (nine months) to final adoption. Late September through December, 1988 saw a flurry of shared comment letter drafts, revised drafts and final comment letters among municipal market participants.

Following publication of the Proposing Release, one of the authors, Paul Maco was appointed Chairman of NABL's Special Committee on Securities Law and Disclosure, which was tasked with preparing NABL's comment letter responding to the Proposing Release for approval by the NABL Board.[60] The drafters of the comment letters for NABL, ABA Federal Securities, and ABA Urban, State, and Local, joined by drafters for the Government Finance Officers' Association and the Public Securities Association (a predecessor of the Securities Industry and Financial Markets Association (SIFMA)), agreed to coordinate, consult, and share work product prior to submission to the SEC. Citations to the comment letters of each of these groups run throughout the Release adopting the rule.

Several key modifications were made from the Proposed Rule to the Final Rule. As explained in the Adopting Release, they reflected the Commission's sensitivities to the unique market structure of offering and selling municipal bonds. In describing the Final Rule amendments, the Adopting Release cited reliance on numerous comment letters of market participants. Key changes from the proposed to final version included:

[58] Municipal Securities Disclosure, 54 F.R. 28799 (July 10, 1989).

[59] 54 F.R. 28800.

[60] Members of the Committee were: Patrick K. Arey, Helen C. Atkeson, Robert W. Doty, John M. Gardner, Stanley Keller, Peter C. Kornman, Paul S. Maco (Chair), Gregory A. Sandomirsky, Francis R. Snodgrass (Vice-Chair), and Richard A. Spellman.

- **Thresholds**: The Final Rule lowered the applicability of the Rule from aggregate offering amounts of $10 million to $1 million. The Commission declined requests to distinguish between type of issues (i.e., governmental bonds and conduit bonds are both subject to the Final Rule) and clarified that the Final Rule applies to "primary offerings" only.

- **"Near Final" to "Deemed Final" Preliminary Official Statement**: Instead of requiring the underwriter to determine that an official statement is "complete," except for permitted omissions, at the time of pricing, as would have been required under the Proposed Rule, under the Final Rule the underwriter must obtain an official statement that is merely "deemed final" by the issuer;

- **Distributing the Preliminary Official Statement**: The Final Rule narrowed a requirement of the Proposed Rule that the underwriter distribute copies of any preliminary official statement that is prepared by the issuer to any person requesting the document. Instead, under the Final Rule, only underwriters in a negotiated offering are subject to the requirement, and they need send the most recent preliminary official statement only to any "potential customer" who requests a copy. Neither the Proposed Rule nor the Final Rule requires issuers to produce a preliminary official statement.

- **Receipt of the Final Official Statements:** The Final Rule extended the period after sale within which an underwriter must contract to receive final official statements from two (as initially proposed) to seven business days. It also defined the "issuer" from whom disclosure documents must be received to include governmental issuers and issuers of separate securities, i.e., conduit borrowers, so that an underwriter could contract to receive final official statements from either and either could deem a preliminary official statement "complete.". Also, in response to comment letters, the definition of "final official statement" was revised to include a set of documents and to be "complete" when delivered rather than "final" as of the earlier sale date. The Adopting Release explained that "complete" means merely that the issuer intends no further changes to it.[61]

- **Providing the Final Official Statement to Potential Customers:** Noting that "significant problems exist in the distribution of disclosure documents," the Adopting Release set exact time frames for the underwriter to deliver a final official statement to investors (from the date of availability until available to investors from a recognized repository, but not less than 25 days or more than 90 days after closing or, if later, the underwriter depletes its inventory of the securities). Unlike under the Proposed Rule, the underwriter's distribution responsibilities would not be unlimited in time.

[61] 54 F.R. 28806.

- **Repositories or "NRMSIR":** The Adopting Release noted 40 comment letters, expressing a divergence of market views on a central repository. The Commission elected to support "strongly" the development of one or more central depositories for disclosure documents, and the earlier termination of distribution obligations for final official statements submitted to a central repository was intended to incentivize submissions. However, without prejudging an impending MSRB proposal to create and mandate submissions to a central repository, the Commission recognized benefits that may accrue from (and stated conditions under which it would recognize) competing private repositories.[62].

