

LIVE AND LET DIE: PEELING BACK ON MUNICIPAL BOND REGULATION AFTER THE 2008 FINANCIAL CRISIS

Heita Miki*

Municipal bonds have traditionally been considered, rightly or wrongly, mundane assets that require little regulation. However, the most recent financial crisis did not leave municipal bonds untouched. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and liquidity requirements for banks, enacted in response to the 2008 financial crisis, have had far-reaching effects in the banking industry as well as the municipal bond market. While the registration requirements for municipal advisors have garnered much attention, other provisions may negatively impact the liquidity of the municipal bond market and raise the costs of raising capital for municipalities.

This Note focuses on three provisions, all of which increase the cost of raising capital for municipalities without a meaningful improvement in the safety of the banking system: the Liquidity Coverage Ratio, the Volcker Rule, and the Risk Retention Rule. Secondly, this Note makes mitigating suggestions. This Note concludes that the most liquid municipal bonds should qualify as eligible for high-quality liquid asset status, which would be consistent with international standards. Additionally, exemptions should be granted under the Volcker Rule and the risk retention provisions for tender option bonds.

* J.D. Candidate 2016, Columbia Law School; B.A. 2010, Dartmouth College. Many thanks to Professor Kathryn Judge for providing invaluable guidance and insight throughout the process of writing this Note. Additional thanks to the exceptional staff and the editorial board of the *Columbia Business Law Review* for their hard work in preparing this Note for publication, and to my family and friends for their support in my endeavors. All errors are my own.

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I. INTRODUCTION

The 2008 financial crisis ushered in a wave of new regulations designed to ensure the stability of the financial

system.¹ In the United States, the enactment and implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) and the regulations inspired by Basel III² to strengthen supervision and risk management in the banking sector have had far-reaching effects. One such area affected, the municipal bond market, traditionally had been subject to little regulation. Part of this might have been due to the perception that municipal bonds are boring, safe investments—Professor Theresa Gabaldon once referred to municipal securities regulation as the “antithesis of sexy,” with a “powerful soporific effect.”³

This Note explores new bank regulations relating to municipal bonds and synthetic derivatives involving municipal bonds promulgated after the 2008 financial crisis. The analysis focuses on (i) regulations passed as a part of the Dodd-Frank Act and (ii) liquidity regulations modeled on Basel III. These regulations affect the participation rate of banks in the municipal bond market, which in turn influences the liquidity of the municipal bond market and

¹ See Ema Clark, *The Dodd-Frank Act and Municipal Securities Regulation, Developments in Banking and Financial Law: 2011*, 30 REV. BANKING & FIN. L. 494, 497–98 (2011); CADMUS HICKS, NUVEEN ASSET MGMT., LLC, REGULATORY DEVELOPMENTS AFFECTING MUNICIPAL BONDS 1 (Jan. 2014).

² Basel III is a

comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision, and risk management of the banking sector. These measures aim to improve the banking sector’s ability to absorb shocks arising from financial and economic stress, whatever the source; improve risk management and governance; [and] strengthen banks’ transparency and disclosures.

International Regulatory Framework for Banks (Basel III), BANK FOR INTERNATIONAL SETTLEMENTS, <http://www.bis.org/bcbs/basel3.htm> [http://perma.cc/Y7C5-J8VE].

³ See Theresa A. Gabaldon, *Financial Federalism and the Short, Happy Life of Municipal Securities Regulation*, 34 J. CORP. L. 739, 740 (2009).

the financing costs for municipalities.⁴ Unlike the markets for U.S. government securities and corporate bonds, which are “dominated by a wide variety of institutional investors,” the municipal bond market is largely retail-oriented.⁵ Thus, investors in the over-the-counter municipal bond market depend to a high degree on “robust market-making and liquidity intermediation activity by municipal bond dealers, the largest of which are banking entities.”⁶ Further, municipal bond issuances have skyrocketed in the last several decades, increasing this level of dependence. The size of the municipal bond market has exploded from \$49 billion in 1975⁷ to \$3.7 trillion in 2011.⁸ Banks have become a larger player in the municipal bond market as well; banks held \$416.4 billion of municipal bonds in 2013, almost double their holdings from 2009.⁹ Thus, how banks are regulated in the municipal bond market is important.

This Note considers three regulations with a potential impact on the municipal bond market: (i) the Liquidity Coverage Ratio (“LCR”) requirement¹⁰; (ii) Section 619 of the Dodd-Frank Act, commonly known as the Volcker Rule¹¹; and (iii) Section 15G of the Securities Exchange Act of 1934 (the “Risk Retention Rule”), also part of the Dodd-Frank Act.¹²

⁴ See Citibank Glob. Mkts. Inc., Comment Letter on Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds 2 (Jan. 27, 2012), <https://www.sec.gov/comments/s7-41-11/s74111-91.pdf> [<https://perma.cc/2S4F-SH3U>].

⁵ *Id.* at 1.

⁶ *Id.* at 1–2.

⁷ See Gabaldon, *supra* note 3, at 740 (stating that “\$25 to \$49 billion of municipal securities were outstanding” in 1975).

⁸ See U.S. SEC. & EXCH. COMM’N, REPORT ON THE MUNICIPAL SECURITIES MARKET i (July 31, 2012), <https://www.sec.gov/news/studies/2012/munireport073112.pdf> [<https://perma.cc/JS4A-7295>].

⁹ See Lynn Hume, *Citi: Why Most Munis Are Liquid*, THE BOND BUYER, Apr. 10, 2014, at 1.

¹⁰ See 12 C.F.R. §§ 329.10, 329.20–.22 (2015).

¹¹ See Dodd-Frank Act § 619, 12 U.S.C. § 1851 (2012).

¹² See Dodd-Frank Act § 941(b), 15 U.S.C. § 78o-11 (2012)..

The three regulations may result in higher transaction costs without a meaningful improvement in the safety of the financial system. First, the LCR requirement discourages banks from holding municipal bonds by stipulating that municipal bonds will not be counted towards a bank's stockpile of liquid assets. The LCR requires banks hold a certain amount of High-Quality Liquid Assets ("HQLAs"), in order to meet their obligations in times of financial crises.¹³ Initially, no municipal bonds qualified as HQLAs, prompting concern that banks would be less inclined to participate in the municipal bond market if ineligible for HQLA qualification, which would result in increased borrowing costs for municipalities.¹⁴ In the first half of 2015, the Federal Reserve (the "Fed"), acting unilaterally, submitted a proposal to consider certain municipal bonds as HQLAs, but the Office of the Comptroller of the Currency (the "OCC") and the Federal Deposit Insurance Corporation (the "FDIC") have declined to follow the Fed.¹⁵ A bipartisan coalition led

¹³ See Ryan Tracy, *U.S. Regulators Tweak Final Liquidity Rule for Large Banks*, WALL ST. J. (Sept. 3, 2014), <http://www.wsj.com/articles/u-s-regulators-tweak-final-liquidity-rule-for-large-banks-1409753404> [<http://perma.cc/T3HM-4FPZ>].

¹⁴ See Andrew Ackerman, *Fed Will Consider Adding Municipal Debt as Quality Asset*, WALL ST. J. (Sept. 3, 2014), <http://blogs.wsj.com/moneybeat/2014/09/03/fed-will-consider-adding-municipal-debt-as-quality-asset> [<http://perma.cc/UZR5-2J87>] ("States and localities have warned excluding their securities could cause banks to retreat from the municipal market in which they have increasingly become an important player State Treasurers and other officials say their costs to finance roads, schools and bridges could jump if banks retreat from the market—costs that will ultimately be borne by taxpayers.").

¹⁵ See Liquidity Coverage Ratio: Treatment of U.S. Municipal Securities as High-Quality Liquid Assets, 80 Fed. Reg. 30,383, 30,385 (proposed May 28, 2015) (to be codified at 12 C.F.R. pt. 249); Andrew Ackerman & Victoria McGrane, *Fed Is Expected to Shift on Muni Bonds*, WALL ST. J. (Apr. 16, 2015), <http://www.wsj.com/articles/fed-is-expected-to-shift-on-muni-bonds-1429232200> [<http://perma.cc/7YFM-AMTA>] ("[T]he Fed's decision is only a partial victory for the banks, state officials and lawmakers who had pushed for the change. The other two regulators, the [OCC] and the [FDIC], currently don't plan to follow the Fed, people with knowledge of those agencies said.").

by Rep. Luke Messer (R-Ind.) and Rep. Carolyn Maloney (D-N.Y.) have also introduced legislation that would allow some municipal bonds, only those which are investment grade and actively traded in the secondary market, to be considered in the same tier as some sovereign debt and claims on U.S. government-sponsored entities (“GSEs”) like Fannie Mae and Freddie Mac for the purposes of evaluating liquidity.¹⁶ Messer and Maloney’s bill, H.R. 2209, was passed by the House with unanimous bipartisan support on February 1, 2016.¹⁷

Second, the Volcker Rule influences financing costs for municipalities by imposing restrictions on tender option bonds (“TOBs”)—synthetic derivative instruments involving municipal bonds. The agency regulation implementing the Volcker Rule restricts banks’ investments in “covered funds.”¹⁸ The Volcker Rule classifies TOBs as “covered funds,” putting TOBs in the same risk category as investments in hedge funds and private equity funds and effectively preventing banks from sponsoring TOBs.¹⁹ Municipalities could face higher issuance costs as municipalities lose a source of demand for their bonds, though banks have been working to propose alternative TOB structures to sidestep the Volcker Rule provisions.²⁰ The financial regulators responsible for implementing the Volcker Rule also contemplated that a subset of municipal

¹⁶ See H.R. 2209, 114th Cong. (2015).

¹⁷ Press Release, U.S. Congressman Luke Messer for the 6th Dist. of Ind., House passes Messer-Maloney Bill to Encourage Investment in Local Communities (Feb. 1, 2016) (on file with author).

¹⁸ See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536, 5538 (Jan. 31, 2014) (to be codified at 12 C.F.R. pts. 44, 248, 351, 17 C.F.R. pt. 255).

¹⁹ See Liz Farmer, *What the Volcker Rule Means for the Municipal Market*, GOVERNING (Dec. 18, 2013), <http://www.governing.com/topics/finance/gov-what-the-volcker-rule-means-for-the-municipal-market.html> [<http://perma.cc/2RFY-7XAG>].

²⁰ See *id.*

bonds be ineligible for proprietary trading, but abandoned this interpretation in their final rule.²¹

Finally, the Risk Retention Rule also influences the market for TOBs.²² The Risk Retention Rule stipulates that a sponsor or a securitizer of an asset-backed security (“ABS”) must retain at least five percent of the credit risk of assets collateralizing the issuance of the ABS.²³ Despite opposition from industry officials, the final rule passed in October 2014 includes TOBs within the definition of an ABS.²⁴ Sponsors of TOBs would be required to retain at least a five percent interest in the TOBs, which would increase the costs of TOB issuances.²⁵

This Note argues that regulations promulgated since the financial crisis do not meaningfully create a sounder financial system, and only result in higher costs of raising capital for municipalities. This Note proposes that the most liquid municipal bonds be treated as HQLAs, that the Volcker Rule prohibition on covered funds exempt TOBs, and that TOBs also be exempt from the Risk Retention Rule. This Note does not delve deeply into the technical details relating to how TOBs are structured; instead, it attempts to explore the different ways in which municipal bonds are treated within the framework of the Dodd-Frank Act.

The Note proceeds as follows: Part II begins with a brief background regarding the municipal bond market and the recent heightened scrutiny on municipal bonds and defines a TOB. Part III describes the three new regulations: the LCR, the Volcker Rule, and the Risk Retention Rule. Part IV

²¹ See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. at 5645–46.

²² See Joyce J. Gorman, *Regulators Decline to Exempt TOBs from Risk Retention Rule but Add Helpful Revisions and Clarifications*, BALLARD SPAHR LLP (Oct. 31, 2014) <http://www.ballardspahr.com/alertspublications/legalalerts/2014-10-31-regulators-decline-to-exempt-tobs-from-risk-retention-rule-but-add-helpful-revisions.aspx> [http://perma.cc/9YEH-MAUH].

²³ See *id.*

²⁴ See *id.*

²⁵ See *id.*

analyzes whether these regulations are sensible and meaningfully advance the safety of the financial system. In conclusion, this Note finds that the regulations are not sensible as they do not meaningfully make the financial system safer. Part V provides recommendations for modifications. Part VI concludes.

