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A Survey of Recent Developments

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Over the last year and several recent months various regulatory and other developments have occurred with respect to the municipal bond markets and municipal finance. The purpose of this article is to briefly highlight a number of these developments and point out certain related issues. This is not intended to be exhaustive.

Securities and Exchange Commission (SEC)

Pursuant to the Dodd-Frank financial reform legislation ("Dodd-Frank"), the SEC conducted field hearings on the municipal markets in 2010 and 2011. SEC Commissioner Elisse Walter characterized the field hearings as an "information gathering phase". The SEC indicated that its staff will prepare a report including recommendations which may include "legislation, rulemaking and changes in industry practice". The recommendations may reflect some influence from corporate securities regulation.

Commissioner Walter commented, "...I believe that we can learn from the corporate world, but it is also essential that we recognize the differences in the municipal and corporate finance worlds...". (As of magazine publishing date, the SEC has not yet publicly released a staff report as referenced above.)

Electronic Municipal Market Access system (EMMA) of the Municipal Securities Rulemaking Board (MSRB)

"EMMA" refers to the MSRB's electronic filing system which provides access to official statements, continuing disclosure filings, certain trading information, and other information with respect to municipal securities. EMMA has replaced the private Nationally Recognized Municipal Securities Repositories as the required depository for various filings, notably continuing disclosure filings. The MSRB continues to expand the uses of EMMA in a number of ways.

Certain information and documents related to variable rate demand obligations (VRDOs) are now reported by dealers and displayed on the EMMA website pursuant to "SHORT", which refers to the MSRB's Short-term Obligation Rate Transparency System. Since November 21, 2011, the MSRB has provided free public access to current municipal credit ratings through EMMA from Fitch Ratings and Standard & Poor's. EMMA also provides links to additional credit rating agency information.

EMMA also allows issuers to make certain types of voluntary disclosures. Since May 23, 2011, issuers can disclose on EMMA their voluntary agreement to provide their audited financial statements to EMMA within 120 days of the end of the fiscal year.

EMMA allows for the voluntary submission of financial and event-based information not required pursuant to the SEC's Rule 15c2-12 (which governs continuing disclosure). Since late spring of 2011, issuers may voluntarily submit pre-sale documents such as: preliminary official statements, notices of sale and advertisements announcing an upcoming new issue.

Other MSRB Proposals

As part of the Dodd-Frank financial regulation legislation, the MSRB's mission has been expanded to include the protection of municipal issuers as well as investors. Possibly due to this, as well as other factors, the MSRB has been active in recent months. Although a number of its rules, notices and proposals are mostly relevant for underwriters, brokers and dealers, some may be of practical significance to issuers.

For example, among other recent MSRB rules or proposals, the MSRB has addressed fair dealing obligations owed to issuers, guidance related to underwriters consenting to bond document amendments, and rule changes and interpretive guidance relating to underwriters and dealers complying with issuer's directions related to selling bonds during retail order periods. Certain of these proposals have engendered considerable debate and are subject to change. Copies of the MSRB's proposals as well as comments received in response are available through the MSRB's public website (www.msrb.org).

Swaps (U.S. Commodity Futures Trading Commission)

The U.S. Commodity Futures Trading Commission (CFTC) on January 11, 2012 approved a final rule to imple-

ment Dodd-Frank's business conduct requirements for swap dealers (SDs) and major swap participants (MSPs) in their dealings with counterparties. (In this context, a municipal bond issuer is a counterparty).

The CFTC and the SEC have specified and complex jurisdictions related to swaps with the CFTC's jurisdiction generally being relevant to interest rate swaps. Certain counterparties are "Special Entities" (this would include municipal authorities among other state and local government entities).

The rule provides certain standards of conduct for dealings with counterparties (e.g., must disclose material information about the swap; must have a reasonable basis to believe that recommended swaps are suitable). Special Entities are to be afforded certain added protections. SDs and MSPs must have a reasonable basis that the Special Entity has a representative that meets certain requirements.

A SD that recommends a swap or trading strategy involving a swap tailored to the particular needs of the Special Entity must have a reasonable basis to believe the recommendations are in the best interests of the Special Entity. There is a safe harbor that enables the SD to not be subject to the best interests duty. "Best interests" is not a fiduciary duty under the rule. To meet this requirement, a SD is to employ reasonable care that any recommendation is to further the Special Entity's stated objectives.