In addition to the specific provisions of the Final Rule, perhaps the most consequential part of the Adopting Release and Final Rule was the Commission's discussion of, and Final Rule formulations for, exemptions from Rule 15c2-12. For the Commission, this was a balancing act between the perceived need for rule discipline to promote timely delivery of disclosure documents to investors and not allowing the scope of the rule to restrict access to capital markets by issuers. NABL's comment letter was specifically cited in the Adopting Release as evidence that the Proposed Rule, unless modified, would have effectively eliminated offerings of varying types. In response, the Commission authorized exemptions for $100,000 minimum denomination limited offerings, short term securities, and variable rate demand securities, in each case if offered in minimum denominations of $100,000 or more,[63] noting "the sophistication of the investors and the alternative mechanisms developed by the industry to facilitate disclosure in connection with such offerings." In addition, the Final Rule authorizes the Commission to exempt transactions or classes of transactions, if consistent with the public interest and the protection of investors. This transactional exemption formed the basis of various, instructive SEC no-action letters that were released in the few years following Final Rule implementation and addressed certain types of municipal offering practices.

In addition to addressing Final Rule provisions and exemptions from the Final Rule, the Adopting Release also amended the Interpretation. The Interpretation in the Proposing Release listed factors that would be important in evaluating the extent of review necessary for underwriters to demonstrate a reasonable basis for their belief in the accuracy and completeness of key representations in a final official statement. In the Adopting Release, the Commission emphasized that the list of factors was not intended to be exclusive, and that some factors might not be relevant in some offerings. It also deleted two factors, because "sufficiently ambiguous so as not to be relevant in most offerings:" (1) the manner of offering (best efforts or firm commitment) and (2) the presence or absence of credit enhancement, stating that credit

[62] 54 F.R. 28807-28808. Foreshadowing subsequent amendments of the Rule, in the Adopting Release the Commission observed that "the creation of central sources for municipal offering documents is an important first step that may eventually encourage widespread use of repositories to disseminate annual reports and other current information about issuers to the secondary markets. 54 F.R. 28808 at n. 84.

[63] As recommended in NABL's comment letter.

enhancement "generally would not be a substitute for material disclosure concerning the primary obligor on municipal bonds."[64]

The Adopting Release also negated a possible inference from the Proposing Release. "While the focus of the Interpretation was on the activities of underwriters," the Commission pointed out, "the primary responsibility for disclosure rests with the issuer."[65] In a footnote to the release, the Commission provided an explanation as well as a caution regarding professionals retained to assist in preparing disclosure:

> [I]ssuers are primarily responsible for the content of their disclosure documents and may be held liable under the federal securities laws for misleading disclosure. [cit. om.] Because they are ultimately liable for the content of their disclosure, issuers should insist that any persons retained to assist in the preparation of their disclosure documents have professional understanding of the disclosure requirements under the federal securities laws.[66]

The amendments to the Interpretation became effective immediately on June 28, 1989. Final Rule 15c2-12 was deemed effective on January 1, 1990. During the late Summer and Fall of 1989, numerous municipal market conferences focused on the upcoming effectiveness of Rule 15c2-12. Commission staff participating at such conferences stated their belief that, based on the numerous comment letters received on the Proposed Rule, Final Rule 15c2-12 would not have a significant effect on the manner in which most underwriters were conducting offerings at the time. Indeed, the Adopting Release, and changes between the Proposed Rule and the Final Rule, were heavily sourced on and largely responsive to the numerous comment letters received. In short, the Rule, as a matter of market structure, was intended to be moderately prescriptive in tightening up the timing of delivery of issuer disclosure documents to underwriters and by them to investors. The shared intent at Fall, 1989 municipal market conferences was that implementing such an underwriter rule under Section 15(c) of the Exchange Act, together with responsible SEC enforcement measures under the antifraud provisions, would be the "right" balance for regulation of the municipal securities market.

Conclusion

Rule 15c2-12, modified several times since adoption in 1989, remains the only SEC rule specifically regulating brokers, dealers, and municipal securities dealers.

[64] 54 F.R. 28812. In support of the latter deletion, the Commission noted both a 1987 Commission report on bank guarantees in the corporate securities market and the presence of event risk in insured fixed rate offerings, given the insurer's right to accelerate if the underlying obligor defaults. The Adopting Release therefore appeared to leave the relevance of credit enhancement for variable rate demand securities unaddressed.