II. BACKGROUND

A. The Municipal Bond Market

Historically, the municipal bond market, despite its size and importance, has not been subject to stringent regulation.²⁶ Municipal bonds—“debt securities issued by states, cities, counties, and other governmental entities to finance capital projects, such as building schools, highways or sewer systems, and to fund day-to-day obligations”²⁷—remained mostly unregulated, even after the Great Depression, because issuers, almost all of which are nonfederal governments, strongly resisted federal regulation.²⁸ The only noteworthy regulatory change before the 2008 financial crisis came in 1975, when Congress created the Municipal Securities Regulation Board (“MSRB”) in response to the near-bankruptcy of New York City.²⁹ However, even in establishing the MSRB, Congress constrained its power by not giving the MSRB enforcement powers of its own.³⁰ Despite the historically relaxed approach to regulation, the municipal bond market is huge today, with the total aggregate principal amount of municipal bonds outstanding estimated to be around \$3.7 trillion as of year-

²⁶ See generally U.S. SEC. & EXCH. COMM’N, *supra* note 8, at ii.

²⁷ See *Investor Bulletin: Focus on Municipal Bonds*, U.S. SEC. & EXCH. COMM’N (Sept. 20, 2010), <http://www.sec.gov/investor/alerts/municipal.htm> [<http://perma.cc/GQX9-732M>].

²⁸ See Philip Grommet, *A Call for Action: An Analysis of the Impending Regulatory Crisis in the Municipal Securities Market*, 38 J. LEGIS. 237, 245 (2012).

²⁹ See Clark, *supra* note 1, at 494–95.

³⁰ See *id.* at 495.

end 2011.³¹ Banks have come to occupy a larger share of the municipal bond market as well, with banks holding \$416.4 billion of municipal securities in the year 2013, almost double from 2009.³²

B. Recent Heightened Scrutiny of the Municipal Bond Market

Recent events have called into question the market's safety and security, which has brought about heightened regulatory scrutiny. Beginning with the 2008 financial crisis, municipal bonds began to default at a record pace.³³ There have been a number of high-profile municipal bankruptcies with Stockton, California, San Bernardino, California, and Detroit among the municipalities declaring bankruptcy in the last few years.³⁴ Other municipalities, such as Chicago and Los Angeles, face a growing burden from unfunded pension liabilities.³⁵ None other than legendary investor Warren Buffett has warned that large-scale defaults for municipalities may be looming.³⁶ At the state level in the

³¹ See U.S. SEC. & EXCH. COMM'N, *supra* note 8, at i.

³² See Hume, *supra* note 9.

³³ See Clark, *supra* note 1, at 497 n.27 (citing Tesia Nicole Stanley, *Narrowing the Disclosure Gap: Is Emma Edgar for the Municipal Securities Market?*, 7 J.L. ECON. & POL'Y 91, 96 (2010) ("In 2008, 136 defaults were recorded, totaling a record high of \$7.5 billion."); see also Lisa Anne Hamilton, *Canary in the Coal Mine: Can the Campaign for Mandatory Climate Risk Disclosure Withstand the Municipal Bond Market's Resistance to Regulatory Reform?*, 36 WM. MITCHELL L. REV. 1014, 1018 (2010).

³⁴ See Opinion, *The Muni Bond Lobby*, WALL ST. J. (Sept. 22, 2014), <http://www.wsj.com/articles/the-muni-bond-lobby-1411426709> [<http://perma.cc/M8DF-2G7D>].

³⁵ See *id.*

³⁶ See Tom Petrino, *Buffett Warns (Again) on Muni Bond Risks, but What's Your Time Horizon?*, L.A. TIMES: MONEY & COMPANY BLOG (June 2, 2010, 6:14 PM), http://latimesblogs.latimes.com/money_co/2010/06/warren-buffett-muni-bonds-warning-terrible-problem-angelides-moodys-fcic.html [<http://perma.cc/3R2A-J9FY>].

short term, annual expenditures outpace annual revenues,³⁷ and in the long term, sizable and growing public pension and healthcare obligations are causing fiscal stress.³⁸

Furthermore, the 2008 financial crisis fundamentally changed the municipal bond market. Pre-crisis, nearly fifty percent of municipal bonds were backed by monoline insurance³⁹ providers, who guaranteed the principal and the interest payments with a “credit wrap.”⁴⁰ Because municipal bonds generally had low default rates, monoline insurers had to have AAA credit ratings—what good is an AA-rated monoline guarantee on an already AA-rated bond?⁴¹ However, in 2008, the monoline insurance industry began to unravel as monoline insurers had to cover huge claims on mortgage derivatives.⁴² As monoline insurers’ credit ratings were downgraded, they were no longer able to take on new

³⁷ See PHIL OLIFF, CHRIS MAI & VINCENT PALACIOS, CTR. ON BUDGET & POL’Y PRIORITIES, STATES CONTINUE TO FEEL RECESSION’S IMPACT (2012), <http://www.cbpp.org/files/2-8-08sfp.pdf> [<http://perma.cc/F3R7-SUP9>] (discussing state budget shortfalls).

³⁸ See LUCY DADAYAN & DONALD J. BOYD, NELSON A. ROCKEFELLER INST. OF GOV’T, STATE REVENUE REPORT: STATE TAX REVENUES GAINED NEW STRENGTH IN FOURTH QUARTER 20 (2011), http://www.rockinst.org/pdf/government_finance/state_revenue_report/2011-02-01-SRR_82.pdf [<http://perma.cc/C23T-NJAH>] (“Elements driving this still cloudy outlook include expiration of federal stimulus money and expenditure trendlines that would produce increases beyond the level of available revenues. States will continue to search for ways to climb out of a very deep hole.”); Damian Paletta & Matt Phillips, *S&P Strips U.S. of Top Credit Rating*, WALL ST. J., Aug. 7, 2011, at A1 (“Recent demographic and economic changes, in particular the aging population and ballooning health-care costs, have made the long-term U.S. picture an ugly one . . .”).

³⁹ Monoline insurance is a type of insurance that protects against the risk that a bond or other security will default. If a bond is “wrapped,” or covered by high-quality monoline insurance, the issuer gets the benefit of a “top-notch” credit rating. Gillian Tett, *How Monoline Market Works*, FIN. TIMES, Nov. 16, 2008, <http://www.ft.com/cms/s/0/4465d6c8-93e5-11dc-acd0-0000779fd2ac.html#axzz3r8gbgdmV> [<http://perma.cc/ZSZ5-S5GV>].

⁴⁰ See WELLS FARGO FUNDS MGMT., LLC, DETERIORATION OF MONOLINE INSURANCE COMPANIES AND THE REPERCUSSIONS FOR MUNICIPAL BONDS 3 (2008).

⁴¹ See *id.* at 6.

⁴² See *id.*

business. By 2010, monoline insurance covered only seven percent of municipal bonds.⁴³

Despite the downfall of monoline insurers and heightened concerns about the finances of municipalities, the track record of municipal bonds remains stellar, particularly in comparison to corporate bonds, and municipal bond credit ratings remain high independent of monoline insurance availability.⁴⁴ Historically, municipal bonds have had significantly lower rates of default than corporate bonds and foreign government bonds—municipal bonds rated “Baa/BBB” or higher all have lower default rates than “Aaa/AAA”⁴⁵ rated corporate bonds.⁴⁶ The Moody’s ten-year average cumulative default rate was 0.1032% from 1970 to

⁴³ See *Ambac’s Fall: And Then There Was One*, THE ECONOMIST (Nov. 4, 2010) <http://www.economist.com/node/17420088> [<http://perma.cc/DV5E-EQUW>].

⁴⁴ See generally U.S. SEC. & EXCH. COMM’N, *supra* note 8, at 22–26.

⁴⁵ Gradations of creditworthiness are indicated by rating symbols, with each symbol representing a group in which the credit characteristics are broadly the same. Standard & Poor’s uses a scale whereby the rating “AAA” represents the highest available credit rating, and Moody’s uses a scale whereby the rating “Aaa” represents the highest available credit rating. The ratings “AAA” and “Aaa” are given to issuers with extremely strong capacity to meet their financial commitments. The rating “BBB” under the Standard & Poor’s scale and the rating “Baa” under the Moody’s scale roughly represent similar credit ratings; these ratings are assigned to issuers with adequate capacity to meet their financial commitments. See *Standard & Poor’s Ratings Definitions*, STANDARD & POOR’S RATINGS SERVICES (Nov. 20, 2014), https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 [<https://perma.cc/H4ZS-ZFUR>]; MOODY’S INVESTOR SERVICE, RATING SYMBOLS AND DEFINITIONS 5 (Feb. 2016), https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004 [<https://perma.cc/B4G7-XB7J>]. See also *Long-term Rating Scales Comparison*, BANK FOR INTERNATIONAL SETTLEMENTS, <http://www.bis.org/bcbs/qis/qisrating.htm> [<http://perma.cc/3PPC-24WU>].

⁴⁶ See MOODY’S PUB. FIN. CREDIT COMM., MOODY’S INVESTORS SERVICE, THE U.S. MUNICIPAL BOND RATING SCALE: MAPPING TO THE GLOBAL RATING SCALE AND ASSIGNING GLOBAL SCALE RATINGS TO MUNICIPAL OBLIGATIONS 6–7 (2007), http://www.moodys.com/sites/products/DefaultResearch/102249_RM.pdf [<https://perma.cc/MNP4-HYM4>] [hereinafter MOODY’S GLOBAL STUDY]; H.R. REP. NO. 110-835, at 5 (2008) (comparing the cumulative historical default rates of municipal and corporate bonds).

2006 for the municipal bonds Moody's rated, compared with 9.6999% over the same time period for the corporate debt Moody's rated.⁴⁷

Further, while some observers are concerned about the ability of municipal bond issuers to meet payment obligations, particularly in light of mounting pension obligations, issuers are unlikely to default on their repayment obligations, as repayment obligations currently comprise only a small portion of state and local budgets.⁴⁸ Given that education, health, and human services costs comprise a portion of state and local budgets approximately fourteen times larger than that of bond repayment costs, municipalities are aware that the downside to restructuring debt is much greater than the benefit offered.⁴⁹

Even if investors cannot get comfortable with the performance of the entire municipal bond market, the track record of investment-grade municipal bonds remains excellent. While some municipal governments have defaulted on their obligations lately, such as Stockton, California and Detroit, defaults tend to occur among non-investment grade and non-rated bonds, particularly those related to nonprofit health-care and housing projects.⁵⁰ In contrast, defaults are rare among investment-grade bonds.⁵¹

⁴⁷ MOODY'S GLOBAL STUDY, *supra* note 46, at 6–7.

⁴⁸ See THALIA MEEHAN, PUTNAM INVESTORS, SEPARATING FACT FROM FICTION IN THE MUNICIPAL BOND MARKET 4 (2011), <https://content.putnam.com/literature/pdf/II901.pdf> [<https://perma.cc/4WPS-P28Y>] (“To use California as an example, in 2009 total debt service payments represented less than 5% of total expenditures. In Illinois, debt payments were less than 4% of expenses that year. Meanwhile, education and health and human services in both states accounted for about 70% of current expenses.”).

⁴⁹ *See id.*

⁵⁰ *See* U.S. SEC. & EXCH. COMM'N, *supra* note 8, at 24.

⁵¹ *See* Sec. Indus. & Fin. Mkts. Ass'n, Comment Letter on Proposed Rule on Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring 8 (Jan. 31, 2014), <http://www.regulations.gov/#!documentDetail;D=OCC-2013-0016-0106>.

C. What are Tender Option Bonds?

Prior to a discussion of the Volcker Rule and the Risk Retention Rule, it is worth exploring how a TOB works, and whether TOBs play a significant enough role in the municipal bond market to warrant a discussion on the effects of regulating TOBs.

In a nutshell, TOBs are used as a vehicle to allow money market mutual funds to get short-term capital out of longer-dated mutual bonds, and simultaneously to allow investors such as hedge funds to use leverage to invest in more municipal bonds.⁵² TOB transactions typically consist of “the deposit of a single issue of highly rated, long-term municipal bond in a trust and the issuance by the trust of two classes of securities: a floating rate, putable security (the ‘floater’), and a residual floating rate security (the ‘residual’).”⁵³ Floaters are generally purchased by money market funds, and holders of floaters have the right, usually on a daily or weekly basis, to put the floaters for purchase at par; this put right is supported by a liquidity facility delivered by a highly rated provider, typically a bank, and causes the floaters to be a short-term security.⁵⁴ A longer-term investor holds the residual, typically a bank, insurance company, mutual fund or a hedge fund. The residual investor takes “all of the market and structural risk related to the TOB structure,” with the floater investors only taking “limited, well-defined insolvency and default risks associated with the underlying” municipal bonds, the risks of which are “equivalent to those associated with investing in such municipal securities directly.”⁵⁵ The trade is leveraged because “when the trust issues the floating-rate note, it effectively borrows cash from

⁵² See Patrick McGee, *TOB or Not To Be: Time for a Comeback?*, THE BOND BUYER, Apr. 19, 2010, at 1.

