

# Secondary Market Tax-Exempt Securitization & Other Secondary Market Structures

May 2, 2024



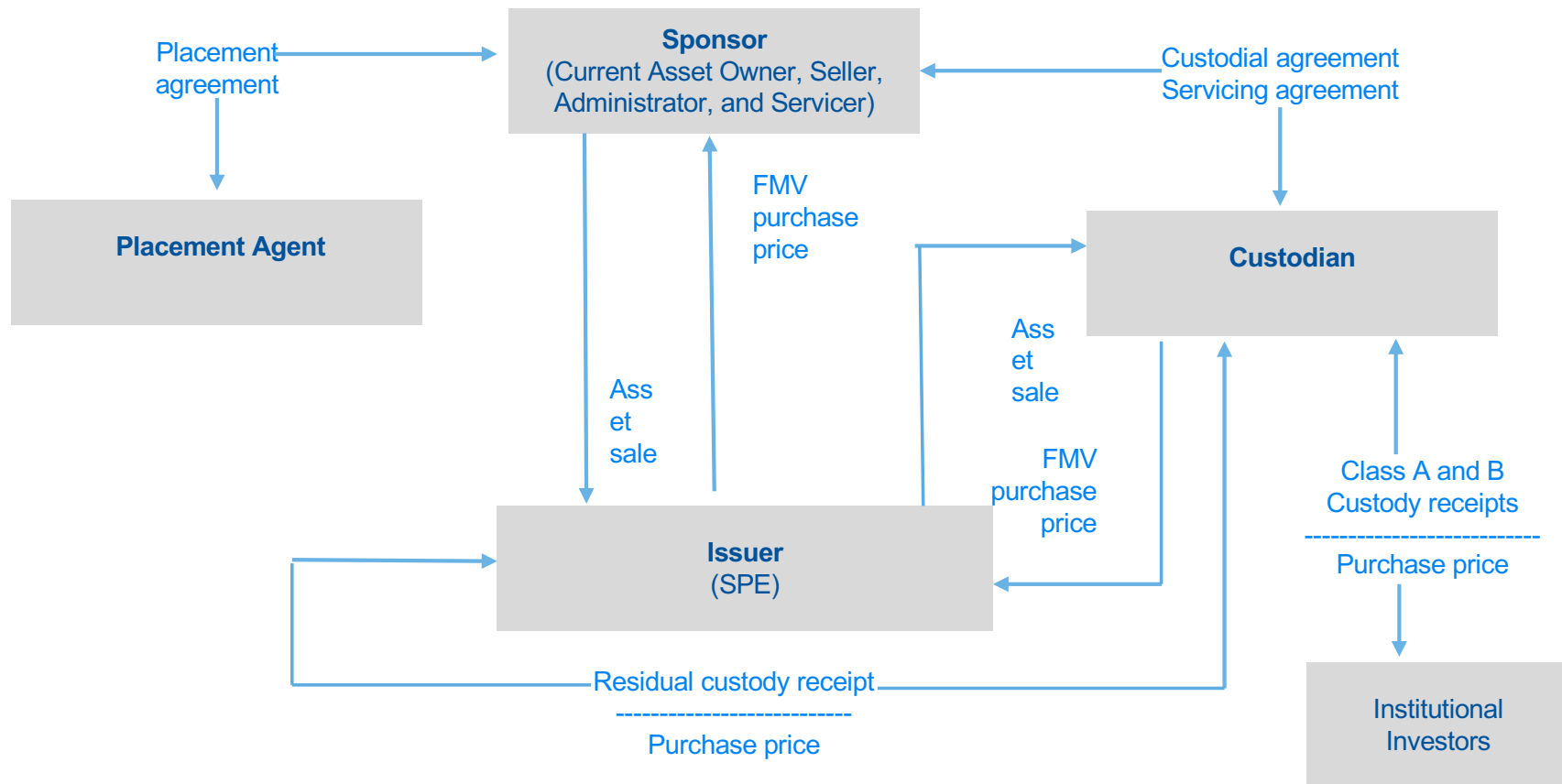
# ► Topics for Discussion

- ▶ Why Securitizations and Structured Credit?
- ▶ How has the legal landscape changed post-financial crisis?
- ▶ Regulatory and Legal issues to consider
  - ▷ Diligence underlying assets
  - ▷ Securities Law
  - ▷ Bankruptcy Law Considerations
  - ▷ Investment Company Act of 1940
  - ▷ Volcker Rule
  - ▷ Risk Retention
  - ▷ Tax
- ▶ Conduit Structures
- ▶ Rated Structures (Can be Conduit and Non-Conduit)
- ▶ Unrated structures
  - ▷ Single and Multi-name Term A/B
  - ▷ TRS
  - ▷ Participations