[65] 54. F.R. 28799, 28811.

[66] *Id*., n.84.

The Interpretation, articulating the Commission's view of the of the responsibilities of underwriters in light of judicial and administrative decisions[67] and MSRB interpretations,[68] has served as both sword and shield in SEC investigations and litigation since.

The utility of the combination of Rule 15c2-12 with the Interpretation is explained by Fippinger and Pittman:

> "By superimposing rule 15c2-12 on the preexisting antifraud rules and the requirements of the MSRB, the Commission has created a process that is designed to improve the disclosure received by municipal investors without subjecting municipal issuers to the more formal disclosure regime applicable to corporate issuers. In considering the application of rule 15c2-12 to municipal offerings, the underwriter or practitioner should view it as a rule primarily concerned with the process of dissemination of information. When a question arises concerning the disclosure responsibilities of the participants, or the negotiation of the division of risk of liability among the parties to a financing, attention should accordingly shift to the general antifraud rules. Rule 15c2-12 will not be determinative of the existence of fraud. By imposing greater discipline in the process of making information available, however, rule 15c2-12 reduces the likelihood that fraud will be an issue in any given transaction."[69]

In addition to articulating the SEC's view of underwriter responsibilities and proposing Rule 15c2-12, the Proposing Release requested comment on an MSRB proposal, supported by members of the municipal securities industry, to establish a central repository to collect information concerning municipal securities. More on that in the next installment in this series.

[67] Fippinger and Pittman, at 130.

[68] *Id.*, n. 18.

[69] Fippinger and Pittman, at 156.

MUNICIPAL BOND RETROSPECTIVES

Notoriety of Blind Pool Transactions

David Cholst[1] and Cliff Gerber[2]

Historically, blind pool transactions have had a bad reputation among tax practitioners. The law, however, does not expressly prohibit them. Indeed, the law contains limitations that imply Congress and Treasury intended to allow some blind pool transactions. This article explores the history of tax-exempt blind pool financings and the law that developed from transactions that fell from favor.

Definition of "Blind Pool"

Blind pools are not defined clearly in any Code or regulation provision. The term "pooled financing bond," though, is defined in the Code (and purports to target blind pools as well as "dedicated" pools). The law restricts pooled financing bonds in a way that appears to target "blind pools," but not all pooled transactions are "blind pools." Many bond issues are structured so that some or all of the proceeds are lent out to other entities upon bond issuance. If all of the sale proceeds of the issue are lent to ultimate borrowers at the time of issuance, the authors would refer to the transaction as a "dedicated" or "sighted" pool and not a blind pool.[3]

As used in this article and consistent with the way the term is used in the industry, a blind pool is a pooled financing bond transaction in which the ultimate borrowers of the sale proceeds are not known at the time of bond issuance. The main concern about blind pools is the same concern about any bond issue: "Does the issuer reasonably expect to allocate all of the sale proceeds (and investment earnings thereon) to

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[3]There are also many transactions (including many governmental bond issues) where all of the proceeds are lent by the bond issuer to a single other entity. This evidently surprised TEB personnel who classified transactions for examination as pooled transactions simply because the Form 8038-G had indicated that 100% of the proceeds would be lent to another governmental unit. The instructions to Form 8038-G were changed so that Line 37 now only applies to pooled transactions. In an earlier version of the form, the issuer was just asked to provide the amount of proceeds lent to other entities.

expenditures?"[4] Unfortunately, the track record of blind pools has ranged from sketchy to notorious. For many of the blind pool bonds issued in the 1980s, high percentages of the sale proceeds ended up being used to collapse the bond issue after the period for lending the proceeds expired.