⁵³ Am. Securitization Forum, Comment Letter on Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds 17 (Feb. 13, 2012), <https://www.sec.gov/comments/s7-41-11/s74111-291.pdf> [<https://perma.cc/K8VR-9C46>].

⁵⁴ See *id.*

⁵⁵ *Id.*

the money market funds against the long-term collateral,” and allows the investor to “use that cash to finance the purchase of more bonds.”⁵⁶ Those additional purchases are “dependent on the cash flow created by the carry trade—the spread between the short-term borrowing rate and the bond yield—which means the investor has more volume riding on the collateral than its original value.”⁵⁷ The TOB market is small relative to the overall market for municipal bonds: the TOB market is estimated to be approximately \$75 billion in size,⁵⁸ whereas the municipal bond market as a whole is \$3.7 trillion in size.⁵⁹ The TOB market used to be nearly twice its current size, however, before \$70 billion in TOBs were liquidated in 2008.⁶⁰

Despite the size of the TOB market, TOBs are important to the proper functioning of the municipal bond market for several reasons. Most importantly, TOBs bridge the gap between municipalities, which generally issue bonds with fixed interest rates and long-term maturities, and money market funds, which are looking for high-quality short-term debt.⁶¹ This has the effect of exerting downward pressure on the long end of the municipal yield curve, thereby lowering borrowing costs for state and local governments.⁶² Further, TOBs have been popular with large investment firms that use debt in “leveraged strategies that aim to boost returns

⁵⁶ McGee, *supra* note 52.

⁵⁷ *Id.*

⁵⁸ See Comment Letter of Citibank Glob. Mkts. Inc., *supra* note 4, at 13 (estimating the size of the TOB market as of 2012).

⁵⁹ See CADWALADER, WICKERSHAM & TAFT LLP, CLIENTS & FRIENDS MEMO: A CRITICAL ANALYSIS OF THE POTENTIAL IMPACT OF THE VOLCKER RULE ON MUNICIPAL BONDS (Dec. 12, 2011), <http://www.cadwalader.com/uploads/cfmemos/4ad42d9e6206d57794b11a1b7be0e948.pdf> [<https://perma.cc/3GD2-DC5T>].

⁶⁰ Daniel Bergstresser, Randolph Cohen & Siddarth Shenai, *Financial Guarantors and the 2007–2009 Credit Crisis* 22 (Harv. Bus. Sch., Working Paper No. 11-051, 2010).

⁶¹ See McGee, *supra* note 52.

⁶² See *id.*

using borrowed money.”⁶³ Finally, because the municipal bonds underlying TOBs are “typically traded in the secondary market, any impact on their market values will affect all holders of municipal bonds, from individuals to institutional investors.”⁶⁴ Thus, despite the fact that TOBs occupy a small part of the overall municipal bond market, they create additional demand for municipal bonds and allow investors to obtain short-term liquidity they would otherwise be unable to obtain.

TOBs do, however, carry some dangers, and they helped destabilize the municipal bond market in 2008.⁶⁵ Dissolution of TOB programs was wide and rapid, and \$70 billion worth of TOB programs were liquidated in the crisis.⁶⁶ Such “rapid deleveraging has been identified as a cause of dislocations in the market for municipal debt.”⁶⁷ The situation further deteriorated when the bankruptcy of Lehman Brothers caused short-term rates to skyrocket, creating a yield inversion phenomenon.⁶⁸ As noted earlier, since investors rely on the carry trade for profitability, yield inversion

⁶³ Al Yoon, Andrew R. Johnson & Michael Rapoport, *Volcker Rule Shows Its Wide Reach*, WALL ST. J. (Dec. 16, 2013, 7:23 PM), <http://www.wsj.com/articles/SB10001424052702304173704579262634287534164> [<http://perma.cc/TF6N-A55H>].

⁶⁴ Inv. Co. Inst., Comment Letter on Proposed Rule on Credit Risk Retention 7 (Oct. 30, 2013), <https://www.sec.gov/comments/s7-14-11/s71411-414.pdf> [<https://perma.cc/BRJ7-6K4Q>].

⁶⁵ See McGee, *supra* note 52 (“Most of the problems that came about in 2008 were really brought on by very highly leveraged structures on fairly weak underlying bonds, and as a result, when things went wrong, there was not enough liquidity to unwind those vehicles, and that’s why you saw plummeting prices,” a Wall Street banker said recently.”).

⁶⁶ See Bergstresser, Cohen & Shenai, *supra* note 60, at 22.

⁶⁷ *Id.*

⁶⁸ See McGee, *supra* note 52; see generally Bergstresser, Cohen & Shenai, *supra* note 60 (exploring a number of potential causes for the yield inversion phenomenon in municipal bonds). Yield inversion occurs when interest rates on conventionally less attractive debt (such as shorter-dated or uninsured debt) are higher than rates on conventionally more attractive debt (such as longer-dated or insured debt) and was a major ingredient in causing the disruptions in the municipal bond market during the 2008 financial crisis.

meant that TOBs were no longer profitable for investors, and investors took huge losses.⁶⁹

III. BRIEF OVERVIEW OF VARIOUS POST-FINANCIAL CRISIS PROVISIONS WITH AN INFLUENCE ON FUNDING COSTS FOR MUNICIPALITIES

A. The LCR and HQLA Requirement

The LCR was initially developed in response to the 2008 financial crisis, and stipulates that large banks must hold enough cash-like assets—i.e., HQLAs—to meet their obligations for thirty days in a liquidity stress test scenario.⁷⁰ Since a key trigger of the 2008 financial crisis was the initial “liquidity crunch,” when many banks had adequate capital levels but struggled to meet obligations because they lacked short-term liquidity,⁷¹ regulators’ strategy to develop a more resilient banking sector focused on promoting short-term liquidity.⁷² The LCR, modeled after Basel III, a global, voluntary regulatory framework for banks, stipulates that banking organizations with greater than \$250 billion in total consolidated assets are subject to the LCR and HQLA requirements; bank holding companies with total consolidated assets between \$50 billion and \$250 billion are subject to less stringent rules.⁷³ Banks in both asset ranges

⁶⁹ See *supra* note 57 and accompanying text; see also McGee, *supra* note 52.

⁷⁰ BASEL COMM. ON BANKING SUPERVISION, BASEL III: THE LIQUIDITY COVERAGE RATIO AND LIQUIDITY RISK MONITORING TOOLS paras. 10–11, 16 (Jan. 2013), <http://www.bis.org/publ/bcbs238.pdf> [<http://perma.cc/BTH5-6APX>].

⁷¹ See *id.* at para. 2.

⁷² See *id.* at para. 1.

⁷³ DAVIS POLK & WARDWELL LLP, U.S. BASEL III LIQUIDITY COVERAGE RATIO FINAL RULE VISUAL MEMORANDUM 6 (Sept. 23, 2014), <http://usbasel3.com/docs/Final%20LCR%20Visual%20Memo.pdf> [<https://perma.cc/T5EP-EHGN>].

must hold enough liquid assets to survive a thirty-day stress test.⁷⁴

Under the international Basel III standard, there are two classes of HQLA-eligible assets—Level 1 and Level 2, with Level 2 assets being divided further into Level 2A assets and Level 2B assets. Level 1 assets are cash-like assets that can comprise an unlimited percentage of the HQLA pool and are not subject to haircuts, which are reductions to the asset's market value for the purpose of calculating the asset's value to meet capital requirements.⁷⁵ Some examples of Level 1 assets under Basel III include coins, banknotes, and central bank reserves.⁷⁶ Level 2A assets and 2B assets are considered less liquid assets that may together comprise up to forty percent of a bank's pool of HQLAs, and are subject to haircuts.⁷⁷ Typical Level 2A assets under Basel III include debt guaranteed by sovereigns, central banks, or public sector entities, subject to certain liquidity requirements, and corporate debt with a rating of at least AA-.⁷⁸ Level 2B assets under Basel III include certain residential mortgage-backed securities, corporate debt with a rating of between A+ and BBB-, and common equity.⁷⁹ Basel III generally treats municipal bonds as Level 2A assets, as they fit within the Basel III definition for Level 2A assets of "marketable securities representing claims on or guaranteed by sovereigns, central banks, public sector entities or multilateral development banks."⁸⁰

⁷⁴ See *id.* at 4. See also Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, Final Rule, 79 Fed. Reg. 61,440, 61,520–21 (Oct. 10, 2014) (to be codified at 12 C.F.R. pts. 50, 249, 329) (explaining 21-calendar-day stress test period originally proposed for banks with assets between \$50 billion and \$250 billion and reasons a 30-calendar-day period was selected for such banks in the final rule).

⁷⁵ See generally DAVIS POLK & WARDWELL LLP, *supra* note 73, at 11.

⁷⁶ See BASEL COMMITTEE ON BANKING SUPERVISION, *supra* note 70, at para. 50.

⁷⁷ See *id.* at para. 51.

⁷⁸ See *id.* at para. 52.

⁷⁹ See *id.* at para. 54.

⁸⁰ See *id.* at para. 52.

While the American LCR is similar to those promulgated under Basel III, there are key differences between the Basel III framework and the LCR.⁸¹ For the purposes of this Note, the key differences relate to the mix of assets that may satisfy the HQLA requirement.⁸² In September 2014, when the Fed unanimously agreed to a new liquidity rule requiring thirty of the nation's largest banks to hold a combined \$100 billion more in cash or cash-like assets, municipal bonds were excluded from HQLA status.⁸³ What is notable is the treatment of municipal bonds in contrast to financial instruments that are comparable: corporate debt securities may qualify as Level 2B assets.⁸⁴ Further, bonds issued by GSEs ("GSE bonds") are classified as Level 2A assets.⁸⁵

⁸¹ See DAVIS POLK & WARDWELL LLP, *supra* note 73, at 14.

⁸² See Tracy, *supra* note 13.

⁸³ See *id.*

⁸⁴ 12 C.F.R. § 50.20(c)(1) (2015); 12 C.F.R. § 249.20(c)(1) (2015); 12 C.F.R. § 329.20(c)(1) (2015). Corporate bonds are considered Level 2B assets if they are:

- (i) Investment grade under 12 CFR part 1 as of the calculation date; (ii) Issued or guaranteed by an entity whose obligations have a proven record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions, as demonstrated by: (A) The market price of the corporate debt security or equivalent securities of the issuer declining by no more than 20 percent during a 30 calendar-day period of significant stress, or (B) The market haircut demanded by counterparties to secured lending and secured funding transactions that are collateralized by the corporate debt security or equivalent securities of the issuer increasing by no more than 20 percentage points during a 30 calendar-day period of significant stress; and (iii) Not an obligation of a financial sector entity and not an obligation of a consolidated subsidiary of a financial sector entity.

Id.

⁸⁵ 12 C.F.R. § 50.20(b)(1) (2015); 12 C.F.R. § 249.20(b)(1) (2015); 12 C.F.R. § 329.20(b)(1) (2015).

An asset is a level 2A liquid asset if the asset is liquid and readily-marketable and is . . . [a] security issued by, or guaranteed as to the timely payment of principal and

The exclusion of municipal bonds has triggered a wave of commentary from academics, regulators, politicians, and the financial services industry. Supporters of the exclusion of municipal bonds from HQLA designation contend that municipal bonds have low trading activity, and that the corresponding lack of liquidity and the inability to monetize municipal bonds quickly justify their exclusion.⁸⁶ However, critics, including Sen. Charles Schumer (D-N.Y.), highlighted the size and scope of the municipal bond market in fighting for its inclusion.⁸⁷ In response, Federal Reserve Board Governor Daniel Tarullo left the door open for municipal bonds to become HQLA-eligible,⁸⁸ and in early 2015, the Fed proposed a rule that would amend the LCR requirement so that municipal bonds would be treated as Level 2B liquid assets for the LCR.⁸⁹ However, those lobbying for more favorable treatment of municipal bonds could not consider

interest by, a U.S. government-sponsored enterprise, that is investment grade under 12 CFR part 1 as of the calculation date, provided that the claim is senior to preferred stock.

Id.

⁸⁶ See Stephen J. Lubben, *When Debt Markets Don't Really Act as Markets*, N.Y. TIMES (Oct. 1, 2014, 3:57 PM), <http://dealbook.nytimes.com/2014/10/01/when-debt-markets-dont-really-act-as-markets> [<http://perma.cc/2EPM-GHN7>]; Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, Final Rule, 79 Fed. Reg. 61,440, 61,444, 61,462 (Oct. 10, 2014) (to be codified at 12 C.F.R. pts. 50, 249, 329).

