Bond Case Briefs

Municipal Finance Law Since 1971

Ballard Spahr: Regulators Decline to Exempt TOBs from Risk Retention Rule but Add Helpful Revisions and Clarifications.

Although regulators have rebuffed industry efforts to have tender option bonds (TOBs) exempted from the final credit risk retention rule (the CRRR), they have nevertheless provided some helpful changes and clarifications that may offset any disappointment with this decision. The rule implements Section 15G of the Securities Exchange Act of 1934, which was enacted as part of the Dodd-Frank legislation.

The CRRR governs risk retention with respect to asset-backed securities (ABS), some of which (like qualified residential mortgage loans) are exempt from the requirement. No exemption from the 5 percent risk retention requirement is provided, however, for sponsors of issuing entities concerning TOBs, a secondary market municipal bond financing technique, as many commenters had requested. It is worth noting that TOBs did not play any part in the financial crisis that led to Section 15G's enactment.

Our recent alert summarized key aspects of the CRRR, which was issued more than three years after it was originally proposed by the three prudential bank regulators, the Securities Exchange Commission, and the housing finance regulators (collectively, the Agencies). We noted that the CRRR largely tracked the version of the rule that was re-proposed in September 2013 (the Re-proposed Rule). With respect to TOBs, the final rule and accompanying release, in addition to providing certain technical changes and clarifications, also raise several issues that may merit further clarification.

A TOB involves the deposit of one or more highly rated (typically tax-exempt) municipal bonds (munis) into a trust and issuance by the trust of two classes of securities: floating rate, puttable securities (floaters) and an inverse floating rate (residual) security. TOBs provide municipalities with access to a diverse investor base and a more liquid market. The CRRR definition of TOB focuses on those features entitling the holders to tender such bonds to the issuing entity for purchase at any time upon no more than 397 days' notice, for a purchase price equal to the approximate amortized cost of the security, plus accrued interest (if any) at the time of tendering.

A key TOB-related concept in the CRRR is the newly created term "qualified tender option bond entity" (QTOBE), which is defined as a TOB issuer that:

- Issues no securities other than a single class of TOBs with a preferred variable return payable out of capital that itself meets the risk retention requirements
- Holds only tax-exempt munis as assets and issues only securities, the income from which is tax-exempt to investors
- Is collateralized solely by servicing assets and munis that are not subject to substitution and that have the same municipal issuer and the same underlying obligor or source of payment (without regard to any third-party credit enhancement)
- Has a legally binding commitment from a regulated liquidity provider to provide a 100 percent

guaranty or liquidity coverage with respect to all outstanding TOBs

The following discussion highlights the noteworthy changes and clarifications contained in the final rule, as compared with the Re-proposed Rule.

The CRRR's Definitions of TOB and QTOBE

- Deletion of any requirement that a TOB qualify for purchase by money market funds in accordance with Rule 2a-7 under the Investment Company Act of 1940
- Extension from 30 days to 397 days of the maximum notice period for tender by a TOB holder
- The clarification that the determination of same source of payment on the municipal securities is made without regard to any third-party credit enhancement
- The clarification that a QTOBE may hold a pass-through pro rata beneficial interest in an underlying tax-exempt municipal security

In addition, although the CRRR requires that a QTOBE have a binding commitment from a regulated liquidity provider to provide a 100 percent guarantee or liquidity coverage with respect to all of the issuing entity's outstanding TOBs, the release recognizes that such liquidity coverage may not be enforceable against the regulated liquidity provider upon the occurrence of a tender option termination event (TOTE). (TOTEs typically result from a bankruptcy, default, downgrade below investment grade, or event of taxability relating to the underlying bond(s) and other principal credit sources).

No changes were made to the Re-proposed Rule's requirements that the munis be tax-exempt or that they have the same municipal issuer or source of payment. Accordingly, QTOBEs may not hold taxable munis or pool bonds from different underlying obligors or credit sources.

Compliance by the Sponsor

The sponsor of a QTOBE is solely responsible for satisfying the risk retention requirements. The release contains two helpful clarifications regarding sponsor identification:

- Recognition that more than one party could meet the definition of sponsor for purposes of the rule, in which case the transaction parties may designate which party is the sponsor with responsibility for satisfying the risk retention rule
- Explicit comfort that designation of a party as the "sponsor" for purposes of the final rule bears no relationship to whether or not such party is the "sponsor" for other purposes, such as Rule 2a-7 under the Investment Company Act or the Volcker Rule

Risk Retention Methods

No changes were made regarding satisfaction of the risk retention requirements by a sponsor (a) by retaining an eligible vertical interest (at least 5 percent of each class of ABS issued) and/or an eligible horizontal interest (generally a first-loss interest in an amount equal to at least 5 percent of the par value of all ABS interests issued), (b) by retaining an interest that upon issuance meets the requirements of an eligible horizontal interest, but upon the occurrence of a TOTE will meet the requirements of an eligible vertical interest, and/or (c) by holding munis from the same issuance of, and with a face value equal to, 5 percent of the face value of the munis deposited in the QTOBE.

