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State Treasurer Cites Potential Adverse Effects of Proposed Regs on Arbitrage Restrictions.

Washington State Treasurer James McIntire has expressed concern with proposed regs (REG-148659-07) modifying the rules for determining the issue price of tax-exempt bonds for arbitrage purposes, warning that the regs would impose burdensome and potentially unworkable market monitoring obligations on municipal issuers.

November 27, 2013

Internal Revenue Service

P.O. Box 7604

Ben Franklin Station

Washington DC 20044

November 26, 2013

Re: Comments on REG-148659-07

To whom it may concern:

I am writing on behalf of the State of Washington to comment on the Internal Revenue Service's proposed regulations released on September 13, 2013, (REG-148659-07) specifically the proposed provisions modifying the long-standing rules for determining issue price (the "Proposed Issue Price Rules").

Based on our experience as a large and frequent issuer of municipal bonds, we strongly believe the Proposed Issue Price Rules, if enacted as drafted, would increase the cost of capital for the State of Washington, result in higher arbitrage yields, increase the amount of interest income exempt from Federal tax and increase the potential for profitable "flipping" of tax-exempt bonds in the secondary market. Further, the Proposed Issue Price Rules would impose burdensome and potentially unworkable market monitoring obligations on municipal issuers. It is critical to the continued effective functioning of the municipal bond market that any revised issue price rules retain a "reasonable expectations" provision and maintain the definition of "substantial amount" or "safe harbor amount" at or close to 10%.

Eliminating the "reasonable expectations" provision and changing the 10% "substantial amount" definition to a 25% "safe harbor" provision creates strong incentives for underwriters and issuers to price bonds at interest rates that ensure that 25% of each maturity of a bond issue will be sold to end investors at the list price immediately on the date of sale. Qualifying for the 25% safe harbor in this way eliminates (a) the costs and time commitment required for issuers, underwriters and/or legal counsel to monitor and interpret secondary market trading information over multi-week time periods; (b) the need to perform onerous and potentially complex yield adjustment calculations; (c) the risk of being required to make “yield reduction payments;” and (d) an underwriter’s risk that it could be accused of abusive “flipping” of bonds post sale. But pricing bonds to be able to qualify for the 25% safe harbor will undoubtedly result in higher interest rates.

In negotiated sales, the State of Washington negotiates with underwriters to achieve the lowest possible all-in cost for a bond issue, given market conditions at the time of sale. Frequently, this process results in certain maturities being fully or partially underwritten by the underwriting group rather than being sold immediately to end investors on the day of sale. The practical requirement to immediately sell 25% of each maturity to end investors will greatly diminish our ability to negotiate for higher prices or interest rates that are lower than the rates required to sell 25% of each maturity. This will generally lead to higher all-in interest costs on negotiated bond sales and higher arbitrage yields. It also generates more interest-income exempt from Federal tax. Moreover, this will create more opportunities for end investors or underwriters to “flip” bonds at lower interest rates and higher prices in the days and weeks after a bond sale.

The Proposed Issue Price Rules could even more severely disrupt the functioning of the competitive new issue market by introducing significant uncertainty and administrative burden. This will have a material negative impact on our state’s cost of capital as Washington issues nearly all of its debt through competitive sales. In competitive bond sales, there are very limited opportunities for dealers to “pre-market” upcoming issues to investors. Underwriters bid for entire bond issues at prices they expect but have no assurance will enable them to sell most of the bonds to the public and other dealers. The practical requirement to ensure that 25% of each maturity will be sold quickly to the public at list price will motivate underwriters to bid lower prices and higher yields.

In addition to the significant adverse impact the Proposed Issue Price Rules would have on borrowing costs of issuers like ourselves, there are significant impediments to their accurate application in any case. Market information dissemination platforms provided by the MSRB (EMMA), Bloomberg and Thompson-Reuters (TM3) provide reasonably good information on secondary market trading, but the information is not 100% accurate. Further, the information provided can be difficult to interpret given that no dealer or investor names are disclosed, trade amounts greater than $5 million par amount are not disclosed until one week following the trade date and trade details can be revised long after the trade information is originally submitted. Further, trade tracking can be complicated by intra-entity trades and distribution affiliation agreements that exist among some dealer firms.

In conclusion, we are strongly in agreement with the wide range of market participants who believe that the Proposed Issue Price Rules will penalize issuers who negotiate the best deals with underwriters, result in higher arbitrage yields for tax purposes and increased amounts of interest income exempt from Federal tax. We firmly believe that the current rules, coupled with prudent IRS enforcement, are and will continue to be highly effective in achieving the interrelated goals of minimizing borrowing costs for issuers, minimizing arbitrage yields and minimizing the amount of interest income exempt from Federal tax.

Sincerely,

James L. McIntire

State Treasurer

State of Washington

Olympia, WA