⁸⁷ See Letter from Charles E. Schumer, U.S. Senator, to Daniel Tarullo, Member, Bd. of Governors of the U.S. Fed. Reserve Bd., Thomas J. Curry, Comptroller of the Currency, and Martin J. Gruenberg, Chairman, Fed. Deposit Ins. Corp. (Sept. 16, 2014), https://www.fdic.gov/regulations/laws/federal/2013/2013-liquidity_coverage_ae04-c_97.pdf [<https://perma.cc/N6ZD-ACJ9>].

⁸⁸ See Tracy, *supra* note 13 (“Mr. Tarullo said staff would reconsider [the treatment of municipal debt securities] in the future and ‘develop some criteria for determining which such bonds fall into [the HQLA] category and thus might be considered for inclusion’ as a high-quality liquid asset.”).

⁸⁹ See Liquidity Coverage Ratio: Treatment of U.S. Municipal Securities as High-Quality Liquid Assets, 80 Fed. Reg. 30,383, 30,385 (proposed May 28, 2015) (to be codified at 12 C.F.R. pt. 249).

the Fed proposed rule a victory. Under the proposal, Level 2B assets could not account for more than fifteen percent of the total HQLA amount, and the Fed would also cap the amount of HQLAs that an institution could hold via municipal bonds at five percent.⁹⁰ More importantly, the OCC and the FDIC did not follow suit in proposing a similar position as the Fed.⁹¹ The OCC indicated that it is not convinced that municipal bonds can be easily traded, while the FDIC's position remains unclear.⁹² As the primary regulator for many large institutions capable of impacting market liquidity, the OCC's lack of willingness to change its LCR requirements is concerning. Of the top nine holders of municipal bonds in the country, seven are regulated by the OCC, although the Bank of New York Mellon and State Street Bank & Trust are notable exceptions.⁹³ Lawmakers have attempted to take matters into their own hands; a bipartisan coalition of members of the House Financial Services Committee, led by Rep. Luke Messer (R-Ind.), have proposed H.R. 2209, which would require that the LCR rule treat investment grade municipal bonds actively traded in the secondary market as Level 2A assets, the same tier as claims on GSEs.⁹⁴

B. The Volcker Rule

The Volcker Rule, enacted in Section 619 of the Dodd-Frank Act, added Section 13 to the Bank Holding Company Act, which regulates the actions of bank holding companies.⁹⁵

⁹⁰ See *id.* at 30,387.

⁹¹ See Ackerman & McGrane, *supra* note 15 (“The other two regulators, the [OCC] and the [FDIC], currently don’t plan to follow the Fed, people with knowledge of those agencies said.”).

⁹² See *id.*

⁹³ See Kyle Glazier, *Fed: Muni HQLA Gets a Proposal*, THE BOND BUYER, May 22, 2015, at 1, 3; Ackerman & McGrane, *supra* note 15.

⁹⁴ H.R. 2209, 114th Cong. (2015) (“To require the appropriate Federal banking agencies to treat certain municipal obligations as level 2A liquid assets, and for other purposes.”).

⁹⁵ See *Hearing on the Impact of the Dodd-Frank Act on Municipal Finance: Hearing Before the H. Subcomm. on Capital Mkts. and Gov’t*

The Volcker Rule has two primary objectives: preventing banks from engaging in proprietary trading in certain classes of securities, and preventing banks from making certain risky investments in those hedge funds and private equity funds defined under the rule as “covered funds.”⁹⁶ There were concerns based on regulators’ proposed regulation that financial institutions subject to the Volcker Rule would have to (a) suspend secondary trading in at least some category of municipal bonds and (b) refrain from acquiring or retaining an ownership interest, or sponsoring TOBs.⁹⁷ The former concern was resolved in favor of financial institutions and municipalities, as all municipal bonds are eligible for proprietary trading under the final Volcker Rule.⁹⁸ This Note focuses on why the latter should be

Sponsored Enters. of the H. Comm. on Fin. Servs., 112th Cong. 71 (2012) (Statement of Kenneth Gibbs, Member, Board of Directors and Chair, Municipal Securities Division, Securities Industry and Financial Markets Association).

⁹⁶ See HICKS, *supra* note 1, at 2; see Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536, 5668 (Jan. 31, 2014) (to be codified at 12 C.F.R. pts. 44, 248, 351, 17 C.F.R. pt. 255) (describing the statutory Volcker Rule codified at 12 U.S.C. § 1851).

⁹⁷ See *generally* NUVEEN ASSET MANAGEMENT, LLC, THE VOLCKER RULE AND THE MUNICIPAL BOND MARKET 1 (Jan. 2014).

⁹⁸ See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. at 5644–46. The initial proposed rule exempted municipal bonds issued by state and local governments from proprietary trading restrictions, but it did not exempt those issued by an *agency* of state and local governments. Commenters noted that the proposed rule would bifurcate the municipal bond market without a meaningful improvement in the soundness of banking entities. *Id.* at 5645. Many states and municipalities rely on securities issued by agencies and instrumentalities to fund “essential activities, including utility systems, infrastructure projects, affordable housing, hospitals, universities, and other nonprofit institutions.” *Id.* at 5646. “Exempting obligations issued by state and municipal agencies and instrumentalities in the same manner as the direct obligations of states and municipalities lessens potential inconsistent treatment of government obligations across states and municipalities that use different funding methods for government projects.” *Id.* Regulators found these arguments persuasive over concerns

resolved in favor of financial institutions and municipalities as well.

1. The Volcker Rule and Tender Option Bonds

With respect to the “covered funds” requirement, the Securities Industry and Financial Markets Association (“SIFMA”), an American trade group representing securities firms, banks, and asset managers, and individual firms in the industry have been largely unsuccessful at favorably influencing regulators’ interpretation of the Volcker Rule. The final rule implementing the Volcker Rule prohibits any banking entity, as a principal, from acquiring or retaining an ownership interest or sponsoring a “covered fund,”⁹⁹ which is defined to include any issuer that would be an “investment company,” as defined in the Investment Company Act of 1940 (the “1940 Act”), “*but for* Section 3(c)(1) or 3(c)(7)” of the 1940 Act.¹⁰⁰ The definition of “covered fund” generally covers high-risk entities such as private equity funds and hedge

that bonds issued by agencies and instrumentalities of states or municipalities pose risks to the banking system because the market for these bonds has not been properly regulated or controlled, as regulators decided that both bonds issued by municipalities and agents of municipalities are ultimately the obligation of the municipality. *Id.* Ultimately, whether the municipality issues the obligation directly or by an agent reflects only a difference in funding source.

⁹⁹ 17 C.F.R. § 255.10(a) (2015).

¹⁰⁰ 17 C.F.R. § 255.10(b)(i) (2015). *See also* SULLIVAN & CROMWELL LLP, VOLCKER RULE: U.S. AGENCIES APPROVE FINAL VOLCKER RULE, DETAILING PROHIBITIONS AND COMPLIANCE REGIMES APPLICABLE TO BANKING ENTITIES WORLDWIDE 62–63 (Jan. 27, 2014), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Volcker_Rule.pdf [<http://perma.cc/7CS7-5KMQ>] [hereinafter SULLIVAN & CROMWELL] (“[A]s a threshold matter, a company may be an investment company if it issues or proposes to issue any security and ‘is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities’ or ‘is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer’s total assets (exclusive of Government securities and cash items) on an unconsolidated basis.’”).

funds.¹⁰¹ Unfortunately for banks, municipalities, and borrowers, TOB vehicles are included within the definition of a “covered fund.”¹⁰² Moreover, to the extent that a banking entity is serving as the sponsor, investment adviser, or investment manager to a TOB vehicle, the Volcker Rule would prohibit the banking entity or its affiliates from entering into certain “covered transactions” with the TOB vehicle, including providing liquidity facilities and credit enhancement.¹⁰³ This created fears that the Volcker Rule would limit the market for TOBs, since banks would have to cease participating in the TOB market.¹⁰⁴

A number of commenters called for the exclusion of TOB vehicles from the definition of a “covered fund” because TOBs are similar to repurchase agreements, which the Volcker Rule excludes.¹⁰⁵ Nevertheless, TOB vehicles were not exempted from the definition of “covered fund” in the final version of the Volcker Rule.¹⁰⁶ Regulators cited the fact that while the Volcker Rule does not apply to municipal

¹⁰¹ See *id.* at 60. (Some commenters on the Proposed Rule suggested that Agencies attempt to provide qualitative, characteristics-based definitions of “hedge fund” and “private equity fund,” so as not to capture those vehicles that are not part of an investment fund management business.

¹⁰² See SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, RISK RETENTION RULES IMPACT REGISTERED FUND TENDER OPTION BOND FINANCINGS 2 (Jan. 2015), https://www.skadden.com/sites/default/files/publications/Risk_Retention_Rules_Impact_Registered_Fund_Tender_Option_Bond_Financings.PDF [<https://perma.cc/PVH8-L24P>].

¹⁰³ See CADWALADER, WICKERSHAM & TAFT LLP, *supra* note 59.

¹⁰⁴ See Farmer, *supra* note 19 (“There ‘may be an increase in financing costs to municipalities as a result of a decrease in demand for the types of municipal securities’ typically financed with TOBs, the rule says. Without this financing mechanism, some municipalities may have to offer higher interest rates in order to sell their bonds.”).

¹⁰⁵ See Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536, 5702 (Jan. 31, 2014) (to be codified at 12 C.F.R. pts. 44, 248, 351, 17 C.F.R. pt. 255).

¹⁰⁶ See *id.*

bonds, TOBs are more similar to bond repackaging securitizations, which are not excludable under the rule.¹⁰⁷

C. Risk Retention Provisions

Finally, the Risk Retention Rule influences the municipal bond market by requiring issuers of TOBs to retain some of the risk on the TOBs.¹⁰⁸ The risk retention provisions in Section 941 of the Dodd-Frank Act are applicable to asset-backed securities (“ABSs”) such as TOBs. The Risk Retention Rule, otherwise known as the “skin-in-the-game” requirement, is expected to impose significant costs and obligations on issuers subject to it.¹⁰⁹ Commenters lobbied for the exclusion of TOBs from the definition of an ABS, thus sparing them from the Risk Retention Rule,¹¹⁰ but regulators refused to grant a full exemption.¹¹¹

In a nutshell, Section 941 and its implementing regulation stipulate that a “sponsor” of an ABS transaction retain some of the credit risk of the securitized assets in one of several permitted forms. The “sponsor” is an entity that “organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, to the issuing vehicle.”¹¹² Sponsors must retain at least five percent of the credit risk of the assets collateralizing the ABSs that they bundle and sell as securities on their books to align the interests of participants in the securitization

¹⁰⁷ See *id.* at 5702–03.

¹⁰⁸ See 15 U.S.C. § 78o-11 (2012).

¹⁰⁹ See SHEARMAN & STERLING LLP, CLIENT PUBLICATION, CREDIT RISK RETENTION RULES FINALIZED 1 (Oct. 24, 2014), <http://www.shearman.com/~media/Files/NewsInsights/Publications/2014/10/Credit-Risk-Retention-Rules-Finalized-DSP-102314.pdf> [<http://perma.cc/MZ5V-59HK>].

¹¹⁰ See, e.g., Inv. Co. Inst., Comment Letter on Proposed Rule on Credit Risk Retention 6–8 (July 15, 2014), <https://www.sec.gov/comments/s7-14-11/s71411-580.pdf> [<https://perma.cc/CAZ3-HSC3>].

¹¹¹ See Gorman, *supra* note 22 (describing regulators’ refusal to grant a full exemption for TOBs before discussing other TOB-related changes regulators made in the final risk retention rule in response to industry comments on the proposed rule).

¹¹² See SHEARMAN & STERLING LLP, *supra* note 109, at 2.

process.¹¹³ This can be done in several ways: the risk can (i) be a “horizontal interest” in the “first-loss” tranche of an ABS structure equal to five percent of the fair value of all ABS interests in the issuing entity, (ii) be a “vertical interest” consisting of five percent of the value of each tranche, or (iii) be a combination of the two.¹¹⁴ The specific mechanics of the required risk retention methods are beyond the scope of this Note, but the key point is that traditional risk retention methods applicable to most ABS interests do not work for TOBs, since they do not preserve the tax-exempt structure of TOBs.¹¹⁵ Rule-makers allowed for a “qualified tender option bond entity” (“QTOB”) to meet the Risk Retention Rule through an alternate method that preserves the tax-advantaged structure.¹¹⁶ A TOB must qualify as a QTOB to take advantage of the alternate risk retention measures. The result is that, as a practical matter, TOBs that do not meet the definition of a QTOB are not issuable, as they are required to meet the broadly applicable risk retention requirements that fail to preserve TOBs’ tax-advantaged status.

