National Association *of* Bond Lawyers

Commonly-Asked Questions regarding Securities and Tax Implications of Auction Rate Bond Market Turmoil

February 27, 2008

The recent turmoil in the public finance markets, particularly with respect to auction rate securities, has presented a number of new legal issues. These include questions pertaining to the federal tax and securities law implications of issuers' efforts to convert their outstanding auction rate bonds to other modes and to avoid failed auctions. Many of these issues were thoroughly discussed during the panel sessions of the National Association of Bond Lawyers (NABL) Tax and Securities Law Institute held last week in San Francisco, attended by approximately 400 NABL members and a number of government representatives. In an effort to keep all NABL members apprised of recent developments, the Board of Directors asked two of our directors, John McNally of Hawkins Delafield & Wood LLP and Ed Oswald of Orrick, Herrington & Sutcliffe LLP, to prepare a brief "plain English" summary, in question and answer format, of the recent securities and tax law issues. This summary is not intended as legal advice of NABL or of John's or Ed's respective firms, but reflects their best collective judgments based on information and events as of the date of this advisory. We should all appreciate the time and effort devoted to this project by John, Ed and the NABL staff.

Federal Securities Law

- ***May a broker-dealer that is acting as auction agent for particular bonds buy such bonds for its own proprietary account in an auction that it is conducting?***

Yes. The SEC advised in the auction rate bonds global settlement (SEC Rel. Nos. 33-8684, 34-53888 (May 31, 2006)) that "[t]his order does not prohibit broker-dealers from bidding for their proprietary accounts when properly disclosed."

- ***May an issuer buy its bonds in an auction? May a conduit borrower?***

Maybe. Counsel should determine whether such purchases are authorized by the underlying contractual agreements, and whether the possibility of such purchases was either clearly disclosed in the Official Statement pursuant to which such bonds were initially sold or can be cured by new disclosure. In addition, the SEC staff has expressed concerns that an issuer or a conduit borrower that enters a buy order in an auction (primary market) may be impacting the price that would otherwise occur but for such order, which may constitute "market manipulation." "Market manipulation" is a potential federal securities fraud violation under Section 15(c)(1) and Rule 15c1-2 of the 1934 Act, which apply to brokers, dealers, and municipal securities dealers. The Securities Industry and Financial Markets Association has submitted a no-action request to the SEC staff asking the staff to advise that the purchase by an issuer or a conduit borrower of auction bonds in the secondary market (i.e., after an auction has established the rate and the bonds are

between auction dates) would not result in the staff recommending an enforcement action. The issuer (or the obligor) could then determine to either sell or to hold the purchased bonds on the next auction date, but once again could not purchase additional bonds in a primary auction market. The response to that no-action request is expected to be released and made public soon.

Purchases by issuers or conduit borrowers also raise state law issues, including the question of extinguishment of debt, which are not addressed in this primer.

- ***If an issuer determines to replace its auction rate bonds with variable rate demand obligations (either through a permitted change in modes or pursuant to a current refunding), what form of disclosure document is appropriate?***

Most counsel take the position that a variable rate demand obligation that (1) is supported by a direct-pay letter of credit, which provides credit and liquidity support, (2) may be tendered by the holder at any time upon short notice (generally seven days), (3) for which disclosure is made that the prospective investor should look only to the provider of the credit and liquidity support in making its investment decision whether to purchase the bonds, may be sold pursuant to a "short-form" Official Statement that contains little (if any) information concerning the underlying obligor. On the other hand, (A) the SEC staff has expressed the view, most recently in testimony provided by the Director of the Division of Trading and Markets to Congress on February 14, 2008, that "the presence of credit enhancements are generally not a substitute for material disclosure concerning the primary obligor on municipal bonds," and (B) certain investment banking houses, in light of recent market events, are not accepting the short-form disclosure documents if they are acting as remarketing agent.

- ***If an issuer converts from auction rate bonds to variable rate demand obligations pursuant to the terms of the original indenture or bond resolution, is the sale of the obligations a "primary offering" of the issuer? Of the underwriter? What is the importance of such analysis?***

Whether there is a primary offering subject to Rule 15c2-12 will be determined by the terms of that rule, in particular the definition of "primary offering." (See also letter from SEC staff to Pillsbury Madison dated Mar. 11, 1991, advising that the definition of "primary offering" is intended as "examples [that] are illustrative, and do not define the universe of remarketings that are subject to the Rule.")