# ➤ Why Securitizations and Structured Credit?

- ▶ Economics of securitization and structured credit transaction
- ▶ Sponsors and Investors and Counterparties

# Securitization Transaction Diagram





# How has the legal landscape changed post-financial crisis?

- ▶ Volcker Rule
  - ▷ Covered Fund
  - ▷ Ownership Interest
  - ▷ Proprietary Trading v. Market Making
- ▶ Risk Retention and the QTOB provisions
- ▶ Conflicts Rule-“Conflicted Transactions” and ABS
- ▶ BOI Reporting Rule-Reporting Companies and Sales to Individuals

# ➤ Regulatory and Legal Issues

- ▶ Transfer restrictions on underlying assets
- ▶ State law restrictions
- ▶ Securities Law Considerations
- ▶ Bankruptcy Law Considerations
- ▶ Volcker Rule
- ▶ Risk Retention
- ▶ Investment Company Act of 1940 – Rule 3a7
- ▶ Tax Law (Federal and State) Considerations

# ➤ Regulatory and Legal Issues to Consider

- ▶ **Diligence underlying assets** – Transfer restrictions on underlying assets
- ▶ **State law restrictions**
- ▶ **Securities Investment Company Act of 1940 ('40 Act)**
  - ▷ Volcker Rule
  - ▷ Rule 3a7
  - ▷ Loan Securitizations
- ▶ **Risk Retention**
  - ▷ General requirements
  - ▷ QTOBs provisions



# Volcker Rule

- ▶ Title VI, Section 619 of the Dodd-Frank Act (the “Volcker Rule”)
- ▶ Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission (collectively, the “Joint Regulators”)
- ▶ The Joint Regulators issued final regulations on December 10, 2013 (the “Final Regulations”) implementing the Volcker Rule which impose strict limitations on the sponsorship by banking entities of “*covered funds*” and on contracts between banking entities and such funds.



## ▶ Volcker Rule (cont'd)

- ▶ Under the Final Regulations, the term “**covered fund**” includes, in relation to any “**banking entity**”, any issuer of securities that (i) is sponsored, managed or advised by the banking entity, and (ii) relies upon the exception from registration under the **Investment Company Act** provided by **Section 3(c)(1)** or **Section 3(c)(7)** thereof.
- ▶ In particular, (i) under the Volcker Rule and the Final Regulations banking entities are prohibited from owning or sponsoring covered funds and (ii) under the so-called “*Super 23A*” provisions of the Volcker Rule banking entities and their affiliates are prohibited from providing loans and/or credit support to covered funds and from purchasing assets from covered funds (e.g., under a liquidity asset purchase agreement).



# Volcker Rule – Loan Securitization Exemption

- ▶ The Final Regulations provide an exemption from covered fund status for certain issuers of securities in loan securitization transactions (the “*Loan Securitization Exemption*”).
- ▶ If a securitization vehicle meets the requirements of the Loan Securitization Exemption, it would not be a “*covered fund*” and none of the restrictions on the securitization activities of the banking entity would apply.
- ▶ The term “*loan*” is defined in Section 2(s) of the Final Regulations as “*any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative.*” To the extent that the assets acquired by the trust are limited to finance leases, they should qualify as loans under the Final Regulations.



# Volcker Rule – Loan Securitization Exemption (cont'd)

- ▶ A banking entity must evaluate whether the assets acquired by the trust are loans or securities under federal securities laws. The Supplementary Information related to the Final Regulations explains:
  - ▷ “the parties’ characterization of an instrument as a loan is not dispositive of its treatment under the federal securities laws or federal laws applicable to derivatives. The determination of whether a loan is a security or a derivative for purposes of the loan definition is based on the federal securities laws and the Commodity Exchange Act. Whether a loan is a “note” or “evidence of indebtedness” and therefore a security under the federal securities laws will depend on the particular facts and circumstances, including the economic terms of the loan.