IV. ANALYSIS OF WHETHER THE POST-FINANCIAL CRISIS REGULATIONS ON MUNICIPAL BONDS MEANINGFULLY CONTRIBUTE TO THE SOUNDNESS OF THE FINANCIAL SYSTEM

This section examines whether post-financial crisis rulemaking on municipal bonds will have a meaningful impact in creating a sounder financial system, or if the regulations have made it more difficult for municipalities to

¹¹³ See 15 U.S.C. § 78o-11(b)–(c)(1) (2012); Credit Risk Retention, 79 Fed. Reg. 77,602, 77,603–04 (Dec. 24, 2014) (to be codified at 12 C.F.R. pts. 43, 244, 373, 1234, 17 C.F.R. pt. 246, 24 C.F.R. pt. 267).

¹¹⁴ See HICKS, *supra* note 1, at 2.

¹¹⁵ See Gorman, *supra* note 22.

¹¹⁶ See David M. Lynn, *A Closer Look at US Credit Risk Retention Rules*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 16, 2014, 9:00 AM), <http://blogs.law.harvard.edu/corpgov/2014/11/16/a-closer-look-at-us-credit-risk-retention-rules/> [<http://perma.cc/YK7W-R7YM>].

raise capital without a meaningful improvement in the soundness of the financial system. This Note contends that post-financial crisis rulemaking raises financing costs for municipalities without a meaningful improvement in the safety of the financial system.

A. The Exclusion of Municipal Bonds from the HQLA Framework Does Not Make Sense, as Riskier Asset Classes Are HQLA-Eligible.

The current exclusion of municipal bonds from HQLA eligibility will increase lending costs for municipalities without meaningfully contributing to the safety of the financial system. Regulators have declined to classify municipal bonds as HQLAs,¹¹⁷ and they have expressed further concerns that the funding of municipal bonds is limited in the repurchase market, making municipal bonds difficult to monetize.¹¹⁸ Regulators acknowledged criticisms that credit quality, default rates, and central bank eligibility all point to the inclusion of municipal bonds as HQLAs, particularly in light of the fact that corporate debt and sovereign debt issued by companies or countries that have experienced financial troubles can count towards a bank's HQLA requirement.¹¹⁹ While the credit risk of a security may be an important factor, regulators noted that it is merely one factor for consideration along with trading volume and the presence of deep, active sale or repurchase markets.¹²⁰ Regulators also highlighted that the treatment of municipal bonds is consistent with other asset classes that “significantly vary in trading volume and lack access to deep and active repurchase markets,” such as covered bonds and

¹¹⁷ See 12 C.F.R. § 249.20 (2015); 12 C.F.R. § 329.20 (2015); 12 C.F.R. § 50.20 (2015).

¹¹⁸ Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, Final Rule, 79 Fed. Reg. 61,440, 61,463 (Oct. 10, 2014) (to be codified at 12 C.F.R. pts. 50, 249, 329).

¹¹⁹ See *id.*

¹²⁰ See *id.*

ABS.¹²¹ Finally, regulators stated their belief that the exclusion of municipal bonds will have minimal effect, as banks will continue to invest in municipals for their yield, credit quality, and other factors.¹²² Since regulators have focused on the availability of “deep, active sale or repurchase markets,” the following analysis focuses on this aspect of municipal bonds in order to dispense with the regulators’ aforementioned concerns.¹²³

First, in terms of trading volume, municipal bonds compare favorably to corporate bonds. At first glance, it appears that there is a more robust market for corporate bonds. In 2012, trading volume in municipal bonds averaged \$11.3 billion, as opposed to \$22.6 billion for corporate bonds.¹²⁴ However, taken as a percentage of the entire market, 0.31% of total outstanding municipal bonds traded in 2012, as opposed to 0.25% for corporate bonds, suggesting that turnover in municipal bond ownership is actually higher than for corporate bonds.¹²⁵ In addition, “trading volume in the municipal market, while subject to some seasonality and variation based on issuance activity and other factors, remains fairly constant within a range.”¹²⁶ Wells Fargo noted in a comment letter to the Fed that municipal bond prices experience less volatility than U.S. Treasuries.¹²⁷

Further, regulators noted that the ability to easily value a security is important to assessing the liquidity of an asset.¹²⁸

¹²¹ *Id.*

¹²² *See id.* at 61,464.

¹²³ *Id.* at 61,463.

¹²⁴ Sec. Indus. & Fin. Mkts. Ass’n, *supra* note 51, at 3.

¹²⁵ *Id.* at 3.

¹²⁶ *Id.* at 4.

¹²⁷ *See* Wells Fargo & Co., Comment Letter on Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring 17 (Jan. 31, 2014), http://www.federalreserve.gov/SECRS/2014/January/20140131/R-1466/R-1466_013114_111898_491608851579_1.pdf [<http://perma.cc/SMU4-78KT>].

¹²⁸ Citigroup Global Mkts., Inc., Comment Letter on Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring 12 (Apr. 9, 2014), <http://www.federalreserve.gov/SECRS/2014/May/2014>

Valuing municipal bonds is easier than regulators suggest thanks to the availability of three non-bank service providers: Standard & Poor's Securities Evaluations, Interactive Data Corporation, and Bloomberg Asset Valuation.¹²⁹ Because prices are provided by third-party rating agencies, there is transparency in the rating process, and the prices provided have a high degree of accuracy.¹³⁰ In a comment letter, Nuveen Asset Management contended that as of November 29, 2013, the market-value weighted average difference, in absolute terms, between the prices provided by Standard & Poor's and Interactive Data Corporation on close to 14,000 municipal bonds with a total market value in excess of \$56 billion was only 1.22%, a figure which declined to just 0.92% when the universe was narrowed to investment grade securities only.¹³¹ The municipal bond market views similarly structured municipal bonds—i.e. those that have similar coupons and maturities—as being substitutable, so the price of a municipal bond may be ascertained even if the individual security does not trade on a daily basis.¹³² Additionally, the municipal market is one with many broker-dealers that provide market-making functions. The MSRB, as of January 15, 2014, regulated 1664 registered broker-dealers.¹³³

Finally, municipal bonds have historically been treated similarly to treasury bonds and GSE securities, in that all three asset classes have been subject to less onerous laws and regulations that “impose fewer restrictions on, and allow for more advantageous terms when, lending cash against these collateral types.”¹³⁴ Thus, municipal bonds and GSE

0506/R-1466/R-1466_040914_115071_570402890178_1.pdf [http://perma.cc/ZY36-DTQL].

¹²⁹ See *id.*

¹³⁰ See *id.*

¹³¹ See *id.* (citing Nuveen Asset Management, LLC, Comment Letter on Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring 6 (Jan. 30, 2014)).

¹³² See Wells Fargo & Co., *supra* note 127, at 18.

¹³³ See *id.* at 19.

¹³⁴ See Citigroup Global Mkts., Inc., *supra* note 128, at 2, 14.

securities should be treated similarly under the LCR as well. When municipal bonds are posted as collateral to a Federal Reserve Bank, they are accepted at very high advance rates—the same rate as AAA-rated dollar denominated foreign sovereign bonds and U.S. GSE securities, which are treated as Level 1 and Level 2A liquid assets, respectively.¹³⁵ State finance laws in the United States also “create a well of advantageous funding for securities deemed to be of sufficiently high credit and liquidity value,” such as treasury bonds, GSE securities, and municipal bonds.¹³⁶

As outlined in the last several paragraphs, there are compelling reasons to include municipal bonds as HQLAs, though there is a debate as to just how much of a quantifiable impact would be felt. Regulators rightly pointed out that many banks subject to the LCR requirements “did not include municipal bonds in their holdings of liquid assets for contingent liquidity stress purposes prior to the LCR, yet continued to invest in municipal bonds.”¹³⁷ Furthermore, the largest banks have already prepared for the non-inclusion of municipal bonds, meaning that much of the adjustments have already been made by banks.¹³⁸

However, there is market data suggesting that the exclusion of municipal bonds from the HQLA framework has already had an effect on the market for municipal bonds.¹³⁹ As of the end of October 2014, the daily amount of municipal bond transactions had fallen to three billion dollars from four

¹³⁵ See Sec. Indus. & Fin. Mkts. Ass’n, *supra* note 51, at 7.

¹³⁶ See Citigroup Global Mkts., Inc., *supra* note 128, at 14.

¹³⁷ See Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. 61,440, 61,464 (Oct. 10, 2014) (to be codified at 12 C.F.R. pts. 50, 249, 349).

¹³⁸ See Brian Jacobsen, *Municipal Bonds and Liquidity Coverage Ratios*, WELLS FARGO ASSET MGMT.: ADVANTAGEVOICE BLOG (Sept. 4, 2014), <https://blogs.wellsfargo.com/advantagevoice/2014/09/municipal-bonds-and-liquidity-coverage-ratios> [<http://perma.cc/W6HC-8XYE>].

¹³⁹ See generally Simon Colvin, *Muni Bonds Lose Out in Fed Reshuffle*, MARKIT (Oct. 28, 2014), <http://www.markit.com/Commentary/Get/28102014-Equities-Muni-bonds-lose-out-in-Fed-reshuffle> [<http://perma.cc/ZL5V-KE6A>].

billion dollars in the beginning of September 2014.¹⁴⁰ Furthermore, at the start of 2014, the weighted average “haircut” for municipal bond collateral—i.e., the amount of extra collateral required to be posted against a loan—was 1.5%.¹⁴¹ That number climbed to 2.5% by October 2014, suggesting the weakness of the asset class.¹⁴² The negative effects from the HQLA omission could have a disproportionate effect on small issuers—those without good market access.¹⁴³ For instance, Utah-based Zions National Bank holds \$558 million in held-to-maturity municipal bonds and an additional \$66 million in the available-for-sale category.¹⁴⁴ Zions has said that it would have to unload some of these municipal bonds; previously, banks were happy to support the local economy by buying municipal bonds from municipalities with limited funding to access, but now banks may be disincentivized from doing so, leading to higher financing costs.¹⁴⁵

For the reasons raised above, excluding municipal bonds from the definition of HQLAs when corporate bonds are included is inconsistent. The factors mentioned above demonstrate that the municipal bond market is more liquid than regulators suggest, and that municipal bonds hold up relatively well during times of crisis as compared to HQLA-eligible corporate bonds.

B. The Non-Exclusion of TOBs from the Volcker Rule Will Raise Financing Costs for Municipalities Without Making the Financial System Safer.

The Volcker Rule’s overbroad “covered fund” definition limits the ability of banks to participate in TOB programs, hurting state and local government borrowers who

¹⁴⁰ *See id.*

¹⁴¹ *See id.*

¹⁴² *See id.*

¹⁴³ *See generally* Joe Rennison, *US Muni Treasurers Warn LCR Could Crimp Spending*, RISK MAGAZINE (May 28, 2014).

¹⁴⁴ *See id.*

¹⁴⁵ *See id.*

potentially stand to lose an important alternate source of demand for their securities, and increasing the costs of raising capital for municipalities. Furthermore, money market mutual funds and their shareholders will lose an important source of low-risk, high-quality investments. TOBs are actually safer than municipal bonds themselves, since TOBs are supported by liquidity facilities from banks.¹⁴⁶

Rule-makers have provided specific exclusions from the Volcker Rule for securities that they interpret as falling within the rule of construction contained in Section 13(g)(2) of the Bank Holding Company Act, including exclusions for the sale and securitization of loans and for securities that do not function as investment funds.¹⁴⁷ However, since TOBs have municipal bonds, not loans, as underlying assets, regulators declined to exempt TOBs from proprietary trading restrictions.¹⁴⁸ The exemption was not given with the belief that the re-securitization of municipal debt should not be treated any differently from the re-securitization of other debt instruments, other than loans.¹⁴⁹ Regulators recognized the potential increase in financing costs as a result of reduction in demand for the types of municipal bonds involved in TOBs, but declined to extend the Volcker Rule exemption to TOBs and are adhering to the language of the rule.¹⁵⁰

From a practical standpoint, TOBs serve an important role by providing the equivalent of “repo financing” with municipal bonds.¹⁵¹ In other words, TOBs are a way of obtaining short-term financing while maintaining the tax-free nature of interest in municipal bonds, since TOBs are

¹⁴⁶ See *Hearing, supra* note 95, at 73 (statement of Kenneth Gibbs).

¹⁴⁷ See Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536, 5702 (Jan. 31, 2014) (to be codified at 12 C.F.R. pts. 44, 248, 351, 17 C.F.R. pt. 255).

¹⁴⁸ See *id.*

¹⁴⁹ See *id.*

¹⁵⁰ See *id.* at 5703.

