

Bond Case Briefs

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The Use Of A Crisis To Create Opportunity In The Muni Market.

The Coronavirus pandemic has led to death, tragedies and social and economic disruptions. Most of the disruption was unavoidable and unknowable and some individuals actually saw opportunities to create services and products that would be welcomed in this environment. Others, however, saw opportunities to use the economic disruption to achieve gains by playing on the publics' fear. The municipal bond market is highly vulnerable to fear based abuse because of its mediocre performance in public disclosure and a weak secondary market.

While the municipal market is no stranger to abusive practices in bond issuance and secondary market pricing, its greatest vulnerability is in its failure to police ongoing disclosure compliance. The Municipal Securities Rulemaking Board, or MSRB, has been given the responsibility for overseeing disclosure practices, but has little enforcement power or staff to maintain order in this massive and unregulated market. The SEC can step in to curb abuse since they do have a broader mandate, but they appear to have priorities elsewhere.

My concern today is that large investors in existing issues are using their ability to manage the information flow about a specific project to discourage smaller investors and motivate them to sell their bonds which they can then buy up at below their true value. Remember that the municipal secondary market is not a truly competitive market and even less so when the required public information filings are not being made. Their motivation for this are as diverse as:

- A need to restructure the bonds. Buying up other holders' bonds reduces their haircut on their holdings.
- Seeing the need to provide additional funding to the project which would benefit others as well.
- Seeing a high coupon long maturity bond issue which can be re-purposed for a more viable project.
- An opportunity to profit from investors fearing the worst as they tend to do when the information flow is not there.

So how does one hold back on the information flow and create an information vacuum:

- Own or gain control of 25% or more of the bonds. Trustee's, who are the main enforcers of the disclosure and payment requirements love to obtain guidance from such a proportion of bondholders in order to avoid being liable for anything they do or fail to do.
- Stop interest payments and maturity redemptions even if there are reserve funds available. This is usually justified as being done to preserve funds for legal actions or other contingencies.
- Reach a standstill agreement with the project owner whereby he too comes under the control of the majority bondholders who can then manage his information flow and other actions.
- Stop public reporting of the projects status and keep bondholders informed by teleconference where there is no written record of what was said.
- Minimize the information any non-current bondholder can see in order to make a competing price offer.
- Let the brokerage firms, who make a market in specific bonds, know you are a buyer and at what

price.

You would think that the bond trustee would exercise some professional responsibility here when he senses what is happening. More likely is that he will resign from the account if he feels vulnerable or is removed if he starts to act responsibly. Note that I have never seen a notice of a trustee resignation or removal that gave a cause. This can be need-to-know information, but good luck with that.

Bank trustees' loyalty is first to themselves, next to the obligor who pay them their annual fees and then to the bondholders representing 25% or more of an issue. And don't expect any help from the bond issuing authority who are lending their name and provenance to the bonds. They will go out of their way to tell you that they have absolutely no liability on the bonds, which translates into also having no concern with how bad a bond issue is from inception.

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