Expectations of Expenditure

Bond counsel have consistently known the issuer must reasonably expect proceeds to be spent for governmental purposes and so devised ways to document those expectations. The practice for blind pool financings in the 1980s was to conduct a "demand survey" that asked potential borrowers if they would borrow proceeds if bond proceeds were available under the terms of the pooled bond documents. The problem was that these surveys, being non-binding (and often loosely written), frequently indicated significantly more demand than actually existed. Worse, multiple issuers conducted such surveys for the same potential borrowers and then issued pooled bond issues conservatively sized based on those surveys. For example, in a single state,[5] ten different potential issuers might each conduct surveys asking school districts, cities, hospitals, or other potential borrowers how much each might be interested in borrowing. The potential borrowers might answer each of those surveys with the same answer. For example, if a borrower had projects justifying $25,000,000 of borrowing need within the next three years, it might answer all such surveys that it would be interested in borrowing $25,000,000. Each potential issuer would add up all of the responses (sometimes applying a discount factor based on the wording of the response). If the total came to $200,000,000, the issuer would conservatively issue, say, $100,000,000 of bonds. Combined, all ten issuers might issue $1,000,000,000 of bonds to satisfy such demand documented at maybe $200,000,000. After evaluating all of the options available including, issuing its own bonds on a standalone basis, using any of those ten pooled bond transactions, or not borrowing at all, each potential borrower would borrow the amount it determined to be in its best interest. The result was that pooled bonds were vastly overissued.

Successful Blind Pools

This is not to say that all blind pooled transactions were overissued. In the 1980s, and later in the 1990s, there were some well-sized blind pools from which all the proceeds were lent out. One of the distinguishing factors in these pools was that borrowers were given a benefit not available from any other source. For example, blind pooled transactions that were designed to finance small loans for equipment on a

[4] In most blind pool transactions, the expenditures in question are capital expenditures. A tax-exempt blind pool for working capital purposes would be a very aggressive transaction, and as far as the authors know, has not been attempted.

[5] Anecdotally, the Commonwealth of Pennsylvania earned a reputation as a jurisdiction tainted by the prevalence of overlapping demand surveys by potential blind pool bond issuers.

variable-rate basis usually did well. The economies of scale of the pooled transaction made such borrowings lower cost than other options. It was also beneficial to take into account other competing pooled transactions when sizing the issue. Bond issues sponsored by associations of the potential borrowers (such as the Kentucky League of Cities) fared well because the borrowers were members of the sponsoring organization and had some degree of loyalty to the sponsor.

One particular type of blind pool bond issue issued in many states is the State Revolving Fund borrowing for water and wastewater projects. These transactions, while technically blind pools, do not have the problems associated with other blind pool transactions (although they have many structural issues of their own). One characteristic that differentiates these revolving fund transactions from other blind pool transactions is that the source of repaying the bonds is not limited to the repayment of the loans financed by the issue. Under revolving loan programs, an existing portfolio of loans made before the bonds are issued is often pledged to pay the bond issue. In turn, the loans originated with the bond issue may be used to repay other issues to be issued in the future. Also, the loans originated under these programs are heavily subsidized so that the cost to the borrower is often a fraction of the cost of any other source of tax-exempt financing.

Although the most basic attack on the tax exemption of blind pool bond issues is overissuance, that has not been the main attack used by the IRS. In fact, in TAM 199749002, the IRS position was that the bond issue funded a reserve in excess of the 10% limit of Code Section 148(d)(2) because the fund from which loans were to be made seemed to sit idle for so long that it was asserted by the IRS to function essentially as a reserve. Such indirect attacks seem convoluted, but perhaps the direct attack seemed to the IRS to lack the bright lines seen in other abusive transactions such as yield burning.

Non-Asset Bond Considerations

In structuring blind pool bond issues, one key element, described above, is the nature of and interpretation of the demand survey and the results therefrom. There is, however, another element of blind pool structuring that has spawned new financial products and new law designed to disrupt the structures. This is the concept of the "Non-Asset Bond."

When tax-exempt bonds (including blind pool bonds) are issued, some of the sale proceeds are typically spent at or soon after the issuance date for costs of issuance. If the issue price of bonds is $100,000,000, but only $98,000,000 is available on Day 2 to repay the issue, we say that there are $2,000,000 of "non-asset bonds." If all goes according to the documented reasonable expectations, non-asset bonds pose no problem because, as loans to hospitals or cities replace the cash in the loan fund, each borrower in essence assumes its share of the costs of issuance that gave rise to the non-asset bonds. When the first $9,800,000 is lent out, the non-asset bonds are reduced from $2,000,000 to $1,800.000. That first borrower may only borrow $9,800,000 but it promises to repay $10,000,000 of the pool bonds (or it promises to pay a sufficiently higher interest rate than that borne by the pool bonds to recoup allocable issuance costs). By the time 50% is lent out, the non-asset bonds are reduced to $1,000,000. At the point when 100% ($98,000,000) is lent out, there are no longer any non-asset bonds.[6] However, in order for bonds to be marketed (and to be rated), bondholders must be assured of getting repaid even if there is not 100% (or even 95%) origination.