¹⁵¹ CADWALADER, WICKERSHAM & TAFT LLP, *supra* note 59, at 11.

treated as trusts, which for tax purposes is treated as a pass-through entity.¹⁵² Without TOBs, it will be more difficult for investors to invest in municipal bonds on a short-term basis. From a practical standpoint, TOBs are essentially repurchase agreements,¹⁵³ and repurchase agreements are not subject to Volcker Rule regulations at all because they “do not appear to be of the type the statutory definition of trading account was designed to cover.”¹⁵⁴

The non-exclusion of TOBs from Volcker Rule requirements would send undesirable side effects outside of the municipal bond market as well. Money market funds would also suffer as a result of the Volcker Rule’s application to TOBs. TOBs are important to money market funds because they are often eligible under Rule 2a-7 of the Investment Company Act for investment by money market mutual funds,¹⁵⁵ which are required by law to invest in low-risk securities.¹⁵⁶ However, in order for money market funds to invest in municipal bonds, the maturity mismatch between municipal bonds, which are generally issued with fixed interest rates and long-term maturities to enable state and local governments to manage their borrowing costs, and the demands of money market funds, which are only allowed to invest in short-term debt per the Investment Company

¹⁵² See *id.* at 11–12.

¹⁵³ See *id.* at 16–17.

¹⁵⁴ See Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536, 5553 (Jan. 31, 2014) (to be codified at 12 C.F.R. pts. 44, 248, 351, 17 C.F.R. pt. 255); see also Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846, 68,850 (proposed Nov. 7, 2011) (to be codified at 12 C.F.R. pts. 44, 248, 351, 17 C.F.R. pt. 255);) (proposing to exclude repurchase agreements because they “do not appear to involve the requisite short-term trading intent”).

¹⁵⁵ See *Hearing, supra* note 95, at 73 (statement of Kenneth Gibbs).

¹⁵⁶ See 17 C.F.R. § 270.2a-7 (2015); see also *Fast Answers: Money Market Funds*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/answers/mfmmkt.htm> [<http://perma.cc/Q43V-MJHP>].

Act, must be solved.¹⁵⁷ This maturity mismatch is relieved by TOBs.¹⁵⁸ TOB floaters make up over twenty percent of tax-exempt money market fund holdings in some money market funds,¹⁵⁹ and given that the 2a-7 criteria for what qualifies for deposit into a money market fund have gotten tighter, TOBs are as important as ever as a source of safe, short-term funding.¹⁶⁰ Money market funds have represented a large source of demand for municipal bonds, but assets in money market funds have already shrunk to \$257.4 billion from a peak of \$483.8 billion because of the shrinking pool of investments eligible for purchase by TOBs.¹⁶¹ The non-exclusion of TOBs would further exacerbate this trend.¹⁶²

In response, banks have come up with creative TOB structures that can sidestep the Volcker Rule. The preamble to the Volcker Rule seems to implicitly suggest that if banks can figure out a way that a TOB will not qualify as a covered fund, then regulators would take no issue with it:

The final rule, however, does not prevent a banking entity from owning or otherwise participating in a tender option bond vehicle; it requires that these activities be conducted in the same manner as with other covered funds. In this regard, under the final rule, a banking entity would need to evaluate whether a tender option bond vehicle is a covered fund as defined in the final rule. If a tender option bond vehicle is a covered fund and an exclusion from that definition is not available, then banking entities sponsoring such a vehicle will be subject to the

¹⁵⁷ See CADWALADER, WICKERSHAM & TAFT LLP, *supra* note 59, at 11.

¹⁵⁸ *See id.*

¹⁵⁹ See Yoon et al., *supra* note 63.

¹⁶⁰ See generally *Investor Insights: SEC Rule 2a-7 Guidelines*, MORGAN STANLEY (2013), http://www.morganstanley.com/im/emailers/media/pdf/liq_sol_updt_012013_rule_2a-7.pdf [http://perma.cc/YT2D-MZYE].

¹⁶¹ See Yoon et al., *supra* note 63.

¹⁶² *Id.*

prohibitions in § __.14 of the final rule and the provisions of section 13(f) of the BHC Act.¹⁶³

There are two alternatives: restructuring the TOB as a joint venture, or restructuring the TOB so that the banking entity would participate as an unaffiliated third party.¹⁶⁴

Under a joint venture structure, the municipal bonds are held in a TOB trust, rather than in a traditional TOB structure where the bank would act as the issuer of the TOB trust.¹⁶⁵ The bank would sell the municipal bonds into the TOB trust, which is a joint venture between the banks and the investors.¹⁶⁶ So long as the joint venture does not consist of more than ten parties, the TOB is exempted from registration under the 1940 Act.¹⁶⁷ Regulators have specifically noted that to the extent that one of the included entities qualifies for one or more of the other exclusions from the definition of a covered fund, that entity would not be considered a covered fund.¹⁶⁸ Otherwise, the joint venture structure is essentially a relabeling of the existing TOB structure.¹⁶⁹ Regulators may be loath to allow for a

¹⁶³ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536, 5703 (Jan. 31, 2014) (to be codified at 12 C.F.R. pts. 44, 248, 351, 17 C.F.R. pt. 255).

¹⁶⁴ See KAREN FITZGERALD, STANDARD & POOR'S RATINGS SERVICES, TENDER OPTION BONDS AND THE VOLCKER RULE 4, 5 (Aug. 1, 2014), <http://cdn.bondbuyer.com/media/pdfs/BBrandeis14-Fitzgerald.pdf> [<https://perma.cc/47TM-FCZS>].

¹⁶⁵ See Cate Long, *Moody's Rates First TOB That Passes Volcker Rule*, REUTERS (June 13, 2014, 9:15 PM), <http://blogs.reuters.com/muniland/2014/06/13/moodys-rates-first-tob-that-passes-volcker-rule/> [<http://perma.cc/4C3F-CX6E>].

¹⁶⁶ See *id.*

¹⁶⁷ See *id.*

¹⁶⁸ See Letter from David L. Cohen, Managing Dir. & Assoc. Gen. Counsel, Mun. Sec. Div., and Matthew J. Nevins, Managing Dir. & Assoc. Gen. Counsel, Asset Mgmt. Grp., Sec. Indus. & Fin. Mkts. Ass'n, to Scott Alvarez, Gen. Counsel, Bd. of Governors of the Fed. Reserve Sys., et al. 3 (June 13, 2014) (on file with the U.S. Sec. & Exch. Comm'n).

¹⁶⁹ See Kyle Glazier, *Citi Analyst: Two Options to Save Tender Option Bonds*, THE BOND BUYER, Apr. 9, 2014, at 3 (describing a report that states

relabeling, since it may prompt others to skirt the Volcker Rule provisions in a similar manner, and may opt to squash the joint venture structure in the future.

There are unfortunately further problems with the joint venture structure. One problem is that sometimes banks split either the residual or the holding note into many smaller investment funds, and the joint venture structure will make it more difficult to do so.¹⁷⁰ The TOB must be big enough to be “marketable to potential floater holders because purchasers of floaters generally have minimum purchase requirements to reduce costs and administrative burdens.”¹⁷¹

In contrast, the unaffiliated third party structure takes advantage of the fact that the banking entity, “although it no longer would serve as sponsor of the TOB trust, or have an ownership interest in the trust, could assume certain servicing functions with respect to the trust, consistent with the Volcker Rule.”¹⁷² This can be accomplished by having the banking entity provide credit or liquidity enhancement for a TOB program *that is not its own*, but rather that of a mutual fund or a dealer.¹⁷³ The banking entity could assume certain servicing functions with respect to the trust consistent with the Volcker Rule’s prohibition on ownership of and certain relationships with covered funds.¹⁷⁴ However, banks would no longer be able to assume certain roles in conjunction with the TOB’s operation, such as serving as the trust’s sponsor, having an ownership interest in the trust, or providing credit enhancement, liquidity or remarketing services to the trust; these roles would need to be handled by a non-bank TOB residual interest holder.¹⁷⁵

that “regulators might view [such joint ventures] as a re-definition of an existing structure to skirt the rules”).

¹⁷⁰ *See id.*

¹⁷¹ *See Inv. Co. Inst.*, *supra* note 64, at 10.

¹⁷² *See Inv. Co. Inst.*, *supra* note 110, at 4.

¹⁷³ *See Glazier*, *supra* note 169.

¹⁷⁴ *See Inv. Co. Inst.*, *supra* note 110, at 4 n.10.

¹⁷⁵ *See Glazier*, *supra* note 169; *see* BlackRock, Inc., Comment Letter on Proposed Rule on Credit Risk Retention 2 (July 22, 2014), <https://>

Thus, while adopting this structure would allow for business to go on, banks would disfavor this solution as they would be precluded from assuming key functions in relation to TOBs. The Volcker Rule has forced banks to shut down operations that regulators have deemed risky, squeezing the banks' ability to make a profit. Banks should still be able to operate the TOB program, as it is not the type of speculative activity that the Volcker Rule is aiming to prohibit.

From a societal point of view, the continued existence of TOB programs will not be detrimental to the health of the financial system. One concern that was alluded to earlier is the fact that TOBs helped cause the destabilization of the municipal bond market in 2008. However, Professors Daniel Bergstresser, Randolph Cohen, and Siddarth Shenai have shown that the deteriorating market for TOBs was not the main force that caused the yield inversion phenomenon in the municipal bond market, though it may have altered pricing for monoline insurance.¹⁷⁶ TOB programs post-crisis have also operated with less leverage and better collateral.¹⁷⁷ The collapse of monoline insurers has actually enhanced the safety of TOB programs, since they are now backed with better collateral and cannot rely on the strength of monoline insurers.¹⁷⁸

C. The Risk Retention Provisions of the Volcker Rule Should be Inapplicable to TOBs Since TOBs are Not the Type of Asset that the Risk Retention Rules are Meant to Address.

Additionally, the risk retention provisions of Dodd-Frank will impose significant costs and obligations on TOB programs,¹⁷⁹ and this increase in cost could adversely affect state and local governments that indirectly receive funding

www.sec.gov/comments/s7-14-11/s71411-582.pdf [<https://perma.cc/C6TY-QKQY>].

¹⁷⁶ See Bergstresser, Cohen & Shenai, *supra* note 60, at 2–3.

¹⁷⁷ See McGee, *supra* note 52.

¹⁷⁸ See *id.*

¹⁷⁹ See SHEARMAN & STERLING LLP, *supra* note 109.

from TOB programs.¹⁸⁰ Industry commentators offered a number of suggestions, but regulators were generally unreceptive.¹⁸¹ As explained below, the current Risk Retention Rule provisions relating to TOBs are problematic because they increase the cost of issuance for municipalities without accurately reflecting market standards, and would serve to stifle innovation in the TOB market.

There is a strong case to be made that TOBs should be exempt from the Risk Retention Rule, given that TOBs do not raise the dangers that Congress intended to ameliorate when it passed Section 15G of the Exchange Act.¹⁸² Rule-makers rationalized their decision not to exempt TOBs by stating that “the agencies continue to believe that tender options bonds are asset-backed securities under the definition in section 15G because they are securities collateralized by self-liquidating financial assets and the holders of the securities receive payments that depend primarily on cash flow from the securitized assets.”¹⁸³ That TOBs are considered ABSs is perhaps driven by a desire to simplify and limit exceptions. The desire to simplify can be seen in other sections of 15G—for instance, the Risk Retention Rule stipulates that the amount of risk that must be retained is five percent, regardless of the quality of the assets or other similar factors, because doing so would unnecessarily complicate the rule.¹⁸⁴ Given the density of the Dodd-Frank Act, the drive for simplicity is understandable.

However, several compelling reasons exist to exempt TOB from the risk retention provisions. First, TOBs are not based on the “originate to distribute” model that creates a moral

¹⁸⁰ See *Inv. Co. Inst.*, *supra* note 64, at 7.

¹⁸¹ See Keith R. Fisher, *Ballard Spahr Discusses Risk Retention Rules*, CLS BLUE SKY BLOG (Nov. 21, 2014), <http://clsbluesky.law.columbia.edu/2014/11/21/ballard-spahr-discusses-risk-retention-rules> [<http://perma.cc/UB23-Z3S5>].

¹⁸² See *Inv. Co. Inst.*, *supra* note 64, at 7.

¹⁸³ Credit Risk Retention, 79 Fed. Reg. 77,602, 77,661 (Dec. 24, 2014) (to be codified at 12 C.F.R. pts. 43, 244, 373, 1234, 17 C.F.R. pt. 246, 24 C.F.R. pt. 267).