Internal Revenue Service (IRS)

In the 2011 fiscal year, the IRS's tax-exempt bond group (TEB) undertook certain initiatives related to its Closing Agreement and Voluntary Compliance Agreement Program (VCAP) including updates to related administrative procedures. In general terms, VCAP is a means for issuers to approach the IRS to resolve non-compliance issues. Among other things, new provisions were added which the IRS characterized as "permitting a reduced settlement amount when an issuer timely submits a TEB VCAP request following the identification of a violation pursuant to due diligence monitoring processes established in the issuer's written post-issuance compliance procedures." In another VCAP development, pursuant to Announcement 2011-19 captioned in part as "Relief from Debt Extinguishment for Certain Issuers Purchasing and Holding Their Own Tax-Exempt Bonds", the IRS provides relief for some issuers that purchased their own bonds under temporary rules instituted for the purpose of providing relief from liquidity constraints in the tax-exempt bond market during the financial crisis.

The IRS noted that some issuers that purchased their bonds under the temporary rules were unable to sell them by the prescribed time and that other issuers have an ongoing need to purchase and hold their own tax-exempt obligations due to fiscal challenges. Closing agreements with the Federal Government under this program provide that extinguished bonds are treated as remaining outstanding. The IRS noted that these VCAP requests are due by December 31, 2012.

Governmental Accounting Standards Board (GASB)

In late Fall 2011, GASB presented its Preliminary Views on Financial Projections which has engendered considerable comments including opposition.

This project is subject to changes and GASB may not necessarily go forward with this as proposed. GASB indicated that it believes that users of government financial statements "need forward-looking information to assess fiscal sustainability". GASB's proposal is seeking five years of projections for cash inflows and cash outflows.

Projections for total cash outflows and major individual financial obligations would address: bonds, pensions, other postemployment benefits, and long term contracts. Also sought would be a narrative discussion of major intergovernmental service interdependencies (GASB describes this as existing where one government provides a service on behalf of another government, or together with one or more governments).

From a securities law perspective regarding attempts to limit potential liability, this proposal may raise issues as to how issuers may properly qualify these projections (when included in disclosure statements) as forward looking statements.

Financing Developments—Increasing Use of Direct Bank Loans

The volume of non-public transactions involving direct purchases of bonds by

banks has reportedly increased. This has coincided with a decline in VRDO financings and other transacactions that have been credit enhanced.

Accounting/regulatory reasons (i.e., capital requirements) likely explain why it is easier for some banks to directly purchase bonds rather than issue letters of credit. These transactions are favorable for issuers and borrowers in terms of eliminating/reducing risks related to the credit quality of credit facility providers and related to the need to remarket the VRDOs. These transactions have tended to be exempt from disclosure requirements and have not had official statements or similar offering documents. These issuers may (and likely in many instances) have other debt outstanding that is publicly held and likely rated.

Certain rating agency concerns have been raised about the potential risks of liquidity events to holders of existing debt stemming from such directly placed debt. These concerns are due to direct purchased debt (i) tending to have shorter maturities (or mandatory puts after a few years) resulting in balloon payments that may need to be refunded or rolled over and (ii) being subject to potentially earlier mandatory puts/redemption or acceleration in the case of events of default. Recently, the MSRB has called upon issuers to voluntary provide disclosure about these transactions.

Federal Budget and Tax Law Changes–Potential Risks to Municipal Bond Tax-Exemption over the Long-Term?

Although nothing has developed in Congress as of yet, in light of federal budget deficit issues, the elimination or curtailment of tax-exempt interest on bonds has moved from the unthinkable to the possible (albeit such developments appear to remain unlikely at this stage). For example, in 2011, the Administration at one point had proposed to Congress a bill that would

have limited the value of tax-exempt interest on municipal bonds, taken together with the tax benefits of other expenditures and deductions, to a specific percentage for individuals and married couples at or above certain thresholds for taxable income.

Certain bi-partisan and other federal deficit oriented commissions or working groups have focused on eliminating or curtailing tax deductions or tax expenditures including tax-exemption on municipal securities with other well-established deductions such as those related to employer health-care contributions for employees and mortgage interest.

A Few Other Developments to Monitor

As noted at the beginning of this article, the survey included herein is not meant to be exhaustive. A few additional items are worthy of note which may see developments. Specifically, the Volcker Rule proposal (stemming from Dodd-Frank and relating to restrictions on proprietary trading by certain financial institutions), if implemented as first proposed (which is very uncertain), may impact the municipal market insofar as that its exemption for government obligations would not extend to all municipal securities.

Generally, authority revenue bonds would not have as favorable treatment as say general obligation bonds. This may lead to bifurcation in the market in terms of demand and liquidity.

Also, the SEC continues to rely on a temporary proposed rule related to financial advisor registration. The finalization of this rule may address (among other concerns) the status of appointed issuer board members who, thus far, have not been provided an exemption from the definition of municipal advisor as has been provided to issuer employees and elected officials.

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