Positive Arbitrage

Prior to 1986, positive arbitrage provided the simple answer. The proceeds of the bond issue were invested in a guaranteed investment contract (a "GIC") or other investment that assured the bond owners or credit enhancers that if the proceeds remained invested until a date specified as the end of the origination period, all non-asset bonds would be eliminated. For example, an issuer might issue $100,000,000 of bonds and invest $98,000,000 in a five-year GIC at a yield slightly higher than the bond yield. The issuer would be able to use earnings of the loan fund investment to pay interest on the bond issue and, because of the above-bond-interest-rate earnings on the investments, have $100,000,000 remaining to pay off the bonds in full on the five-year date. Of course, the issuer would document that it reasonably expected to fully lend out and spend the funds no later than three years after closing and that it therefore expected the non-asset bonds to disappear long before the end of the five-year period. However, buyers of the bonds were assured of being paid in full even if expenditures did not meet the issuer's stated expectations.

Because market investment returns were not quite high enough to earn back all of the non-asset bonds in three years, the origination periods of these pools were often longer than the period established for purposes of expectations. GIC returns were driven down by the liquidity required to make loans and expenditures if the expected demand materialized.

Of course, under the then-existing regulations, after the end of the temporary period (generally three years), the remaining funds might have been limited to bond yield plus 1/8%. That materially higher limitation did not, however, stop the bond finance team from demonstrating that bondholders were protected from non-asset bond risk should the proceeds be held for the longest time allowed (often five or ten years).

[6]This is a bit of a simplification. Unless, the proceeds in the loan fund are invested at exactly the bond yield, the non-asset bond amount may grow during the origination period and the amount that must be assumed by each borrower may change. In some transactions, borrowers may assume a bit more non-asset bonds than would be indicated by the percentages described above so that non-asset bonds disappear if even, say, just 95% of the loans are originated.

Rebate's End to Positive Arbitrage

The "positive arbitrage" solution to the non-asset bond problem evaporated with the applicability of rebate.[7] Earnings on the loan fund not required to be rebated, limited to the yield on the bonds, cannot even cover all of the bond interest, much less make up for the 'non-asset bonds."

Rebate did not, however, completely shut down blind pools. Lawyers and bankers came up with ways to continue issuing blind pool bond issues where the expected source of payment of the bond principal and interest was the loan repayments of the ultimate borrowers.

Fee Deferral; Code Section 149(f)

The most obvious way to solve the non-asset bond problem in a post-rebate world is to avoid non-asset bonds entirely by deferring all fees until loans are originated and making those fees contingent on loan origination. Bankers and lawyers, though, might not like such arrangements, but it could be argued that the bankers and lawyers would be "putting their money where their mouths are" if they would only be paid to the extent the bond issue was a success. If the lawyers, bankers, and other persons believed the demand surveys and representations of the issuer and other parties, they should then be willing to make their fees contingent.

Congress did not seem to see it that way and Code Section 149(f)(3) was enacted as part of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"),[8] effectively shutting down this approach. Under Section 149(f), pooled bonds are not tax-exempt if any legal or underwriting fees are contingent or if less than 95% are paid more than 180 days after the date of issuance. After the enactment of Section 149(f), the only way to avoid non-asset bonds in a blind pool bond context is for the bankers and lawyers to work for free. That never became a viable solution.

Although Section 149(f) gives the issuer 180 days to pay legal and underwriting costs, as a practical matter, the provision requires payment of bond counsel fees for subject bond issues to be paid at closing. If the bond counsel fee is not paid at closing, bond counsel can't very well sue to be paid if payment at a later date would make the bonds taxable.

