Memorandum

TO: Bond Dealers of America

FROM: Nixon Peabody LLP

DATE: September 21, 2012

RE: Sequestration

Background. The Budget Control Act of 2011 (the "Act") provided for increases in the federal debt limit and established procedures designed to reduce the federal budget deficit. In order to encourage Congress and the President to reduce the deficit, the Act provided that a failure to do so would result in the automatic budget reduction process of "sequestration." Sequestration is a process of automatic, generally across-the-board spending reductions. Under current law, sequestration triggered by the Act is scheduled to occur on January 2, 2013.

There are numerous exceptions and special rules that apply to the sequestration process, with the general rule being that all spending programs, activities, and projects are covered and will be cut by a uniform percentage absent an applicable exception or special rule. OMB recently published its report detailing its view of the activities that will be cut under sequestration and the amount of the cuts. By law, the President is required to issue an order implementing sequestration and this Order will trigger the reductions in spending. Sequestration will remain in effect until Congress and the President enact a law to make it inapplicable.

BABs and other direct pay bonds. Consistent with the Act and other related laws, OMB identified Build America Bonds and other "direct pay" tax credit bonds such as qualified school construction bonds, qualified zone academy bonds, qualified energy conservation bonds, and clean renewable energy bonds (CREBs), as eligible for sequestration. According to the OMB report, the amounts owed under the BABs and other direct pay programs (other than CREBs) will be reduced by 7.6 percent. Importantly, if not dealt with by Congress, sequestration will affect both BABs and other direct pay bonds that are currently outstanding and those to be issued in the future.

Extraordinary optional redemption provisions. Most BABs were issued with a provision designed to provide the issuer with the option of redeeming the bonds if the BABs subsidy was reduced

or eliminated. Some issuers of BABs, particularly smaller issuers, structured provisions to provide for the bonds to be callable at par. Many BABs, however, provided that the call price was more of a discounted "make whole" call, with the call price based on current interest rates (that is, by discounting the remaining payments on the bonds based on the rate on a then-current Treasury security with a comparable maturity plus 1 percent). A typical optional call provision reads as follows:

> The Bonds are subject to redemption at the option of the Authority if the Authority determines that a material adverse change has occurred to Section 54AA or 6431 of the Internal Revenue Code (pertaining to Build America Bonds) or there is any guidance published by the IRS or the United States Treasury with respect to such Sections or any other determination by the IRS or the United States Treasury, which determination is not the result of any act or omission by the Authority to satisfy the requirements to qualify to receive the federal subsidy from the United States Treasury, pursuant to which the federal subsidy from the United States Treasury is reduced or eliminated.

These optional call provisions raise two issues. First, is it economical for the issuer to call its BABs. A par call with respect to a BAB issued in 2009-2010 may be very valuable to the issuer (and very troublesome to the bondholder) given current low interest rates. A call option at a price based on the discounted make whole provision described above, may or may not be economic. A more difficult question is whether the reduction in the BABs subsidy payment resulting from sequestration is sufficient to trigger the optional call. Is the reduction in the BABs subsidy resulting from sequestration a "determination by the IRS or Treasury that reduces or eliminates the BABs subsidy"? Alternatively, is sequestration a change to Internal Revenue Code Section 54AA (which provide for the issuance of BABs) or Section 6431 (which provides for the ability to obtain the direct cash subsidy from the IRS, rather than a tax credit). It is important to review the specific redemption language for a particular bond since the language may not be the same as the language quoted above.

Implications for tax reform. Much of the discussion related to the potential impact of tax reform on the municipal market has involved the potential to replace tax-exempt bonds with tax credit bonds or BABs. The failure of tax credit bonds to serve as a practical alternative to tax-exempt bonds is well known in the municipal finance industry. BABs, however, had been extremely successful in 2009 and 2010. At that time, concerns with the potential for future reductions in the subsidy were largely ignored. The potential for sequestration has made it clear that issuers cannot be assured that they will receive their subsidy checks throughout the terms of their BABs. This possibility has caused municipal issuers and investors alike to believe that BABs and other direct pay bonds, and even tax credit bonds, could never be an acceptable replacement for tax-exempt bonds.

Conclusion. Unless Congress and the President act soon, sequestration will take effect. While the impact on BABs and other direct pay bonds is significant, the OMB does not have the flexibility to pick and choose the programs affected by sequestration under current law. A new law to delay sequestration or to replace it with a significant budget deal will be necessary to prevent sequestration, but Congress has no plans to discuss these matters before the November elections.