How to Find a Bondholder: DTC and Its Role in Structured Finance Transactions

How do you find a bondholder? This is a question we get a lot these days. As the commercial real estate market continues to suffer distress, this question gains increasing significance because of important control rights held by certain bondholders.

Structured finance transactions typically provide a class of bondholders with special voting or control rights. For example, commercial mortgage-backed securities (“CMBS”) pooling and servicing agreements often permit the “controlling class” of bondholders to replace the special servicer. Similarly, collateralized debt obligation (“CDO”) indentures may grant the majority of the “controlling class” of bondholders the right to direct the trustee to take certain actions on behalf of all bondholders.

These rights are important. When the deal closed, it was probably pretty obvious that the rights sat with the B piece buyer in a CMBS transaction. However, ownership of these rights can change as losses (and, in some cases, appraisal reduction) erode the capital stack. As commercial real estate losses multiply, the velocity with which ownership of these rights changes increases substantially. Moreover, as mentioned above, the determination of who can exercise control is not straightforward and not uniform across programs. It’s increasingly probable that as realized losses erode the capital stack, mezzanine, or, indeed, senior bondholders might unknowingly inherit such rights. These bondholders, who never thought terribly much about control rights when the bonds were purchased (that was the concern of the first-loss buyers), now matter for control of servicing and other major decisions.

So, it’s important to figure out who holds the bonds.

Most certificates have been transferred numerous times since they were issued. Moreover, bonds are often held by other structured finance vehicles such as CDOs which themselves have highly complex ownership structures. So investors may purchase a control position without knowledge of the rights or duties it carries with it and without a clear understanding of the transaction documents or the need to step forward to carry out such duties.

To make matters worse, the vast majority of all certificates in structured finance transactions are not held directly by the investor that owns them, but are held through the Depository Trust Company (“DTC”).

What is DTC?

The Depository Trust & Clearing Corporation (“DTCC”), through its subsidiaries such as DTC, provides clearing, settlement and information services for equity instruments, corporate and municipal bonds, government and mortgage-
backed securities, money market instruments and over-the-counter derivatives. DTCC is a non-profit cooperative owned by approximately thirty of the largest Wall Street players that typically act as brokers or dealers in securities. These thirty banks are called the “DTC participants.”

Thousands of companies within the global financial services industry, including brokers, dealers, institutional investors, banks, trust companies, mutual fund companies, insurance carriers, hedge funds and other financial intermediaries rely on DTC for its custody and asset servicing capabilities. DTC has over $28 trillion assets under management and in 2008, more than $1.88 quadrillion in securities transactions were settled by the subsidiaries of DTCC. All services provided through the DTCC and DTC are subject to regulation by the U.S. Securities and Exchange Commission (“SEC”).

How Do Investors Hold Through DTC?

Each security traded through DTC is listed in electronic “book-entry” form on the books of various intermediaries between the ultimate owner, e.g. a private or retail investor or a brokerage firm that holds on its behalf, and the DTC participants. Such book-entry securities are often referred to as “Global Certificates” in offering memoranda, CMBS pooling and servicing agreements and other structured finance transaction documents. Ownership of Global Certificates is considered beneficial ownership because each security that is held by DTC lists Cede & Co. rather than the ultimate owner as its registered owner.

Therefore, when certificates are issued to investors in a structured finance transaction, most classes of certificates are issued initially in DTC’s street name, Cede & Co., rather than in the name of the investor or the brokerage firm that owns the position. Because DTC has the capacity to act as a depository for all Global Securities in the United States, structured finance issuers are able to deposit a single certificate representing all the outstanding securities in a particular class or series. This has streamlined the issuance of debt securities such as residential mortgage-backed securities and CMBS to such an extent that the use of Global Certificates (as opposed to non-registered “physical” or “definitive” certificates) is the norm in structured finance transactions.

The Practical Effects of DTC

DTC simplifies the process for the party who serves as trustee to make distributions on Global Certificates. All payments or distributions on any Global Certificate are made to DTC as bondholder, and DTC is responsible for crediting the amount of such distribution to the accounts of the DTC participants. Each DTC participant is then responsible for disbursing such distribution to the bondholders that it represents and to each indirect participating brokerage firm for which it acts as agent. Each brokerage firm is then responsible for disbursing funds to its clients.

While this system performs well in facilitating the distribution of funds from deal to beneficial owner, it impedes any sort of two way flow of information. There is no mechanic in the system to really allow a servicer or trustee to identify and consult with bondholders before taking a particular action nor is there an easy way for a beneficial owner to identify or consult with other bondholders. Typically, structured finance transaction documents provide that the trustee shall not have any duty to monitor, maintain records concerning (or determine compliance with any of the restrictions on transfer set forth in the transaction documents with respect to) owners of beneficial interests in Global Certificates and that the trustee shall not have any liability for the accuracy of the records of DTC. Therefore, there is no central registry of bondholders in most instances, and no one party knows the identity of the parties that hold the various classes of certificates.

Steps Commonly Taken to Identify the Beneficial Owner of a DTC Bond

To address this, most structured finance transaction documents give DTC the authority to act as the authorized representative of the owners of Global Certificates for the purposes of exercising the rights of the bondholders. The party seeking input from the bondholders must contact DTC with a request for direction and/or a solicitation for a vote from selected bondholders. DTC then must contact its participants, who will be responsible for delivering the communication to the beneficial owner of the related certificate. Not an efficient system, to be sure.
Some limited bond ownership information may also be available from Bloomberg. Bond CUSIPs may be searched from the “PHDC” screen on a Bloomberg Terminal. If the search is successful, Bloomberg will populate the search field with publicly-available ownership information about a CUSIP. Since Bloomberg typically obtains this information using SEC filings by public companies, it may still be difficult to identify the owner of a bond if it is held by an entity that does not make public filings of its holdings. Moreover, given the lag in reporting public company data, the Bloomberg data may be far from current.

A trustee may periodically also require the ultimate owner of a Global Certificate to deliver evidence of its ownership interest in order to ensure that it is communicating with the appropriate counterparty to take a necessary action. Such evidence may, for example, take the form of a “screenshot” that shows the CUSIP number of the security held by a bondholder on the website of the brokerage or DTC participant who is serving as the bondholder’s intermediary with DTC. Once again, this is a very inefficient mechanism for identifying beneficial owners. Ultimately, it is the responsibility of the beneficial owner of a Global Certificate to identify itself to its DTC participant who can put such owner in contact with the deal party seeking its input. Neither DTC nor the DTC participants have an obligation to share the name of the beneficial owner of any certificate with transaction parties and further, this ownership information is likely protected under a confidentiality agreement with the DTC participant or brokerage firm who represents the investor.

The bottom line is that for a party to a transaction that has a need to identify the bondholders of a particular class in order to take action to clarify voting rights, the only mechanism available is to request the trustee to pass on a request to the DTC participants who will ultimately pass the request on to beneficial owners whose ownership is reflected on the DTC participants’ books, who may then respond back through the system to the initiating party. This is not a system designed for the efficient flow of information or for the development of a dialogue about the enforcement of rights or the determination of control.

The system has worked fine in an unstressed environment when control rights were stable and issues that bondholders might wish to discuss were few. We’ve discovered that, in a more stressed environment, the shortcomings of the system are more apparent. Perhaps this is another issue to address in connection with CMBS 2.0.

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