TAMRA imposed additional requirements on blind pools unrelated to non-asset bonds. Section 149(f)(2) imposes a reasonable expectations requirement. While that

[7]There were some targeted transition rules in the Tax Reform Act of 1986 that allowed some post-1986 bond issues for pooled purposes to be exempt from the rebate requirement and therefore allowed a few post-1986 bond issues to continue to use the positive arbitrage approach to solve the non-asset bond problem.

[8]Code Section 149(f) was enacted by Section 5051 of TAMRA.

requirement is tighter than the reasonable expectations requirement imposed by the arbitrage rules (to avoid an early issuance), the change had little practical effect. Based on demand surveys, issuers would reasonably expect to lend at least 30% within one year and 95% within three years. Under prior law, they were already required to reasonably expect to spend 85% of the spendable proceeds (later changed to "net sale proceeds") within three years.

Factors Preventing Expectations from Being Viewed as Reasonable

The 1988 act also prohibited the issuer from taking certain factors into account in establishing its reasonable expectations. Depending on how Section 149(f)(2)(B) is interpreted, this provision may have prohibited most fixed-rate blind pooled transactions. Section 149(f)(2)(B) states that the issuer cannot take into account expectations as to changes in interest rates. Obviously, one could not reasonably expect borrowers to borrow the money if the loan rates were far in excess of prevailing borrowing costs. So, the provision clearly prohibited issuers from relying on expectations of increasing market interest rates to justify expectations of lending all of the money. Some bond counsel, however, took the position that an issuer could base its expectations of making loans on reasonable predictions that market borrowing costs would not drastically decline during the origination period. Is that position correct? Many of us have our personal opinions, but fixed-rate blind pools are effectively prohibited by the IRS's interpretation of the provision.[9] For blind pool transactions issued after TAMRA's enactment, borrowings have employed a variable rate, and issuers documented that they reasonably expected to lend the proceeds whether rates were to go up or down.[10]

We note that Sections 149(f)(4) and 149(f)(5) impose still additional restrictions on blind pool transactions, but those provisions were not part of TAMRA and will be discussed later in this article.

[9]The IRS had indicated that it would aggressively examine any issue where the expectations for the expenditure of proceeds were based on market rates staying the same (or rising). It is noted that the same limitation on taking into account expectations related to market rates applies for purposes of the hedge bond rules of Code Section 149(g). See IRC § 149(g)(2)(B), referencing IRC § 149(f)(2)(B). Can one really ever expect to lend or spend proceeds without relying on some expectations as to the status quo? For example, if proceeds are not all to be spent at closing, a change in law might prohibit the future expenditure of bond proceeds. Does the prohibition on taking into account "expectations as to . . . changes to the provisions of this title [26]" (*Id.*) mean that one can't assume that the tax law won't be changed to prohibit the expenditures?

[10]Derivative products have been used to turn such issues into synthetic variable rate issues. With proper use of derivative products, the borrowers can be offered fixed rate loans.

Non-Asset Bond Guarantees

The question after 1988 then became, was there any remaining way to deal with non-asset bonds? The answer was the "non-asset bond guarantee." The concept was that if a bank or other creditworthy entity reviewed the demand surveys and other data and determined that it expected all loans to be made, the guarantor could take the risk of non-origination. The guarantee could even be a qualified guarantee if all of the rules for qualified guarantees were met. In theory, that made a lot of sense. Many (although, perhaps a minority) blind pooled transactions really did work, and why is this risk any different from any other risk taken by qualified guarantors?

For a guarantee to be a qualified guarantee, among other things, the non-asset bond guarantor needed to reasonably expect not to make any payments on the guarantee (other than ones that would be immediately repaid). The demand surveys and representations of the issuer and others provided ample evidence upon which a guarantor could rely for its representation. If the loans in fact proceeded as the issuer expected (or at least claimed to expect), no payments would be made on the non-asset guarantee because the non-asset bonds would disappear. However, traditional bond insurers at the time (*e.g.,* MBIA, AMBAC, FGIC) did not tend to place a lot of trust on those demand surveys and the guarantors tended to be banks. Fees for the non-asset bond guarantees also seemed to be higher than one would expect if the potential guarantors really didn't believe that they would have to pay. In fact, it seemed like the pricing mechanism for non-asset bond guarantees was such that the guarantor would not lose money even if it had to pay all of the non-asset bonds. The guarantor could invest the fee and at worst use the fee and the earnings thereon during the investment period to pay off the non-asset bonds. Note that, assuming market rates supported it, the issuer could recover the non-asset bond guarantee fee as a qualified guarantee fee by investing at the bond yield (or investing higher and rebating the difference).[11] In effect, the non-asset bond guarantee allowed the issuer to recover costs of issuance indirectly in the (unexpected) case that the loans were not originated. This led to serious questions about whether non-asset bond guarantees should really get the benefit of the qualified guarantee provisions of the arbitrage regulations.

