

# **Bond Case Briefs**

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## **Market Groups Agree: Proposed Issue Price Rules Unworkable.**

Municipal market groups often at odds with one another are for once in agreement, with each telling the Internal Revenue Service that its proposed issue price rules are unworkable and would hurt issuers as well as the market.

Groups representing lawyers, dealers, municipal advisors and issuers asked the IRS in comments on its proposals to keep the reasonable expectations standard in the existing issue price rules. Several of the groups have asked the IRS to withdraw its proposed rules.

The National Association of Bond Lawyers told the IRS in the summary of its 23-page letter, "The proposed definition of 'issue price' is not required or appropriate to address the policy objectives and state concerns of Treasury and the IRS." The group also warned the proposal "is not administrable by issuers under existing law and market practices" and would "impose substantial additional expense on issuers and alter long-standing practices in the municipal market."

The Securities Industry and Financial Markets Association, in its 19-page letter, said it wants to be a constructive contributor to updating the issue price rules but, "the proposed regulations, while well intentioned, represent an approach to defining and documenting issue price which is unworkable based on limitations on the ability of issuers, underwriters and others to monitor sales of bonds during the order period."

While issuers are often at odds with dealers, the State Debt Management Network, an affiliate of the National Association of State Treasurers, told the IRS that it has "grave doubts about the ability of issuers or the IRS to administer the proposed standard based on currently available secondary market information."

The proposed rules were published in September, and comments about them were to be sent to the IRS by Monday. A public hearing about the proposed rules is scheduled for Feb. 5.

The IRS and Treasury Department proposed the issue price rules to address their concerns that the current rules do not result in a true issue price of bonds and may contribute to "flipping," when the prices of munis trade up on the day of issuance, with dealers and institutional investors buying them at the lowest prices and retail investors at the highest prices.

Issue price is extremely important because it is used to help determine the yield on bonds and whether the issuer is complying with arbitrage rebate or yield restriction requirements, as well as the amount of federal subsidy payments issuers receive for direct-pay bonds such as Build America Bonds. Issue price also plays a role in complying with other muni tax rules such as the 2% limit on issuance costs for private activity bonds and the size of debt service reserve funds.

Under the current rules, 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%. The issue price is usually determined based on reasonable expectations

when the bonds are priced, before the closing of a bond deal.

However, the proposed rules would eliminate the reasonable expectations standard and instead base the determination of issue price on actual sales of the bonds. The proposed rules include a safe harbor under which the issue price would be the price at which the first 25% of the bonds is actually sold to the public. Under the proposed rules, “the public” would be any person other than an underwriter, a term that would be defined 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 is concerned about the reasonable expectations test, believing it can be manipulated. When it proposed the issue price rules, the agency said that trade reporting data on the Municipal Securities Rulemaking Board’s EMMA system, “has shown, in certain instances, actual sales to the public at prices that differed significantly from the issue price used by the issuer. These price differences have raised questions about the ability of the reasonable expectations standard to produce a representative issue price. The reported trade data has also called into question whether sales to underwriters and security dealers have been included as sales to the public in determining issue price in certain instances.”

But market participants are particularly concerned with the proposed move away from the reasonable expectations standard and creation of a safe harbor of 25% of actual sales.

Groups said that there is no good way to track the prices of bonds to determine when 25% of each maturity is sold to the public. The Municipal Securities Rulemaking Board’s EMMA system “lacks sufficiently specific details of trades to provide a solution to the problem,” the Bond Dealers of America said in its 12-page letter. The proposed rules also “fail to distinguish changes in bond prices that result from changes in interest rates and other external factors,” BDA said.

The Government Finance Officers Association and other groups noted that some maturities may not meet the 25% actual sale test for days, weeks or months after the bond sale, and that the rules don’t address what an issuer should do if the 25% threshold is not met.

Market groups said that the proposed rules would result in higher borrowing costs for issuers. To satisfy the safe harbor, issuers will need to ensure that 25% of each maturity is sold to the public. But to achieve that goal, bonds probably would be sold at lower prices, meaning higher interest rates for the issuer.

The National Association of Independent Public Finance Advisors and other groups were particularly concerned that the proposed rules would make it hard for issuers to sell bonds on a competitive rather than negotiated basis.

Generally, underwriters of competitive sales take on the risks of unsold bonds, knowing that they might not be able to find buyers at the offering price immediately after the sale. There is no preliminary order period and limited marketing, NAIPFA said.

In addition, the proposed rules may lead issuers to have negotiated sales in order to assure the bonds are underwritten at the final stated price. But issuers have historically achieved “significant financial benefits” from using the competitive sale method, NAIPFA said.

NABL President Allen Robertson told The Bond Buyer that “any revised definition of issue price would need [issue price] to be determined as of the sale date.”

If the IRS proposed the issue price to be determined after the sale date, issuers could violate state

law, policy of authorizing resolutions and could also unintentionally violate other provisions of federal tax law, he said. Also bond counsel has to be able to confirm whether they can give an unqualified approving opinion on the sale date. If it can't do so because issue price can't be determined until after the issue date, the bonds would not be issued and the bond purchase agreement would "crater" between pricing and closing, NABL warned.

The SDMN said the proposal could lead to higher costs to the federal government for the tax-exemption for municipal bonds. Since the proposed rules may lead to higher yields to meet the 25% threshold, there would be more interest exempt from federal income taxes.

While the IRS proposed the rules in order to discourage flipping, they could actually lead to more bond flipping, GFOA said.

"If the standard requires 25% of each maturity to be sold to the public, an issuer will have to accept lower prices on the bonds in order to sell enough bonds to meet that threshold, leading to artificially inflated rates at greater taxpayer expense, which would actually encourage flipping," the issuer group told the IRS.

NABL said that concerns the IRS has about the offering and distribution process for municipal securities — such as an underwriter making a public offering of only 10% of a maturity to establish a lower issue price and then selling the remaining 90% at a higher price — would be better addressed by working with municipal securities regulators than by changing tax policy.

Groups also contend the proposed rules' definition of an underwriter is unreasonable. "It uses extremely broad terms and requires that issuers determine the intent of bond purchasers," BDA said. "Even with the ability to cure bond yield-related problems through yield reduction payments, it will be impossible for an issuer and its bond counsel to determine the parties that the IRS might view as an underwriter with the sort of certainty necessary to conclude that a bond issue is tax-exempt."

The proposal allowing for yield-reduction payments if the issue price of the bonds is greater than the price originally assumed at the issuance date is problematic, SDMN said. Reliance on these payments would increase issuer costs. In addition, issuers relying on yield reduction payments would have to be willing to bear risk and the uncertainty of not knowing the issue price and allowable yield at closing.

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