¹⁸⁴ See Credit Risk Retention, 79 Fed. Reg. at 77,716.

hazard for the sponsors of some securitization transactions.¹⁸⁵ The moral hazard situation occurs when the sponsor would have the tendency to incur risks because another party—the investors—would shoulder the risks of the transaction.¹⁸⁶ However, “TOB programs are almost uniformly used to finance municipal bonds, not to transfer risk.”¹⁸⁷ Moreover, TOBs are not considered by the marketplace to be ABSs.¹⁸⁸ Additionally, a TOB program “does not create information gaps for investors.”¹⁸⁹ The concern that the SEC has with regards to ABS securitizations is that the underlying pool of assets in an ABS consists of hundreds and thousands of unrelated assets.¹⁹⁰ In contrast, assets underlying TOBs are “high quality and are typically publicly issued, rated debt securities that are subject to the anti-fraud provisions of the federal securities laws.”¹⁹¹

Even if regulators will not grant a full exemption from risk retention provisions for TOBs, they can make mitigating changes in order to ensure that the TOB market remains innovative without sacrificing safety. This would be done by expanding the definition of a QTOB. As mentioned earlier, a complication relating to TOBs in the risk retention context is that traditional risk retention methods are not available to TOBs.¹⁹² Thus, the agencies have defined QTOBs, and have allowed them to satisfy the risk retention requirements via alternate means.¹⁹³ TOB programs which do not qualify as

¹⁸⁵ See Ashurst LLP, Comment Letter on Proposed Rule on Credit Risk Retention 3 (Oct. 30, 2013), <https://www.sec.gov/comments/s7-14-11/s71411-407.pdf> [<https://perma.cc/QZF5-TBBF>].

¹⁸⁶ See *id.* at 3 n.4.

¹⁸⁷ Inv. Co. Inst., *supra* note 64, at 6 n.19.

¹⁸⁸ See Credit Risk Retention, 79 Fed. Reg. at 77,660 (citing comment letters received in response to the proposed credit risk retention rule).

¹⁸⁹ See Ashurst LLP, *supra* note 185, at 3.

¹⁹⁰ See *id.*

¹⁹¹ Inv. Co. Inst., *supra* note 64, at 6 n.19.

¹⁹² See Gorman, *supra* note 22; Ashurst LLP, *supra* note 185, at 4.

¹⁹³ See SIDLEY AUSTIN LLP, AGENCIES ADOPT FINAL DODD-FRANK RISK RETENTION RULES FOR ASSET-BACKED SECURITIES 26 (Nov. 25, 2014),

QTOBs will not be able to take advantage of the modified risk-retention mechanisms, so they will essentially have to cease operating.¹⁹⁴ Thus, the definition of a QTOB becomes crucial. A QTOB is a TOB issuer that has the following characteristics:

[i]ssues *no securities other than a single class of TOBs* with a preferred variable return payable out of capital that itself meets the risk retention requirements; [h]olds *only tax-exempt munis as assets and issues only securities*, the income from which is tax-exempt to investors; [i]s *collateralized solely by servicing assets and munis that are not subject to substitution* and that have the same municipal issuer and the same underlying obligor or source of payment (without regard to any third-party creditor enhancement); [and h]as a *legally binding commitment from a regulated liquidity provider to provide a 100 percent guaranty or liquidity coverage with respect to all outstanding TOBs*.¹⁹⁵

Once a TOB satisfies the QTOB requirements, then residuals would qualify as qualified horizontal residual interests before a tender option termination event (“TOTE”) and as eligible vertical interests after a TOTE.¹⁹⁶ Additionally, a sponsor’s direct ownership of the same municipal bonds held as collateral by a TOB issuer may count towards the five percent risk retention requirement.¹⁹⁷ These mechanisms allow for TOBs to survive under the Risk Retention Rule, though the rule still limits the TOB market as only TOBs that qualify as QTOBs will still be issuable.

<http://www.sidley.com/news/11-25-2014-sidley-update> [<http://perma.cc/HL9S-JHYF>].

¹⁹⁴ See Ashurst LLP, *supra* note 185, at 4 (“A sponsor of a non-‘qualified’ TOB Program would very likely have to stop engaging in many transactions because it would not be in a position to comply with section 15G at all.”).

¹⁹⁵ Gorman, *supra* note 22 (emphasis added). See also Credit Risk Retention, 79 Fed. Reg. 77,602, 77,659–60 (Dec. 24, 2014) (to be codified at 12 C.F.R. pts. 43, 244, 373, 1234, 17 C.F.R. pt. 246, 24 C.F.R. pt. 267).

¹⁹⁶ See SIDLEY AUSTIN LLP, *supra* note 193, at 26.

¹⁹⁷ See *id.* at 26–27.

In sum, TOBs provide municipalities with access to a diverse investor base and a more liquid market, and the risk retention requirements would significantly increase the costs of TOB programs and adversely affect state and local governments that indirectly receive funding through these programs.¹⁹⁸ The risk retention provisions make sense in the context of other securitized products where there is a divergence of interests between the issuer and there are information gaps for investors, but these concerns do not exist for TOBs. Further, non-exemption will “decrease the availability of tax-exempt investments in the market for money market funds, which are continuing to face limited investment options due to constraints imposed by Rule 2a-7 under the Investment Company Act.”¹⁹⁹ To reiterate the general concerns regarding the benefits and drawbacks of the continued existence of TOB programs addressed in the previous section, TOBs worsened the condition of the municipal bond market, but they did not alone cause the yield inversion phenomenon.²⁰⁰ Additionally, TOB programs are being run in much safer ways than they were before the 2008 financial crisis, with less leverage and better collateral.²⁰¹

V. PROPOSALS FOR CHANGE

Current rulemaking relating to municipal bonds—the LCR, the Volcker Rule, and the Risk Retention Rule—has increased the costs of raising capital for municipalities. However, the increased costs do not bring about a significant improvement in the soundness and safety of the financial system. With that in mind, several recommendations follow.

¹⁹⁸ Credit Risk Retention, 79 Fed. Reg. at 77,660 (citing comment letters received in response to the proposed credit risk retention rule).

¹⁹⁹ *Id.*

²⁰⁰ See Bergstresser, Cohen, and Shenai, *supra* note 60, at 3.

²⁰¹ See McGee, *supra* note 52.

A. Classify Investment-Grade Municipal Bonds as Level 2A HQLAs

With regards to the LCR and the corresponding HQLA requirement, the most liquid municipal bonds should be treated as Level 2A liquid assets. This treatment is consistent with Basel III and would match H.R. 2209. Municipal bonds compare favorably with two classes of debt included as HQLAs: investment-grade corporate bonds and GSEs.

Municipal bonds are highly liquid, as they are convertible into cash with little or no loss of value during a period of liquidity stress.²⁰² As noted earlier, municipal bonds compare favorably with corporate debt in terms of volatility, trading volume and ability to ascertain prices.²⁰³ Additionally, legislative history shows that municipal bonds are treated similarly to GSEs.²⁰⁴ Furthermore, the world's supply of "safe" assets is increasingly limited, as the stock of "safe" assets shrank by almost half from 2007 to 2012, even as demand increased.²⁰⁵ Given this shrinking pool of safe assets, it will become even harder and more expensive for banks to obtain HQLA-eligible capital, which suggests it may make sense to make municipal bonds HQLA-eligible.

Some argue the HQLA exclusion will have a minimal influence, since most banks have anticipated that municipal bonds would not qualify for HQLA status; thus, most banks have not been holding municipal bonds with liquidity in mind, but rather for a profit motive.²⁰⁶ Many big banks were able to meet the LCR requirements in September 2014

²⁰² Sec. Indus. & Fin. Mkts. Ass'n, *supra* note 51, at 3.

²⁰³ See *supra* notes 124–33 and accompanying text.

²⁰⁴ See *supra* note 134 and accompanying text .

²⁰⁵ See CREDIT SUISSE, 2012 GLOBAL OUTLOOK: PIECING TOGETHER OR FALLING TO PIECES? 143 (Dec. 1, 2011), https://doc.research-and-analytics.csfb.com/docView?language=ENG&format=PDF&source_id=em&document_id=932631241&serialid=jM9q0YXAnJeurwyoxEn6RjL9NVRTTgKMMfroRYNFrmI%3d [<https://perma.cc/EXE5-2E5L>].

²⁰⁶ See Jacobsen, *supra* note 138.

despite the treatment of municipal bonds.²⁰⁷ Further, many banks have already posted enough collateral to continue to hold their municipal investments.²⁰⁸ Finally, Bank of America Merrill Lynch contends that only roughly half of the municipal bonds held by U.S. banks are held by banks large enough to be subject to the HQLA regulations.²⁰⁹

However, the announcement in September that municipal bonds would not count towards the HQLA requirement for the time being has influenced the market.²¹⁰ In the first nine months of 2014, municipal bond daily trading volume dropped from \$4 billion to \$3 billion.²¹¹ Additionally, not including municipal bonds as HQLA may not drive day-to-day investment decisions, but it could affect long-term planning as banks allocate capital away from municipal bonds, and it may compel banks to sell off municipal bonds in times of market volatility, when issuers would most need support from banks.²¹² A financial crisis like the one in 2008 may be unlikely to occur soon,²¹³ but other liquidity events could force banks out of the municipal bond market. For instance, in 2013, following the announcement by Ben Bernanke, then Chairman of the Federal Reserve, that the Federal Reserve would consider tapering its quantitative

²⁰⁷ See Tracy, *supra* note 13 (“Regulators say banks are already well on their way to meeting the rules.”).

²⁰⁸ See *Topic of the Week: Banks as Municipal Advisors*, MUNICIPAL ISSUER BRIEF (Mun. Mkt. Advisors), Sept. 22, 2014, at 2 [hereinafter *MMA September*].

²⁰⁹ See Michael Aneiro, *BofA Sees Limited Harm To Munis From New Bank Liquidity Rule*, BARRON’S: INCOME INVESTING BLOG (Sept. 8, 2014, 5:37 PM), <http://blogs.barrons.com/incomeinvesting/2014/09/08/bofa-sees-limited-harm-to-munis-from-new-bank-liquidity-rule> [<http://perma.cc/3HCB-E932>].

²¹⁰ See Colvin, *supra* note 139. See also *Topic of the Week*, MUNICIPAL ISSUER BRIEF (Mun. Mkt. Advisors), June 2, 2014, at 3 [hereinafter *MMA June*] (assessing potential market impacts of the HQLA requirement)

²¹¹ Colvin, *supra* note 139, at 2.

²¹² See *MMA June*, *supra* note 210.

²¹³ See *id.* (“MMA does not believe we will face another 2008-era crisis in the near term, but the market is currently deprived of significant dealer support so losing an element such as the bank support would be unwelcomed.”)

easing program, bond markets froze.²¹⁴ Finally, in the past, banks have acted as the “buyers of last resort” during times of crisis, such as when municipal bond funds had to sell bonds at distressed prices to meet payment obligations.²¹⁵ As banks have been forced to shrink their balance sheets, they may be even less inclined to act as the “buyer of last resort” if municipal bonds are not HQLA-eligible.

One concern regards *which* municipal bonds should be incorporated as HQLAs, as regulations would essentially pick “winners” and “losers” from the municipal bond market.²¹⁶ The standard outlined in 12 C.F.R. § 1.2 for assessing whether corporate bonds are investment grade may be a logical starting place for assessing municipal bonds,²¹⁷ since credit agencies’ ratings cannot be used to make determinations of investment grade status.²¹⁸ One fear is that the inability to use ratings may force regulators to decide whether something is appropriate for inclusion as HQLA based on factors such as the size of the municipality,²¹⁹ meaning smaller municipal issuers whose bonds do not trade as widely are not likely to have their securities classified as HQLA.²²⁰ Senator Schumer has received some criticism for lobbying for the classification of municipal bonds as HQLA because his constituency, New York City, is a relatively respected issuer the bonds of which

²¹⁴ See Nicholas Venditti, *The Hidden Risk in the Municipal Market*, THORNBURG INV. MGMT., 1 (Sept. 2014), http://www.thornburg.com/pdf/separate-accounts/TH3168_HiddenRisk_article.pdf [<http://perma.cc/YX93-CP4F>].

²¹⁵ See *id.*

²¹⁶ *MMA September*, *supra* note 208.

²¹⁷ 12 C.F.R. § 1.2(d) (2014) (“*Investment grade* means the issuer of a security has an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected.”).

²¹⁸ See Citigroup Global Mkts., Inc., *supra* note 128, at 16.

²¹⁹ See *MMA September*, *supra* note 208.

²²⁰ See *id.*

are very likely to qualify as HQLA.²²¹ Thus, there is the potential that funding costs for smaller municipalities, those that do not have as much access to funding in the first place, will rise disproportionately compared to the rest of the municipal market. These effects might be mitigated, however, by the fact that local issuers may borrow from community and regional banks unaffected by the rules, whereas larger banks that are subject to the HQLA might already be investing in larger issues of municipal bonds.²²² Thus, the choosing of “winners” and “losers” should not have a bifurcating effect on the municipal bond market.