Limits on Non-Asset Bond Guarantees – Treas. Reg. § 1.148-4(f)(4)(ii)(C)

Treasury decided to use regulations to tamp down on non-asset bond guarantees. Treas. Reg. § 1.148-4(f)(4)(ii)(C) was added in 1993. The provision adds a requirement for qualifying as a qualified guarantee. A guarantee is not a qualified guarantee if the guarantor takes a risk that the financed project will not be completed and the issuer does not qualify for the normal 3-year (or 5-year) temporary period for

[11] A qualified guarantor is not a "substantial beneficiary" of a tax-exempt financing, and hence property of the guarantor is not subject to arbitrage rules.

capital projects.[12] This provision was clearly directed at non-asset bond guarantees (though not necessarily in a blind pool context), but it failed to distinguish between problematic and non-problematic guarantees, because in (almost) every case, the issuer does qualify (or at least so certifies) for a temporary period by reasonably expecting to spend at least 85% of the issue's proceeds in three years. Generally, even before the change, bond counsel would have treated a blind pool not expected to fully lent and expended within three years to be an overissuance. Demand surveys would back up the expectations.

Attempts to Manipulate Non-Asset Bond Guarantee Structure

Non-asset bond guarantors have been difficult to engage at reasonable cost because traditional guarantors have been skeptical of the predictions of demand surveys. A bank asked to be a non-asset bond guarantor might set a fee high enough so that it would at least break even if no loans were originated at all. One enterprising banker noticed that the cost of a non-asset bond guarantee could be reduced and it would be easier to locate a guarantor, if the guarantor was also the GIC provider for the loan fund. A loan fund GIC must guarantee the investment yield to be at or above bond yield for the full loan period (usually three years) even though the issuer expects to draw the funds for expenditures much more quickly than that. The issuer must also have sufficient liquidity to meet the expected draws. (Usually, these GICS provided full liquidity for the purpose of making loans.) The GIC market rate was necessarily reduced below what it would have been without the liquidity. So, the GIC provider stood to make a windfall if no loans were originated and the loan fund remained fully invested for the full loan period. The non-asset bond guarantor on the other hand would make money if the expectations of loan origination were met. The worst situation for the guarantor was the non-origination scenario. Thus, the GIC provider's worst scenario was the best scenario for the non-asset bond guarantor. The two roles provided natural hedges for each other.

The problem with getting any advantage from this natural hedge is that GICs needed to be at fair market value and for practical reasons needed to be awarded to the bidder providing the highest yield in a competitive auction meeting the requirements of Treas. Reg. § 1.148-5(d)(6)(iii). One could not just award the GIC to the guarantor. If the GIC were awarded first through competitive bidding and then the non-asset bond guarantor was selected as the GIC provider, it might be hard to establish that the guarantee fee was exclusively for guarantee purposes. Also, a fair auction for the GIC provider would likely result in a provider that was not interested in providing such a guarantee. The universe of GIC providers has generally been larger than that of

[12]The regulation actually states as one of the conditions for not qualifying that "the guarantor is not reasonably assured that the bonds will be repaid if the project to be financed is not completed." Obviously, if the guarantor believes itself to be solvent, the guarantee itself assures that the bonds will be paid. The language thus should be more narrowly interpreted by disregarding the existence of the guarantee in making this inquiry.

potential non-asset bond guarantors. Finally, if the winning bidder on the GIC were asked to quote a fee as guarantor, it would have no incentive to reduce its fee significantly below what other potential guarantors might charge.