## ➤ Rule 3a-7

- ▶ Rule 3a-7 under the Investment Company Act of 1940 (the “40 Act”) excludes issuers of asset-backed securities (ABS) from the definition of “investment company” upon the satisfaction of certain conditions, including:
  - ▷ being limited to issuers that do not issue “redeemable securities”,
  - ▷ the securities are rated in one of the four highest categories by a rating agency (or are sold to “accredited investors” or “qualified institutional buyers” as such terms are defined in the Securities Act of 1933),
  - ▷ the issuer is engaged in the business of holding financial assets, and
  - ▷ the issuer does not acquire or dispose of financial assets for the primary purpose of recognizing gains or decreasing losses resulting from market value changes.



## Rule 3a-7 (cont'd)

- ▶ In the event of the insolvency of a covered bond issuer, the covered pool assets are the only source of cash flow available to make payments to holders, similar to a securitization. The covered bonds are reliant on the cash flows from the covered pool to make such payments on the covered bonds, and the covered pool assets are assets that automatically convert to cash within a finite period of time, satisfying the definition of financial asset under Rule 3a-7.



## Rule 3a-7 (cont'd)

- ▶ Rule 3a-7 places restrictions on the purchase and disposal of issuer assets. Such actions may only be taken in if the following conditions are met:
  - ▷ (i) the action is taken in accordance with transaction terms or conditions set out in applicable transaction documents;
  - ▷ (ii) the action does not result in a ratings downgrade of the issuer's securities; and
  - ▷ (iii) the assets are not purchased or sold for the primary purpose of realizing a gain or decreasing a loss in market value.



## Risk Retention

- ▶ In October 2014, the SEC, FDIC, Federal Reserve, OCC, FHFA and HUD (the “Joint Regulators”) adopted a final rule (the “**Final Risk Retention Rule**”) implementing the requirements of Section 15G of the Exchange Act. Section 15G (which was added pursuant to Section 941 of the Dodd-Frank Act) required the Joint Regulators to prescribe regulations to:
  - ▷ (i) require any sponsor of asset-backed securities (“ABS”) to retain at least 5% of the credit risk related to that securitization; and
  - ▷ (ii) restrict the transfer, hedging or pledge of the risk that the sponsor is required to retain.



## Risk Retention (cont'd)

- ▶ The Final Risk Retention Rule became effective for all asset classes other than RMBS on December 24, 2016.
- ▶ A “sponsor” is the person who organizes and initiates an ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.
- ▶ A sponsor can satisfy risk retention by retaining:
  - ▷ Eligible Vertical Interest
  - ▷ Eligible Horizontal Residual Interest
  - ▷ Eligible Horizontal Cash Reserve Account





## Risk Retention (cont'd)

- ▶ Eligible Vertical Interest
  - ▷ a single vertical security (i.e., an ABS interest entitling sponsor to 5% of the principal and interest paid on each class of ABS interests in the issuing entity (other than such single vertical security)); or
  - ▷ 5% interest in each class of ABS interests issued as part of the securitization transaction; or
- ▶ Eligible Horizontal Residual Interest (“EHRI”)
  - ▷ must equal at least 5% of the ***fair value*** of all ABS interests
  - ▷ first-loss characteristic – most subordinated claim to payments of both principal and interest (i.e. any shortfalls must reduce the EHRI prior to any reduction in the amounts payable to any other ABS interest (whether through loss allocation, operation of the priority of payments, or other governing contractual provision (until the amount of such ABS interest is reduced to zero)); or



## Risk Retention (cont'd)

- ▶ Eligible Horizontal Cash Reserve Account
  - ▷ account is held by the trustee (or a person performing similar functions) in the name and for the benefit of the issuing entity
- ▶ The Final Risk Retention Rule requires that an EHRI be measured at fair value, using a fair value measurement framework under GAAP, rather than the initial principal balance of the retained interests. Under the Final Risk Retention Rule, a fair value calculation is not necessary for vertical retention.



# Regulatory and Legal Issues to Consider

## ▶ **Securities Law Issues**

- ▶ 4(a)(2) private placements – Suitability/Blue Sky
- ▶ Due Diligence and 3rd party reports 15Ga-2
- ▶ Rule 17g-5 (rated structures)
- ▶ Rule 15c2-12 (for conduit structures)

## ▶ **Bankruptcy Law Considerations**

- ▶ True Sale/Substantive Consolidation for unenhanced deals

## ▶ **Tax Considerations**

- ▶ Debt v. Equity – Gain Share and Termination Events
- ▶ Partnership reporting/2003-84
- ▶ PTP
- ▶ TMP

# ➤ Structuring Options for Pooled Securitizations

- ▶ Letter of Credit or Liquidity
- ▶ Bond Insurance
- ▶ CDO structure – subordinated residual