In the rulemaking, concerns were raised about how a TOB sponsor could retain:

- An eligible horizontal interest in the context of the TOB structure (which generally requires the sponsor to bear the first loss) without jeopardizing the tax rules for pass-through of the tax-exempt

interest
- An eligible vertical interest (i.e., two classes of ABS interests with the holders of residual interests typically not also being holders of TOB interests)

To address these concerns, the Agencies specify that a residual interest in a QTOBE would meet the requirements of an eligible horizontal interest before, and an eligible vertical interest after, the occurrence of a TOTE under the following circumstances:

- Prior to the occurrence of a TOTE, the residual holder bears all market risk associated with the underlying tax-exempt municipal security
- After the occurrence of a TOTE, any credit losses are shared pro rata between the TOBs and the residual interest

Therefore, a first-loss residual interest is not required to satisfy the requirements for an eligible horizontal interest before a TOTE; and it is not necessary for the sponsor to hold both floater and residual interests to satisfy the requirements for an eligible vertical interest after a TOTE.

The final rule requires the sponsor to calculate the fair value of all ABS interests issued upon an issuance of TOBs that increases the face amount of TOBs then outstanding. Calculation of such fair value is thus required upon initial issuance of the TOBs, without any obligation to recalculate unless the face value of the TOBs outstanding exceeds the face value of the TOBs initially issued. If the face value of TOBs outstanding is increased—e.g., in connection with an additional deposit of munis, an increase in leverage, or the issuance of more TOBs to reflect the amount of accreted interest on zero coupon bonds—the fair value of the ABS interests would need to be recalculated to ensure that the risk retention percentage is satisfied.

Hedging

In response to questions regarding prohibited hedging of the required retained risks, the Agencies also clarified that, consistent with the treatment of other credit risk retention options in the final rule, the holder of retained credit risk may not hedge its exposure to the requisite retained 5 percent, but it may hedge any ABS interests or municipal securities in excess of the minimum requirement.

Disclosure

The CRRR requires the sponsor to provide certain mandatory disclosures to potential investors within a reasonable time before the sale of the ABS and, upon request, to the SEC or the appropriate federal banking agency. The final rule tailors the disclosure requirements as follows:

- Sponsors that retain munis outside the QTOBE must clearly disclose the identities of the TOB entity and the municipal issuer and specify the face amount of munis deposited in the TOB entity and the face amount retained outside the TOB entity and subject to the hedging prohibition.
- Sponsors that hold a residual interest meeting the requirements of an eligible vertical interest before a TOTE and an eligible horizontal interest after a TOTE must make the requisite disclosures required for both interests.

Effective Date

For TOBs, the rule is effective beginning two years after date of publication in the Federal Register. There will be no grandfathering of TOB entities formed before the effective date.

Some Open Issues

Several questions to be considered in applying the new rule include:

- The release provides that the holder of risk retention may divide the ABS interests or munis required to be retained among its majority-owned affiliates, but may not do so among unrelated entities that are managed by the sponsor or by an affiliate of the sponsor. May the residual interest be divided among related entities that are not majority-owned affiliates, such as multiple mutual funds in a fund complex? If so, may such entities designate a single residual holder entity as the "sponsor" with responsibility for satisfying the risk retention requirements?
- Does the prohibition on transfer of a retained interest prohibit pledging as security for a liquidity facility or credit enhancement the portion of a residual interest that is required to be retained?
- Can taxable munis be financed in a TOB-like structure and still satisfy the CRRR?

Ballard Spahr's Bank Supervision and Regulation practice and Public Finance Department include experienced lawyers who, among other things, counsel a variety of financial services industry clients and their boards of directors and senior management on a variety of transactional and compliance issues. Over the past several years, they have provided advice and counsel on, and transactional assistance in connection with, the myriad rules issued under Dodd-Frank.

****

by Keith R. Fisher and Joyce J. Gorman

October 31, 2014

For more information, please contact Keith R. Fisher in the Bank Supervision and Regulation practice at 202.661.2284 or fisherk@ballardspahr.com, or Joyce J. Gorman in the Public Finance Department at 202.661.2217 or gormanj@ballardspahr.com.