Separate from the analysis of whether there is a primary offering for Rule 15c2-12 purposes, there is the issue whether there is a primary offering for other federal securities law purposes. Clearly, if there is a current refunding with a new Official Statement, such offering should be treated as a primary offering for purposes of both the issuer and the underwriter. For the issuer, the advice of the SEC is that "issuers are primarily responsible for the content of their disclosure documents and may be held liable under the federal securities laws for misleading disclosure." (1988 Release) For the underwriter, if there is a primary offering the underwriter must have a "reasonable basis for belief in the truthfulness and completeness of the key representations made in any disclosure documents used in the offerings." (1988 Release)

On the other hand, if the bonds are being converted from auction rate to variable rate pursuant to the terms of the original documents, such conversion should be considered to be a secondary market transaction. If a new disclosure document were prepared, the issuer would have responsibility and attendant liability for such disclosure document used in connection with the secondary market sale. The investment banker, however, may be considered to be wearing the hat of remarketing agent rather than of an underwriter, and may not have the attendant responsibilities established in the 1988 release for underwriters.

- ***If bonds that were subject to a Rule 15c2-12 Continuing Disclosure Agreement when issued (e.g., as auction rate bonds), are converted to a mode that would be exempt from Rule 15c2-12 in the context of a primary offering, does the Continuing Disclosure Agreement continue in effect?***

Maybe. In a letter to NABL dated September 19, 1995 (known as "NABL II"), the SEC staff responded in its answer to question 13 that the Continuing Disclosure Agreement may be terminated or suspended on these facts, but only if the agreement expressly provided for such termination or suspension. In general, however, Rule 15c2-12 works like a ratchet. Once bonds are the subject of a continuing disclosure agreement, they continue to be subject to such agreement, regardless of whether they are converted to a mode that would otherwise have been exempt if it were a new issue. In addition, many issuers provide continuing disclosure regardless of whether exempt from Rule 15c2-12.

- ***Must a material event notice be provided regarding the rating downgrades of insured bonds?***

Yes. Rule 15c2-12 requires that Continuing Disclosure Agreements include provisions that an issuer (or an obligated person) file "in a timely manner" notices of certain specified events "if material." One of such events is "rating changes," which includes upgrades and downgrades, but not credit watches. The SEC staff has clarified that material event notices must be filed for any insured bonds that have been downgraded as a result of the downgrade of the insurer.

- ***Does the obligation to file a material event notice only apply if the issuer has received a notice of downgrade directly from the rating agency?***

No. Fitch Ratings, for example, has not been sending notices to the issuers. On the other hand, the information as to whether a particular issue has been downgraded is available from the Fitch website. An issuer should file notice if the information regarding the downgrade can be readily obtained, even if the issuer was not notified directly by the rating agency.

- ***Is a cover sheet necessary, and if so where can it be obtained?***

The form of the industry cover sheet is downloadable from the GFOA's website, which can be accessed from a hyperlink on the Municipal Market portion of the SEC's website (www.sec.gov). If the notices are sent to Disclosure USA (aka Texas MAC or the CPO) for transmission to the NRMSIRs, then no cover sheet is needed. The process for entering

the data on the Disclosure USA website will automatically generate the information the cover sheet would otherwise provide.

- ***Is a material event notice required if the insurance was procured by the winning bidder in a competitive bid underwriting?***

Maybe. Many issuers in a competitive bidding context allow the bidder to determine whether to procure bond insurance, which is paid for by the bidder and factored into the bid. In those instances, the issuer will generally, with appropriate disclaimers, include the information regarding the policy and the insurer, as well as the insured rating, in the final Official Statement. If the insured rating is downgraded, the issuer should file a material event notice regardless of who procured the insurance. On the other hand, if all the information regarding the insurance is set forth in a "wrap" to the official statement that is prepared by the underwriter, if the issuer expressly disclaims any responsibility for such wrap, and if the Continuing Disclosure Agreement makes clear that the issuer has no responsibility to file rating changes that result from a downgrade of the insurer, then a material event notice may not be required.

