Bond Case Briefs

Municipal Finance Law Since 1971

Market Has Concerns, Questions About IRS Issue Price Rules.

Internal Revenue Service's proposed rules on issue price would drastically change market practices and raise major questions and concerns, representatives of issuer and dealer groups said Monday.

"It completely changes industry practices regarding issue price by eliminating reasonable expectations," said Ben Watkins, chair of the Government Finance Officers Association's debt committee and Florida's bond finance director.

Watkins said that, in his view, the rules are unworkable and are "going to create a compliance nightmare."

"They're going to create problems for the entire industry — issuers, bond counsel and underwriters," he said.

Michael Decker, managing director and co-head of municipal securities at the Securities Industry and Financial Markets Association, said, "This is kind of a watershed proposal.

"We're really happy that they're out. We've been waiting a long time for them," he said, adding that SIFMA members are still studying the proposals and determining what they like and don't like.

The proposed rules are "complex" and "raise some questions," he added.

Issue price is important because it is used to determine bond yield and whether an issuer is complying with arbitrage rebate or yield restriction requirements, as well whether issuers are receiving the appropriate amount of federal subsidy payments in the case of direct-pay bonds such as Build America Bonds.

Under current tax rules and market prices, the issuer price is determined at issuance based on reasonable expectations. The issue price for each maturity of bonds publicly offered is the first price at which a substantial amount of the bonds is reasonably expected to be sold to the public, with substantial defined as 10%. Sales to underwriters and wholesalers are not considered to be the public and are excluded from the determination of whether the 10% amount has been reached.

But IRS officials were concerned, based on the Municipal Securities Rulemaking Board's EMMA data, that bonds were being flipped, or almost simultaneously traded up between dealers and other dealers or institutional investors, so that retail investors paid the highest prices for the lowest yields. IRS officials felt the first 10% of sales at the lowest prices did not represent the true issue price, which should have been higher. If that were the case, the interest rate and bond yield should have been lower so the issuer's investments would have to be at a lower yield to avoid arbitrage problems and the Treasury's subsidy payments to BAB issuers should have been lower.

In its proposed rules, the IRS would eliminate the reasonable expectations standard and instead base issue price on actual sales. It also would expand the percentage of bond sales to be taken into account in determining issue price to 25% from 10%. The IRS would remove any mention of wholesalers. The proposed rules say sales to underwriters could not be counted toward the 25% amount. They would define the term underwriter somewhat broadly in a manner that is subject to interpretation.

Both Watkins and Decker said the proposed rules would mean the issuer and underwriter typically would not know what the issue price was at the time of issuance and without checking the prices on EMMA for several days or possibly even weeks.

Watkins is particularly concerned the proposed rules do not distinguish between negotiated and competitive transactions. In competitive deals, dealers bid to underwrite the bonds. Florida does a lot of competitive deals and typically chooses the underwriter willing to buy the bonds at the highest prices and lowest yields, Watkins said.

"If I take bids on bonds that ought to be prima facie evidence that this is the price and yield of the bonds," he said. "But I've got to go check EMMA? Remember we're not talking about one bullet maturity. There can be 20 or 30 maturities in any given bond issue. So I've got to go find the price at which 25% of each of those maturities was sold to the public? I think that's wholly unworkable."

"That's just an indication of a lack of knowledge on the part of Treasury because these regulations are supposed to clarify the rules and this changes the standards," he said. Watkins complained IRS officials are trying "to go after some perceived abuse that simply doesn't exist and in the process of so doing, they are creating a muddled process of what the issue price is."

"I'm not sure how they can have studied this for over three years and yet gotten it so wrong," Watkins said. "This will create a lot more problems than it solves."

"This is so far from what we expected," he said. Watkins said he thought Treasury might expand the percentage of sales used in the determination of issue price to 15% from 10%, but he never imagined the IRS would take away the reasonable expectations standard.

Decker was also surprised that the IRS did not distinguish between competitive and negotiated sales of bonds, as SIFMA had recommended. He said selling bonds competitively "should on its face establish a market price for the bonds."

He said the elimination of the reasonable expectations standard would create "a big difference in the market."

"You now have to wait until 25% of every maturity is sold or committed to investors that meet the criteria. That can take days or, in a worst case scenario, even weeks. And the market moves every day," he said.

Decker also said the definition of underwriter and language on which sales can and cannot be counted toward the 25% is somewhat ambiguous.

The proposed rules say the issue price of tax-exempt bonds issued for money is the first price at which a substantial amount of the bonds is sold to the public. The proposed rules define public to mean any person other than the underwriter. They define underwriter as "any person that purchases bonds from the issuer for the purpose of effecting the original distribution of the bonds, or otherwise participates directly or indirectly in the original distribution."

The IRS said an underwriter would include, besides the lead underwriter, an underwriting syndicate member, and a dealer "that purchases bonds for the purpose of effecting the original distribution."

Decker pointed out that some dealers buy large portions or all of certain maturities for their inventories and may hold them for a while as an investment. "How are you supposed to sell bonds to a dealer desk and know whether it's for the purpose of a long-term investment or the purpose of distribution?" he asked. "It raises ambiguity."

"There are some questions," he said. Can primary market sales to hedge funds, that don't typically hold bonds for any length of time, be counted toward the 25%, he asked.

Some underwriters sell the bonds to dealers who specialize in selling bonds to retail investors, he said. A lot of investors want their bonds distributed to retail investors. Some issuers require their underwriters to have retail order periods.

"It's unclear how the dealers involved in retail distribution are going to be able to adapt to these," he said.

Decker noted SIFMA members have several months to study the rule and said, "We're certainly going to suggest some clarifications and changes."

Comments on the proposed rules are due to be submitted to the IRS by Dec. 16 and a public hearing is to be held Feb. 5, 2014.

Bond Dealers of America also raised concerns about the proposed rules.

Susan Collet, BDA's senior vice president for government relations, said: "BDA is reviewing the proposed rules and looks forward to the opportunity to comment to the IRS, including to relay concerns that the newly proposed framework on issue price sets up a process that could impede the ability of underwriters to execute transactions efficiently on a day-to-day basis and be detrimental to issuers seeking access to the marketplace."

by: LYNN HUME and NAOMI JAGODA