

# Risk Retention Rules Impact Registered Fund Tender Option Bond Financings

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In October 2014, several regulatory agencies approved final rules to implement the risk retention requirement mandated by Section 941 of the Dodd-Frank Act. (See "[Regulators Adopt Final Risk Retention Rules for Asset-Backed Securities](#).") Prior to adopting the final rules, the agencies issued two sets of proposed rules — in 2011 and 2013 — requesting comments on each. As under the previously proposed rules, the credit risk retention requirements apply to tender option bond (TOB) programs. As a result of the final rules, registered investment companies that use TOB trusts to leverage their portfolios will be required to change their practices, which likely will make TOB trusts a more expensive form of leverage.

Under typical TOB trust structures, a registered investment company sells municipal securities to a bank entity, which then creates a special purpose trust (a TOB trust) into which the bonds are deposited. The TOB trust then issues two types of securities: floating rate securities and inverse floating rate (or residual) securities. The floating rate securities typically are sold to money market funds that are only permitted to buy high-quality, short-maturity investments. The inverse floating rate security is retained by the registered fund. Using TOBs effectively enables open- and closed-end funds to borrow (from money market funds) and then use the money to purchase additional long-term, fixed-rate bonds for the fund's portfolio. The expectation is that the purchased long-term bonds will yield more than the borrowing rate paid on short-term floating rate securities issued by the TOB trust.

In response to industry comments to the second set of proposed rules regarding the difficulty of structuring TOB programs within the limits of the risk retention requirements, the final rules add two TOB-specific options for sponsors of TOB programs that meet the definition of a "Qualified TOB Entity." (If a TOB sponsor does not meet the requirements to be a Qualified TOB Entity, the program must comply with the risk retention rules promulgated outside the specific TOB-related section of the final rules.) The conditions set forth in the final rules that sponsors of TOB programs must meet to be deemed a Qualified TOB Entity are as follows:

- The collateral consists solely of servicing assets and municipal securities as defined in Section 3(a)(29) of the Securities Exchange Act of 1934, and all of those securities have the same municipal issuer and the same underlying obligor or source of payment;
- Only two classes of securities are issued: (1) a single class of securities with a preferred variable return and (2) one or more residual equity interests that, in the aggregate, are entitled to all the remaining income of the issuing entity;
- The TOB, the residual interest and the underlying municipal security are issued in compliance with the Internal Revenue Code, such that the interest payments made on those securities are excludable from the gross income of the owners;
- The issuing entity has a legally binding commitment from a "regulated liquidity provider"<sup>1</sup> to provide 100 percent guarantee or liquidity coverage with respect to all of the issuing entity's outstanding TOBs;
- The issuing entity qualifies for monthly closing elections pursuant to IRS Revenue Procedure 2003-84; and

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- The holder of a TOB must have the right to tender such bonds to the issuing entity for purchase at any time upon no more than 397 days' notice.
- Notably, the condition that securities offered by the TOB trust must have "all necessary features so such security qualifies for purchase by money market funds under Rule 2a-7 of the Investment Company Act of 1940" has been removed.

The final rules permit a "sponsor" in a securitization transaction to combine an "eligible horizontal residual interest"<sup>2</sup> and an "eligible vertical interest"<sup>3</sup> in any proportion to achieve the required risk retention percentage of 5 percent of the fair value of the securitization transaction in the aggregate as of the closing date. The final rules also provide a "menu of options" for permissible forms of risk retention that take into account transaction-specific features of various securitization transactions, including asset-backed securities, mortgage-backed securities, collateralized loan obligations, municipal bond repackaging securitizations and TOBs.

The sponsor of a Qualified TOB Entity may satisfy its risk retention requirements through four delineated options, two of which, options 1 and 4 below, have been added to the final rules in response to industry comments:

1. The sponsor retains an eligible vertical interest, an eligible horizontal residual interest or any combination thereof;
2. The sponsor retains an interest that upon issuance meets the requirements of an eligible horizontal residual interest but which upon the occurrence of a "tender option termination event" will meet requirements of an eligible vertical interest;
3. The sponsor holds municipal securities from the same issuance of municipal securities deposited in the Qualified TOB Entity, the face value of which retained municipal securities is equal to 5 percent of the face value of the municipal securities deposited in the Qualified TOB Entity; or
4. The sponsor retains any combination of these interests and securities such that the sum of percentages held in each form equals at least 5 percent. (The municipal securities retained by the sponsor would be subject to transfer and hedging restrictions.)

Under current market practices used in connection with the formation of a TOB trust, a bank entity acts as sponsor of the TOB trust and therefore would be the entity required to comply with the new risk retention rules. However, the Volcker Rule of the Dodd-Frank Act now prohibits a bank entity that acquires or retains an ownership interest in or acts as sponsor of a covered fund, which includes most TOB trusts as currently structured, from engaging in a "covered transaction" with the TOB trust. Covered transactions include, among others, (1) the issuance of a guarantee, acceptance or letter of credit, including an endorsement or standby letter of credit, on behalf of the covered fund and (2) a transaction with a covered fund that involves the borrowing or lending of securities, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the covered fund. Between the restriction on engaging in covered transactions and the prohibition on directly or indirectly guaranteeing, assuming or otherwise insuring the obligations or performance of the covered

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fund, the sponsor bank is effectively barred from engaging in credit enhancement and liquidity support for a TOB trust, and from entering into swap agreements and other such programs.

As a result of the Volcker Rule mandates and the final rules, market participants have looked into alternative structures for TOB financings. Under one such alternative TOB structure, an open- or closed-end fund would act as sponsor of the TOB trust by creating a TOB trust, into which the fund's municipal bonds would be deposited. As the sponsor of the TOB trust, the fund would need to comply with the risk retention rules, which it could do by structuring the inverse floating rate securities to be "eligible horizontal residual interests" as defined in the final rules. A fund may comply with the 5 percent risk retention threshold of the final rules by retaining either some of the municipal securities deposited into the TOB trust or by owning inverse floating rate (residual) securities of the TOB trust, in each case with value equal to or greater than 5 percent of fair value of the face value of the municipal securities deposited in the TOB trust as of the closing date of the TOB transaction.

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<sup>1</sup> Generally banks or certain bank affiliates. The final rules define a "regulated liquidity provider" as a depository institution (as defined in Section 3 of the Federal Deposit Insurance Act); a bank holding company (as defined in 12 U.S.C. § 1841) or a subsidiary thereof; a savings and loan holding company (as defined in 12 U.S.C. § 1467a), provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. § 1843(k) (or a subsidiary thereof); or a foreign bank (or a subsidiary thereof) the home country supervisor of which (as defined in Section 211.21 of Regulation K (12 CFR 211.21)) has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, provided the foreign bank is subject to such standards.

<sup>2</sup> An "eligible horizontal residual interest" is an interest that (1) has the most subordinated claim on cash flows and (2) is allocated all losses until reduced to zero.

<sup>3</sup> An "eligible vertical interest" is (i) an interest in each class of interests in the issuing entity that constitutes the same portion of each such class or (ii) a single vertical security, which is an interest entitling the sponsor to specified percentages of the principal and interest paid on each class of interests in the issuing entity, which specified percentages result in the fair value of each interest in each such class being identical.