- ***Is a notice of a material event required to be filed if the bond insurance is procured by a holder in the secondary market?***

No. If the insurance is procured after the primary offering is completed, the insurance is not described in the Official Statement, and the premium is paid by the holder of the bonds, then the issuer has no responsibility to file a material event notice for a downgrade of the insured bonds. (NABL II, q. 3)

- ***Is a notice of material event required to be filed if the insurer is providing other credit enhancement, the insurer has been downgraded, but the bonds maintain their rating?***

Maybe. If, for example, an insurer is providing credit enhancement in the form of a reserve fund surety or a GIC, and the insurer is downgraded but the bonds have not been downgraded, such downgrade of the insurer may not require a material event notice. (Letter from SEC staff to NABL, dated June 23, 1995 ["NABL I"], q. 9)

- ***Must a notice of a material event be filed regarding the downgrade of a rating that was not requested by the issuer or disclosed in the Official Statement?***

Maybe. Fitch Ratings, for example, provides ratings for insured bonds based on the rating of the insurer regardless of whether such rating is requested by the issuer. In those instances, the Fitch rating of the bonds is not included in the Official Statement. Because the purpose of Continuing Disclosure Agreements is to assure investors are provided with updated information regarding those factors that were evaluated when the bonds were purchased, material event notices may not be required to be filed for the downgrade of a rating that was not included in the Official Statement. On the other hand, Rule 15c2-12 specifically refers only to "rating changes" without any limitation.

- ***Must a notice of a material event be filed if the bonds have an underlying rating higher than the recently revised insured rating?***

No. Notice is required of rating changes. If an issuer were AAA underlying before a downgrade of the insured rating and continues to be AAA, then notice of the downgrade of the insured rating should not be required (e.g., an issuer procures insurance when at the A or AA level, and has since been upgraded to an underlying AAA). On the other hand, because of the confusion in the market place, an issuer may determine that it wishes to file a notice reminding the market that it retains a natural AAA rating.

Federal Tax Law

On February 19, 2008, the Department of the Treasury and the Internal Revenue Service released Notice 2008-27. Notice 2008-27 was issued in response to industry requests for relief from possible reissuance consequences with respect to proposed restructurings of outstanding tax-exempt obligations by issuers and conduit borrowers seeking to replace downgraded credit facilities in connection with the conversion of auction rate securities to variable rate demand bonds "VRDOs," among other possible scenarios.

The reissuance of a bond will trigger the general tax consequences associated with a refunding, which include any final arbitrage rebate payment to the U.S. Treasury, transferred proceeds, a deemed termination of any associated interest rate swap or hedge, and change in law risk.

Notice 2008-27 provides helpful and constructive guidance both with respect to the current deterioration of the auction rate market, the downgrade of bond insurers as well as clarifying certain matters with respect to the tax treatment of tax-exempt qualified tender bonds and the broader reissuance guidance of Code Section 1001.

Notice 2008-27 generally provides that most prescribed interest rate mode changes and underlying security changes can be made with respect to an outstanding qualified tender bond without the risk of triggering a reissuance for purposes of Code Section 103 and Sections 141 through 150. Set forth below is a brief summary of Notice 2008-27.

- ***What is the Purpose of Notice 2008-27?***

Notice 2008-27 sets forth certain special reissuance standards for "qualified tender bonds." Notice 2008-27 provides interim guidance until the promulgation of regulations regarding this subject matter.

- ***What is the Effective Date of Notice 2008-27?***

Issuers may rely on Notice 2008-27 with respect to tax-exempt bonds for any actions taken on or after November 1, 2007, and before the effective date of future regulations.

- ***May I Still Apply Notice 88-130 to Qualified Tender Bonds?***

Yes. Issuers may continue to rely on Notice 88-130 in lieu of Notice 2008-27 until the effective date of future regulations.

- ***Does Notice 2008-27 apply for all Federal Tax Purposes?***

No. Notice 2008-27 provides guidance on whether tax-exempt bonds are treated as reissued or retired solely for purposes of Section 103 and Sections 141 through 150 of the Code.

- ***Are Auction Rate Bonds Qualified Tender Bonds?***

Yes. Notice 2008-27 clarifies that multi-modal bonds in an auction rate mode can be treated as qualified tender bonds.

- ***What is the Maximum Term for Qualified Tender Bonds?***

Notice 2008-27 provides that qualified tender bonds may have a term of up to the lesser of 40 years or 120% of the weighted average economic life of the financed facilities.

- ***Does Notice 2008-27 Relax the "Hair-trigger Rule" of Notice 88-130?***

Yes. Notice 88-130 provides that qualified tender bonds will be treated as reissued if there is any change in connection with a conversion of interest rate mode from greater than one year to one year or less, or vice versa. Under Notice 2008-27, one or more changes in connection with a interest rate mode conversion will not give rise to a reissuance unless those other changes on their own are deemed to be "significant" modifications under the reissuance regulations provided in T.R. Section 1.1001-3.

