MSRB
Municipal Securities Rulemaking Board

MUNICIPAL MARKET ISSUE BRIEF

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Possible Redemption of Build America Bonds

Recently, there have been several new issue refunding deals used to redeem Build America Bonds (BABs). There have also been news reports indicating that there could be more transactions of this type in the near future. This educational piece is intended to make individual investors and market professionals aware of the possibility of BABs being redeemed and what they might encounter when buying or selling BABs. The MSRB is providing this information to help individual investors and market professionals make more informed investment decisions.

BABs are taxable municipal securities issued from April 2009 to December 2010 under the American Recovery and Reinvestment Act of 2009 as direct pay subsidy[1] bonds or tax credit bonds.[2] For BABs issued as direct pay bonds, most of which were, the federal government agreed to provide a 35% subsidy to the issuer for the interest paid. This made them advantageous to issuers. However, because of the automatic spending reductions imposed by repeated episodes of government sequestration, that rate has been reduced each year since 2013, with the current subsidy down 5.7% to a rate of 33%.[3]

IMPACT OF BAB REDEMPTION PROVISIONS

Tax-exempt municipal securities are typically issued with an optional call feature that gives the issuer the ability to call the bonds after a specified date at a specified price, typically par or at a slight premium. However, since BABs are taxable securities, a significant number of issues had a "make-whole call" provision.[4] This is a common type of call feature in the corporate bond market but not in the tax-exempt portion of the municipal market prior to the issuance

[1] Direct pay subsidy is a federal cash subsidy paid directly to the issuer of municipal securities in an amount that may be equal to a percentage of the interest paid on the municipal securities. Such subsidy is typically provided in lieu of the exemption from gross income for federal income tax purposes of the bondholders of such municipal securities. *See* MSRB Glossary of Municipal Securities Terms (Third Edition, August 2013) at 32.

[2] Tax credit bonds are municipal securities that entitle the bondholder to receive, in lieu of interest payments, a credit against federal income tax. *See* MSRB Glossary of Municipal Securities Terms (Third Edition, August 2013) at 99.

[3] *See* Internal Revenue Service, Effect of Sequestration on State & Local Government Filers of Form 8038-CP at https://www.irs.gov/tax-exempt-bonds/effect-of-sequestration-on-state-local-government-filers-of-form-8038-cp.

[4] In general terms, a make-whole call is a type of call provision allowing the issuer to pay off debt early that is designed to protect the investor from losses as a result of the earlier call. In order to exercise the call, the issuer must make a lump sum payment derived from a formula based on the net present value of future interest payments that will not be paid as a result of the call. Because the cost can often be significant, such provisions are rarely used. *See* MSRB Glossary of Municipal Securities Terms (Third Edition, August 2013) at 59.

of BABs. Make-whole calls are often significantly more costly because of the higher payment required, and therefore, less advantageous to issuers. As such, many BABs remain outstanding because of the high cost to redeem the bonds early through a make-whole call.

Many securities issued with optional calls or make-whole calls may also have an extraordinary redemption provision (ERP). An ERP is a mandatory or optional redemption triggered by the occurrence of certain one-time or extraordinary events specified in the bond indenture.

Recently, there have been a number of tax-exempt refunding bond offerings from which the proceeds have been used to redeem BABs through ERPs. In these transactions, the reduction in the federal subsidy for the BABs, as described above, has been cited as the reason for the bonds being redeemed through the ERP, which typically is significantly less costly to issuers than make-whole calls.

Whether an ERP can be used to redeem a particular outstanding issue of BABs is likely based upon the specific ERP language in the bond indenture for each issue, and such language may vary significantly from issue to issue. As a result of such differences, some BABs may be more likely to be called than others. The terms of the ERPs can generally be found in the official statement describing the BABs at the time they were issued.

Prior to these ERP-based refunding offerings coming to market, many of these BABs were trading in the secondary market at a significant premium to par. The redemption at par or at a slight premium will typically cause investors whose bonds were trading at significant premiums to incur losses, whether from the price at which the investor purchased the bonds or from the evaluated price at which the bonds were valued in the investor's portfolio.