# ➤ Conduit Structures - Pros

- ▶ '40 Act exemption
- ▶ Risk Retention exemption (horizontal benefits)
- ▶ '33 Act exemption and increased liquidity for resale

# ➤ Conduit Structures - Cons

- ▶ Additional party
- ▶ Cost
- ▶ Rule 15c2-12 ongoing reporting



## Preston Hollow Transaction Overview

- Preston Hollow (the “Sponsor”) sold their bonds to a Preston Hollow SPV (the “Seller”), which in turn sold and delivered the Bonds to the Public Finance Authority (the “Issuer”)
- The proceeds of the Certificates were used to (i) purchase various municipal bonds from the Seller who, in turn, will purchase the Bonds from the Sponsor and (ii) pay certain costs of issuance of the Certificates

	Class A Certificates	Class B Certificates	Total
<b>Sources</b>			
Principal Amount	\$135,000,000	\$67,500,000	\$202,500,000
Original Issue Premium/(Discount)	(1,842,750)	3,019,937	1,177,187
Additional Sponsor Contribution	-	955,625	955,625
<b>Total Sources</b>	<b>\$133,157,250</b>	<b>\$71,475,562</b>	<b>\$204,632,812</b>
<b>Uses</b>			
Bond Portfolio Acquisition Price	\$132,194,804	\$67,397,046	\$199,591,850
Bond Portfolio Accrued Interest	-	3,122,891	3,122,891
Cost of Issuance	962,446	955,625	1,918,071
<b>Total Uses</b>	<b>\$133,157,250</b>	<b>\$71,475,562</b>	<b>\$204,632,812</b>



## Preston Hollow Transaction Overview

Portfolio Summary by Sector		
Sector	Par Amount	Percent of Portfolio
Special Assessment	\$101,245,000	50.0%
Student Housing	20,110,000	9.9
Public K-12	17,230,000	8.5
Skilled Nursing	16,060,000	7.9
Private Higher Education	16,000,000	7.9
Property Tax Increment	9,895,000	4.9
NFP Hospital	8,660,000	4.3
Hotel	7,150,000	3.5
Federal Qualified Health Clinic	6,150,000	3.0
	<b>\$202,500,000</b>	<b>100.0%</b>

Portfolio Summary by State/Jurisdiction		
State/Jurisdiction	Par Amount	Percent of Portfolio
Ohio	\$25,380,000	12.5%
New York	20,125,000	9.9
District of Columbia	20,110,000	9.9
Virginia	20,010,000	9.9
Georgia	20,000,000	9.9
Maine	20,000,000	9.9
Florida	18,145,000	9.0
Pennsylvania	17,230,000	8.5
North Dakota	16,060,000	7.9
New Jersey	16,000,000	7.9
Texas	7,150,000	3.5
California	2,290,000	1.1
	<b>\$202,500,000</b>	<b>100.0%</b>





## Rated Structures (Can Be Conduit or Non-Conduit)

- ▶ Single name TOB and 3rd party programs
- ▶ Static Multi-name Term TOB structures, Credit Enhanced (Types of Credit Enhancement, LOCs/Bond Insurance)
- ▶ Static Multi-name Term TOB structures, rated with muni-CDO criteria
- ▶ Managed Multi-name Term TOB Structures

# ➤ Unrated Structures

- ▶ Single and Multi-name Term A/B
- ▶ TRS
- ▶ Participations

# ➤ Case Study

## Tax-Exempt Pool Certificates (Standby Letter of Credit Enhanced)

- ▶ \$15,440,000 Class A Certificates
  - ▷ 6 month tenor; assigned a rating of “A-1” by S&P; SIFMA plus .50%
- ▶ \$33,725,000 Class B Certificates
  - ▷ 1 year tenor; assigned a rating of “A+” by S&P; SIFMA plus .65%
- ▶ \$59,600,000 Class C Certificates
  - ▷ 3 year tenor; assigned a rating of “A+” by S&P; SIFMA plus 1.05%
- ▶ \$7,935,000 Class D Certificates
  - ▷ 5 year tenor; assigned a rating of “A+” by S&P; SIFMA plus 1.25%