Overall, the effect of the exclusion of municipal bonds, particularly in the short-term, may be limited, but there are signs that there may be undesirable long-term effects. The exclusion also does not make sense when considering what other asset classes are HQLA-eligible, such as corporate bonds, which are riskier and are not any more liquid than municipal bonds.²²³ The definition for “investment grade” outlined in 12 C.F.R. § 1.2 should be used to determine which municipal bonds are fit for inclusion as HQLAs, and those that meet the criteria should be deemed Level 2A liquid assets, consistent with the proposed policy of H.R. 2209.²²⁴

B. Exempt TOBs from the Volcker Rule “Covered Funds” Definition

As analyzed earlier, good reasons exist to exempt TOBs from the Volcker Rule prohibitions on investments in “covered funds.” While TOBs did help to exacerbate the financial crisis and accelerate the destabilization of the municipal bond market, TOBs were not the instruments primarily responsible for the “yield inversion” phenomenon, and TOB programs are generally being run with lower

²²¹ See *The Muni Bond Lobby*, *supra* note 34.

²²² See *MMA September*, *supra* note 208.

²²³ See Jacobsen, *supra* note 138.

²²⁴ See H.R. 2209, 114th Cong. (2015).

leverage and stronger collateral in the post-crisis years.²²⁵ TOBs are essentially a form of short-term financing in the municipal bond market, and they are actually safer than the municipal bonds themselves.²²⁶ While it is true that the TOB market is much smaller than the underlying municipal bond market, killing the market for TOBs would raise the costs of capital for municipalities by taking away a source of demand for municipal bonds.²²⁷ Eliminating the TOB market would also have negative ripple effects on money market mutual funds, which would be deprived of a source of safe, short-term capital.²²⁸

While it is understandable that rule-makers want to simplify Dodd-Frank when possible, there is good reason to separate how TOB trusts and other entities such as hedge funds are treated under the Volcker Rule. Regulators have relied on the fact that TOBs utilize the same exemption within the Investment Company Act as these other vehicles,²²⁹ Section 3(c)(1) or 3(c)(7) of the Investment Company Act.²³⁰ These exclusions allow for exemptions from certain registration requirements for many securitization entities, including hedge funds and private equity funds, which Congress intended to be subject to Volcker Rule prohibitions.²³¹ However, legislative history and other provisions in Dodd-Frank suggest that a more nuanced distinction is possible between the types of activities that are safe and those that the Volcker Rule sought to correct.²³² The distinction between securitization entities and true “hedge funds” appears elsewhere in Dodd-Frank. Section 402 of the

²²⁵ See *supra* notes 176–77 and accompanying text.

²²⁶ See *Hearing, supra* note 95, at 73 (statement of Kenneth Gibbs).

²²⁷ See *id.*

²²⁸ See CADWALADER, WICKERSHAM & TAFT LLP, *supra* note 59.

²²⁹ See 15 U.S.C. § 80a-3(c)(1), (c)(7) (2012).

²³⁰ See SULLIVAN & CROMWELL, *supra* note 100, at 62 (“Although [the Volcker Rule’s “covered fund”] definition does capture many hedge funds and private equity funds, it also captures many other kinds of commonly used vehicles . . .”).

²³¹ See Am. Securitization Forum, *supra* note 53, at 3.

²³² See *id.* at 7–10.

Dodd-Frank Act distinguishes among “securitized asset funds,” true “hedge funds,” and “private equity funds,” which demonstrates that appropriate definitions of these terms are possible based on substantive distinctions rather than a common Investment Company Act exemption.²³³

In the absence of an exemption for TOBs, there is the possibility that the joint venture TOB and the third-party TOB could step in to fill the void. As argued above, the language of the regulations supports the exemption of TOBs. The requirement under the Investment Company Act that the joint venture be capped at ten parties would not allow for banks to split the residual into many smaller internal funds, a common practice, but would still allow the TOB structure to exist.²³⁴ Given the ten-party cap imposed upon joint ventures for TOBs, it would be preferable if TOBs were granted an exemption from the Volcker Rule regulations. While the third-party TOB structure does not carry the same kind of risks that the joint venture structure does, it is a solution that is unworkable for banks. Banks will have to hand over functions essential to running TOBs to residual holders, and it is not necessary to relegate banks to merely providing support roles in a business that does not pose systematic risks to the financial system. Given how crucial the TOB market has been—through increasing demand for longer-dated municipal bonds, exerting downward pressure on the long end of the municipal yield curve, and lowering borrowing costs for state and local governments—it is likely that the TOB market will continue under either the third-party or joint venture structure.²³⁵ However, the regulations unnecessarily force a restructuring of TOB programs.

C. Exempt TOBs from the Risk Retention Rule

Exempting TOBs entirely from the Risk Retention Rule makes the most sense, though at the very least, there are further modifications that could be made to better reflect the

²³³ See *id.* at 9–10.

²³⁴ See Glazier, *supra* note 169.

²³⁵ See McGee, *supra* note 52.

risk profile of TOBs and current market practices. TOBs are not the type of synthetic derivative instruments that the Risk Retention Rule was aimed at regulating.

One change that could have mitigated some of the negative consequences of the Risk Retention Rule, particularly with respect to minimizing the cost of raising capital for municipalities and maintaining high levels of innovation in the TOB market, relates to the type of underlying assets composing TOBs.²³⁶ Comment letters on proposed TOB rulemaking have suggested expanding the scope of QTOB-eligible TOBs to those that have municipal bonds from more than one issuer, or expanding the scope of eligible underlying securities to taxable municipal bonds and preferred shares of registered closed-end investment funds that primarily invest in municipal bonds.²³⁷ Supporters of expansion contend that the moral hazard problem is addressed because the credit profiles are similar to municipal bonds and market participants view these assets as a part of the TOB universe.²³⁸ To counter, regulators suggest that expanding the rules would lead to issuers gaming the Risk Retention Rule by cramming assets into TOBs that are not fit for them.²³⁹ Further, the majority of TOBs on the market only have municipal bonds from the same issuer as its underlying asset.²⁴⁰

Recognizing that there are concerns with issuers potentially “gaming” the Risk Retention Rule, there are still some good reasons to allow for a more diverse set of underlying assets to qualify as QTOBs. First, only allowing TOBs that have a single issuer could hurt smaller municipalities, which do not issue enough municipal bonds on their own to create a TOB. Furthermore, not allowing taxable municipal bonds and closed-end investment funds

²³⁶ See generally Ashurst LLP, *supra* note 185.

²³⁷ See *id.* at 4.

²³⁸ See *id.* at 4–5.

²³⁹ See Credit Risk Retention, Final Rule, 79 Fed. Reg. 77,602, 77,662 (Dec. 24, 2014) (to be codified at 12 C.F.R. pts. 43, 244, 373, 1234, 17 C.F.R. pt. 246, 24 C.F.R. pt. 267).

²⁴⁰ See Ashurst LLP, *supra* note 185, at 4–5.

would increase funding costs for municipalities by restricting the creation of innovative products that are more in line with the realities of the market. For example, Build America Bonds, a type of bond that has been packaged in a TOB, are taxable bond issuances where the federal government reimburses thirty-five percent of the interest paid, making it a cost-effective way of raising money for municipalities.²⁴¹ Besides the tax treatment, taxable TOBs are identical in structure to traditional TOBs, and therefore do not present novel risks compared to traditional TOBs, assuming that the bond or bonds being securitized are of high quality.²⁴² Taxable TOBs linked to Build America Bonds were introduced in 2010, healthy demand for the product resulted, and the TOB stepped into a void where there was not an active repurchase market for taxable municipal bonds.²⁴³ However, under the risk retention provisions, these types of TOBs could no longer exist. The TOB market, estimated at a relatively small \$75 billion in 2012, was \$175 billion in size at its peak, so the TOB market could easily become more significant depending upon market conditions.²⁴⁴

It is submitted, however, that the most sensible choice would be to exempt TOBs from the Risk Retention Rule entirely. TOBs did not trigger the financial crisis that led to the enactment of Section 15G in the first place,²⁴⁵ and TOBs are fundamentally different from products traditionally designated as ABSs.²⁴⁶ The ability of an issuer of ABSs to enforce its security interest in the underlying assets may be limited, which is not the case with TOBs.²⁴⁷ The underlying

²⁴¹ See MEEHAN, *supra* note 48, at 4; Patrick McGee, *Taxable TOBs Take The Stage: Shorter Maturities, BAB Advantages*, THE BOND BUYER, July 12, 2010, at 1.

²⁴² See McGee, *supra* note 241, at 26.

²⁴³ See *id.* at 1, 27.

²⁴⁴ See Citibank Glob. Mkts. Inc., *supra* note 4, at 14.

²⁴⁵ Gorman, *supra* note 22.

²⁴⁶ See Invesco, Comment Letter on Proposed Rule on Credit Risk Retention 3 (Oct. 30, 2013), <https://www.sec.gov/comments/s7-14-11/s71411-415.pdf> [<https://perma.cc/G7J6-G6EN>].

²⁴⁷ *Id.*

bonds in a TOB “generally are from one original issuance and have the same issuer and borrower/obligor”; investors analyze the credit risk of the underlying borrower as they would for any other municipal investment.²⁴⁸ Moreover, “TOBs typically are backed by a liquidity facility provided by a highly rated financial institution,” and there is liquidity that is not found with typical structured finance products that are the subject of the Risk Retention Rule.²⁴⁹ Subjecting TOBs to the Risk Retention Rule seems particularly inconsistent considering the treatment of Qualified Residential Mortgages (“QRMs”) embedded in the rule.²⁵⁰ Essentially, there is an exemption for mortgages that are of highest quality.²⁵¹ In the final rules, some of the toughest qualifications to obtain the QRM exemption, including a requirement that a residential mortgage have at least a twenty-percent down payment, were abandoned.²⁵² This is on top of the exemption for “community-focused” mortgages and the exemption that already existed for mortgages issued by GSEs (i.e., Fannie Mae, Freddie Mac, and Ginnie Mae).²⁵³ It is inconsistent that a transparent investment vehicle with highly rated securities underlying it, such as TOBs, would be subject to more stringent risk retention requirements than mortgages that have no down payments.

²⁴⁸ *Id.*

²⁴⁹ *Id.*

²⁵⁰ See Floyd Norris, *Banks Again Avoid Having Any Skin in the Game*, N.Y. TIMES, Oct. 24, 2014, at B1, B4 (explaining the QRM exemption and the perception that the “loophole has eaten the rule, and there is no residential mortgage risk retention”).

²⁵¹ *See id.*

²⁵² Christopher Merchant, Frank Serravalli & Daniel Sullivan, *Ten Key Points from the Final Risk Retention Rule*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 2, 2014, 9:00 AM), <http://blogs.law.harvard.edu/corpgov/2014/11/02/ten-key-points-from-the-final-risk-retention-rule/> [<http://perma.cc/8FES-ZYGU>].

²⁵³ *See id.*

VI. CONCLUSION

The motives behind the Dodd-Frank Act and the liquidity rules—preventing the excessive risk taking that led to the financial crisis and improving the banking sector’s ability to absorb shocks arising from financial and economic stress—are sound.²⁵⁴ However, the municipal bond exclusion from HQLA eligibility, the Volcker Rule prohibition on TOBs, and the Risk Retention Rule as it applies to TOBs do not provide protections against excessive risk taking or provide for a more sound banking system while raising financing costs for municipalities. Particularly compared to other asset classes that are more lightly regulated or other asset classes with which municipal bonds are lumped together, municipal bonds are treated harshly. Despite a recent increase in municipal bankruptcies, municipal bonds remain a relatively safe asset class. Higher financing costs for municipalities may have undesirable effects, as they would leave municipalities with less capital to maintain assets and could have potentially harmful spillover effects into industries such as construction.²⁵⁵ In sum, the existing municipal bond regulation framework under the Dodd-Frank Act should be modified in the following ways: the most liquid municipal bonds should be considered assets eligible for HQLA inclusion, and TOBs should be exempt from both the Volcker Rule and the risk retention provisions.

²⁵⁴ See *Wall Street Reform: The Dodd-Frank Act*, THE WHITE HOUSE, <http://www.whitehouse.gov/economy/middle-class/dodd-frank-wall-street-reform> [<http://perma.cc/V49Y-5VW7>]; see also *International Regulatory Framework for Banks (Basel III)*, BANK FOR INTERNATIONAL SETTLEMENTS, <http://www.bis.org/bcbs/basel3.htm> [<http://perma.cc/BX9N-MGPG>].

²⁵⁵ See Rennison, *supra* note 143.