- ***Can Qualified Tender Bonds be Reissued at Other than Par?***

No, with one limited exception. Like Notice 88-130, Notice 2008-27 generally applies only to bonds remarketed at par. One exception to this par remarketing rule is that bonds converted to a fixed rate for the remaining term to maturity may be resold at a premium or discount.

- ***Can Qualified Tender Bonds be Held by the True Obligor for a Period of Time Prior to a Remarketing?***

Yes. Under Notice 2008-27, bonds purchased by or for the account of the issuer (other than pursuant to a credit enhancement agreement), may be held for up to 90 days prior to a remarketing. Under Notice 88-130, such time period is limited to 30 days.

- ***Do Changes in Interest Rates Resulting from Prescribed Interest Rate Mode Changes Need to be Tested for Significance under the Reissuance Regulations?***

No. Notice 2008-27 provides that any change in interest rate on the bonds that is a qualified interest rate mode change does not need to be separately tested to determine whether there is a significant modification of the bonds under T.R. Section 1.1001-3.

- ***Will the Deletion or Addition of Credit Enhancement of a Qualified Tender Bond Cause a Reissuance?***

Not in most cases. Notice 2008-27 contains several examples. In Example 1, the auction rate reset on the bonds is set at 10% as a consequence of a downgrade in the bond insurer's credit rating from a "AAA" to "AA". Shortly after the downgrade, the issuer amends the terms of the bonds to replace the now "AA" rated bond insurance with a "AAA" letter of credit. As a result of the change in credit enhancement the auction rate on the bonds was reduced down to 3%.

Example 1 also provides that the amendment to the terms of the bonds to change the credit enhancement is a "modification" that must be tested for "significance" under the change in security or credit enhancement rule of T.R. Section 1.1001-3(e)(4)(iv). This Example concludes that because the change in security did not cause a change in "payment expectations" on the bonds, the change in credit enhancement is not a significant modification under T.R. Section 1.1001-3.

Importantly, Example 1 makes it clear that any change in interest rates due to a change security or credit enhancement is not required to be tested under the 25-basis point change in yield rule for significant modifications under T.R. Section 1.1001-3(e)(2), because the issuer did not make any change to the interest rate setting mechanism under the terms of the bond.

- ***How does the "Change in Payment Expectations" Rule Apply to Tax-Exempt Bonds?***

In connection with the modification of the security or credit enhancement of a tax-exempt bond (*whether the bond is recourse or non-recourse*), Notice 2008-27 provides that such a modification is "significant" only if the modification results in a change in payment expectations under T.R. Section 1.1001-3(e)(4)(vi). Under this provision, a change in payment expectations occurs only if: (i) there is a substantial enhancement of the capacity to meet the payment obligations and that capacity was primarily speculative prior to the modification and is adequate after the modification, or (ii) there is a substantial impairment of the capacity to meet the payment obligations and that capacity was primarily adequate prior to the modification and is primarily speculative after the modification.

- ***Does Notice 2008-27 Provide any Temporary Relief for Waivers of Interest Rate Caps on Auction Rate Bonds?***

Yes. Notice 2008-27 provides temporary relief for certain waivers of interest rate caps on auction rate bonds. Notice 2008-27 provides that a waiver of an interest rate cap on auction rate bonds will be disregarded to the extent that both the agreement to waive and the effective period of the waiver are between November 1, 2007 and July 1, 2008.

- ***Does Notice 2008-27 Provide any Special Rule for Minor Modifications of Qualified Hedges?***

Yes. Under generally applicable federal income tax rules, hedges are treated as deemed terminated if they are significantly modified. Notice 2008-27 allows minor modifications to be made to a hedge without giving rise to a deemed termination.

Notice 2008-27 provides that modification of a qualified hedge will not result in a deemed termination of the hedge if: (i) as of the date of the modification the modification is not reasonably expected to change the yield on the hedged bonds over the remaining term of the bonds by more than 0.25%, and (ii) the yield on the hedged bonds is adjusted to take into account the payments and receipts on the qualified hedge, as modified. For example, if the issuer converts from auction rate bonds to VRDOs, minor modifications may be made to a qualified hedge associated with the bonds in order to better match the new interest rate mode without giving rise to a deemed termination.