# Case Study

## Tax-Exempt Pool Certificates (Standby Letter of Credit Enhanced)

### General Overview of the Pool

Principal Amount	\$116,710,728.03
Weighted Average Coupon	2.9073%
Average Life	1.35 years
Tranche A Average Life	0.23 years
Tranche B Average Life	0.60 years
Tranche C Average Life	1.78 years
Tranche D Average Life	3.50 years
Largest Single Obligor Concentration	\$3,653,731.35 (3.13%)
Smallest Single Obligor Concentration	\$21,409.68 (0.02%)
Average Transaction Size	\$203,328.79 (0.17%)
Fixed Rate Asset Percentage	100%
Number of Transactions	574



# Case Study

## Tax-Exempt Pool Certificates (Standby Letter of Credit Enhanced)

### Portfolio Composition By Geographic Distribution

STATE	AMOUNT (IN USD)	PERCENTAGE
PA	11,305,898.09	9.6953%
CA	8,760,523.85	7.5125%
OH	8,585,661.37	7.3626%
IL	6,795,835.72	5.8277%
KS	6,131,513.06	5.2580%
AL	5,885,639.44	5.0472%
IN	5,678,045.16	4.8692%
NC	5,531,615.42	4.7436%
MN	4,568,939.94	3.9181%
TX	4,344,762.95	3.7258%
NJ	4,105,488.21	3.5206%
WI	4,104,738.63	3.5200%
MO	3,941,892.50	3.3803%
MI	2,874,732.71	2.4652%
WA	2,451,977.38	2.1027%
AR	2,170,277.68	1.8611%
IA	2,140,078.69	1.8352%
AZ	2,061,600.25	1.7679%
NY	1,989,898.52	1.7064%
DE	1,790,417.02	1.5354%
LA	1,758,371.48	1.5079%
CT	1,731,555.50	1.4849%
OK	1,666,083.07	1.4287%
OR	1,597,780.07	1.3702%



# Case Study

## Tax-Exempt Pool Certificates (Standby Letter of Credit Enhanced)

### Portfolio Composition By Geographic Distribution

STATE	AMOUNT (IN USD)	PERCENTAGE
SD	1,371,087.30	1.1758%
SC	1,289,699.15	1.1060%
HI	1,196,947.04	1.0264%
CO	1,158,010.80	0.9930%
MD	1,157,389.04	0.9925%
GA	1,111,952.33	0.9535%
TN	1,078,309.35	0.9247%
MS	847,140.76	0.7265%
WV	843,640.37	0.7235%
NE	787,821.56	0.6756%
VA	705,906.87	0.6053%
MT	556,446.38	0.4772%
MA	545,672.22	0.4679%
ME	481,425.26	0.4128%
FL	385,222.89	0.3303%
ND	376,729.01	0.3231%
VT	221,548.79	0.1900%
NH	160,961.88	0.1380%
KY	123,810.50	0.1062%
NV	100,100.49	0.0858%
RI	83,808.14	0.0719%
DC	55,206.20	0.0473%
TOTAL	116,710,728.03	100.00%



# Case Study

## 2016 Tax-Exempt Pool Certificates (Standby Letter of Credit Enhanced)

### Segment Overview by Description of Financing

	CLEAN TECHNOLOGY GROUP	FINANCIAL INSTITUTIONS	HEALTHCARE	MATERIALS HANDLING AND CONSTRUCTION	OFFICE EQUIPMENT	PUBLIC FINANCE	TECHNOLOGY FINANCE
Remaining Balance (by Dollar Amount)	\$957,007.54	\$464,688.36	\$5,432,871.78	\$15,841,109.68	\$22,572,094.84	\$5,667,136.47	\$65,677,254.38
Remaining Balance (by Percentage)	0.8207%	0.3985%	4.6589%	13.5844%	19.3566%	4.8598%	56.3211%
Number of Transactions	3	4	16	97	168	31	255
Weighted Average Coupon	2.7584%	2.5728%	2.4894%	2.5535%	3.1081%	2.5734%	1.4650%
Average Transaction Size (by Balance)	\$319,002.51	\$116,172.09	\$339,554.49	\$163,310.41	\$134,357.71	\$182,810.85	\$257,557.86
Average Transaction Size (by Percentage)	0.2733275%	0.0995385%	0.2909368%	0.1399275%	0.1151203%	0.1566359%	0.2206805%

# ▶ Proposed CDO Securitization

## 2010 Tax-Exempt Assets Pool CDO (Multistate Non-AMT)

- ▶ \$95,000,000 Class A-1 Certificates: 2.00%
  - ▷ First in line for distributions of principal; preliminary rating of “AAA”
- ▶ \$80,000,000 Class A-2 Certificates: 3.25%
  - ▷ Second in line for distributions of principal; preliminary rating of “AAA”
- ▶ \$135,000,000 Class A-3 Certificates: 4.125%
  - ▷ Third in line for distributions of principal; preliminary rating of “AAA”
- ▶ \$88,000,000 Class B Certificates: 5.125%
  - ▷ Fourth in line for distributions of principal; preliminary rating of “A+”
- ▶ \$115,000,000 subordinated residual; not rated