To solve these bidding problems, the banker decided to add provisions to the specifications for the GIC that would make it likely that the two roles would be performed by the same person. The problem with that solution is that it violates Treas. Reg. § 1.148-5(d)(6)(iii)(A)(4), which requires that all provisions of the bidding specifications have a legitimate business purpose. Unfortunately, the problem was well hidden and several reputable (even esteemed) bond counsel firms agreed to opine on the structure. All of the resulting transactions were audited and according to newspaper reports and general rumor, large settlements were paid for most of the transactions. The individual banker who assembled these transactions left the business.[13]

One lesson imparted by these transactions is for counsel to be very wary of entities wearing two hats, particularly where there's a potential arbitrage-type benefit at stake. With the benefit of historical perspective, the combined GIC provider and guarantor could not have truthfully represented that its terms for each were independent of the other.

Future of Non-Asset Bond Guarantees

So, without regard to such subterfuge, can a non-asset bond guarantee qualify as a qualified guarantee? The answer to this should be "yes." However, the facts specific to the transaction are very important. The concern should be less with Treas. Reg. § 1.148-4(f)(4)(ii)(C), the regulatory requirement added to control non-asset bond guarantees (qualifying for a three-year temporary period), and more with the general requirements that any qualified guarantor (i) not expect to make payments on the guarantee that it charge a reasonable fee, and (ii) not use more than 10% of the proceeds.

2006 Amendments to Section 149(f)

One more Congressional action was taken to control blind pool transactions. Code Section 149(f) was amended in 2006 to add certain requirements. The additional requirements conformed closely to then-existing practice concerning reasonable expectations and demand surveys. The one substantive addition was a requirement that if loans were not made as expected, the "unlent" proceeds now needed to be used to redeem bonds promptly. Thus, the practice common in the 1980s of having a longer period (such as five years) to originate loans expected to be originated in the first three years was stopped. However, by and large, the new restrictions simply affirmed the ability to do tax-exempt blind pools if proper care (including well designed demand surveys) is taken.

[13] The authors have no knowledge of whether such departure was voluntary.

Avoiding Application of §149(f)

Code Section 149(f)(6) (which was part of the provision as first enacted before 2006) defines a "pooled financing bond" as a bond issue in which more than $5,000,000 of proceeds are to be lent to two or more entities. One enterprising financial advisor wanted to see if the requirements of Section 149(f) could be avoided by keeping the bond issue size to under $5,000,000. He proposed a series of small cookie-cutter bond issues separated by 15 days to fund a large pool of lendable bond proceeds. The theory was that not only would the bond issues not be "pooled financing issues," but also that the issues would be eligible for the small issuer rebate exception since the issuer would be issuing under the annual limit of $5,000,000 (plus $10,000,000 for school construction). Unfortunately for those involved, the first few issues were audited and in Field Service Advice 199936009 and TAM 200214005, the IRS determined that in this particular context, separating sale dates of the bond issues by 15 days was not sufficient to cause them to be treated as separate issues for purposes of the rebate exception.[14] The authors understand that the exams were settled and the program was not continued.

Conclusion

Generally, tax-exempt blind pooled transactions remain viable so long as the non-asset bond problem can be solved and the issuer sufficiently documents its reasonable expectations of lending the proceeds out quickly. The restrictions of Section 149(f) and of Treas. Reg. § 1.148-4(f)(4)(ii)(C) do not impose major burdens on such transactions, but solving the non-asset bond problem (through a non-asset bond guarantee or otherwise) remains the biggest hurdle.[15]

[14]Because the reasoning was based on the failure of the issues to qualify as separate issues, the result would seem to apply equally to Code Sections 149(f) and 148(f). The IRS also determined that the small issuer exception from rebate was not applicable because the purpose of lending to other governmental units was not a "local purpose" of the issuer as required for rebate exemption.

[15]Non-asset bonds can appear even in non-pooled situations. If an issuer wants to use the proceeds of an issue to finance revenue producing facilities and wants to pledge as the only source of payment the revenues to be generated from the financed facilities, there will be non-asset bonds. For example, if an issuer wants to finance one or more governmentally owned apartment buildings to be leased out to low-or-moderate-income residents and not pledge any source but the rents and the buildings to repay the bonds, any money spent at closing on costs of issuance will create non-asset bonds. Further, additional non-asset bonds are created whenever proceeds are spent until the building is placed in service. Non-asset bond guarantees can be used in this context similar to their use in blind pools financings.