MSRB Rule G-15 requires brokers, dealers, and municipal securities dealers (dealers) to display on the trade confirmation provided to an investor buying or selling a bond its yield at the lower of either yield to maturity[5] or yield to a call.[6] This is generally referred to as the yield-to-worst calculation and is the same yield the MSRB displays on the Electronic Municipal Market Access (EMMA®) website. However, the calculation of the required yield disclosure does not take into account ERPs, with the rule requiring dealers to consider only those call features that represent "in whole calls" of the type that may be used by the issuer without restriction in a refunding ("pricing calls").[7] Due to the restrictions related to an ERP, the ERP call is not used in the calculation of yield or dollar price. This means yield to the ERP typically is not included in a customer's confirmation or account statement, nor is it reflected on the EMMA website.

In looking at the trade history for BABs, the MSRB has seen a number of BABs trading in the secondary market at a significant premium to par, which could reflect the trading participants' belief that an ERP is unlikely to be used to redeem those securities. Investors should be aware of the risk that BABs could, depending on the specific terms of the bonds, be called pursuant to an ERP. This could result in a loss, particularly for investors who purchase the BABs at a premium.

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5 Yield to maturity is the rate of return to the investor earned from payments of principal and interest, with interest compounded semi-annually at the stated yield, presuming that the security remains outstanding until the maturity date. Yield to maturity takes into account the amount of the premium or discount at the time of purchase, if any, and the time value of the investment. *See* MSRB Glossary of Municipal Securities Terms (Third Edition, August 2013) at 112.

6 Yield to call is the rate of return to the investor earned from payments of principal and interest, with interest compounded semi-annually at the stated yield, presuming that the security is redeemed on a specified call date (if the security is redeemed at a premium call price, the amount of the premium is also reflected in the yield). Yield to call takes into account the amount of the premium or discount at the time of purchase, if any, and the time value of the investment. *See* MSRB Glossary of Municipal Securities Terms (Third Edition, August 2013) at 112.

7 *See* MSRB Rule G-15(a)(i)(A)(5)(c)(ii).

The likelihood that any individual security will be redeemed through an ERP is generally dependent on many factors. These include the interest rates at which issuers can issue new tax-exempt debt, the amount of cash or cash equivalents an issuer has, and the specific language related to the ERP for the individual security, which is likely to be different for different issuers and issues. Investors should contact their financial professional with any questions about the likelihood that bonds they own, or are considering purchasing, may be called.

OBLIGATIONS OF FINANCIAL PROFESSIONALS

Your financial professional has various duties under MSRB rules or other securities laws that will generally obligate them to take into consideration the unique circumstances and potential impacts of ERPs in connection with such bonds. If your financial professional is a dealer, they have duties to investors that include certain disclosure and pricing obligations under MSRB rules, with additional investor protection duties for transactions recommended to retail investors under the Securities and Exchange Commission's Regulation Best Interest, or to institutional investors under the MSRB's suitability rule.

In meeting these obligations, dealers must take into account all material information they know, or that is reasonably accessible to the market, including information in official statements, continuing disclosures, and trade data available through the EMMA website. Dealers must also obtain, analyze and disclose certain material information about a bond, including but not limited to whether the bond may be redeemed prior to maturity in-whole, in-part or in extraordinary circumstances, or whether the bond has non-standard features that may affect price or yield calculations. In particular, dealers should take care with respect to outstanding securities that may have unusual features. Furthermore, dealers have a duty to ensure that the prices at which bonds are bought or sold are fair and reasonable in relation to the prevailing market price of the bond.

If your financial professional is an investment adviser, they have a fiduciary duty to you under applicable state or federal law in connection with their investment advice to you, which also generally entails disclosure and pricing obligations. You should not hesitate to contact your financial professional to discuss these and other matters relating to your holdings or potential transactions in BABs.