# ➤ Proposed CDO Securitization

## Tax-Exempt Assets Pool CDO (Multistate Non-AMT)

### General Overview of the Pool

<b>Principal Amount</b>	<b>\$476,466,766</b>
<b>Weighted Average Coupon</b>	<b>4.94%</b>
<b>Average Life</b>	<b>13.65 years</b>
<b>Largest Single Obligor Concentration</b>	<b>\$38,905,000 (8.17%)</b>
<b>Smallest Single Obligor Concentration</b>	<b>\$615,328 (0.13%)</b>
<b>Average Transaction Size</b>	<b>\$6,617,594 (1.39%)</b>
<b>Fixed Rate Asset Percentage</b>	<b>100.00%</b>

# ➤ Proposed CDO Securitization

## Tax-Exempt Assets Pool CDO (Multistate Non-AMT) General Segment Overview

	PUBLIC BONDS	PRIVATE BONDS	PRIVATE LOANS/LEASE S
Remaining Balance	\$199,175,000	\$158,410,952	\$118,880,814
Percentage of Portfolio	41.80%	33.25%	24.95%
Number of Transactions	19	12	41
Weighted Average Coupon	4.87%	5.00%	4.99%
Weighted Average Maturity	23.02 years	12.80 years	14.17 years
Average Transaction Size	\$10,482,895	\$13,200,913	\$2,899,532

# Proposed CDO Securitization

## Tax-Exempt Assets Pool CDO (Multistate Non-AMT) Segment Overview by Borrower Type

	HEALTHCARE	GOVERNMENT SUPPORT	WATER AND SEWER	PRIVATE SCHOOLS AND UNIVERSITIES	RADIO AND TELEVISION	UTILITY	HOUSING
Remaining Balance	\$200,118,251	\$140,734,067	\$47,958,497	\$37,375,000	\$21,998,848	\$14,997,595	\$13,284,508
Number of Transactions	36	20	8	2	2	2	2
Weighted Average Coupon	5.36%	4.54%	4.63%	4.42%	5.21%	4.91%	5.02%
Weighted Average Maturity	17.58 years	19.67 years	22.23 years	15.21 years	12.50 years	13.64 years	18.03 years
Average Transaction Size (by Balance)	\$5,558,840	\$7,036,703	\$5,994,812	\$18,687,500	\$10,999,424	\$7,498,798	\$6,642,254
Average Transaction Size (by Percentage)	2.78%	5.00%	12.50%	50.00%	50.00%	50.00%	50.00%

# ➤ Proposed CDO Securitization

## Tax-Exempt Assets Pool CDO (Multistate Non-AMT) Portfolio Composition by Geographic Distribution

STATE	AMOUNT	PERCENTAGE
California	\$150,865,138	31.66%
Texas	62,005,000	13.01%
Montana	38,905,000	8.17%
Wisconsin	32,370,000	6.79%
Nevada	25,695,000	5.39%
Missouri	20,945,000	4.40%
Oklahoma	19,500,000	4.09%
Iowa	17,110,000	3.59%
Florida	14,474,304	3.04%
Other	94,597,324	19.86%
Total	\$476,466,766	100.00%

## Certain Attributes and Legal Considerations

### Structure Type

	Single-name TOB	Pooled Term A/B (non-muni)	Pooled Term A/B (muni)	Total Return Swaps	Participations
<b># of Bonds or Loans</b>	1	3-20	3-20	1	1 or more
<b>Target Investors</b>	Banks, Funds, HNW	Banks, Funds, HNW	Banks, Funds, HNW	Banks & Lenders	Banks & Lenders
<b>Volcker Rule</b>	Yes	Yes	No	No	No
<b>Risk Retention</b>	Yes	Yes	No	No	No
<b>Tax Structure</b>	Partnership	Partnership	Partnership	NPC	Pass-through / Partnership / Strip
<b>Conflicts Rule</b>	Yes	Yes	Yes	No	No
<b>BOI Rule</b>	Yes	Yes	No	No	No
<b>Ongoing Reporting or filings</b>	No	Depends on Structure	Depends on Structure	No	No



**Questions?**

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