
Bond Counsel Group Suggests Changes to Proposed Bond Arbitrage Regs.

The American College of Bond Counsel has commented on proposed regulations (REG-148659-07) on arbitrage investment restrictions applicable to tax-exempt bonds, urging the IRS to withdraw the provision that proposes a new definition of issue price and suggesting improvements and clarifications to the remaining provisions.

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Internal Revenue Service

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This letter contains comments on the September 16, 2013 proposed arbitrage regulations [REG-148659-07] submitted on behalf of the American College of Bond Counsel (the "College").

The College was formed in 1995 and now has nearly 300 lawyer Fellows who have been recognized by their peers for their skill, experience and high standards of professional and ethical conduct in the practice of bond law and for their accomplishments and achievements in the practice of bond law. The College serves to promote high standards of professional and ethical responsibility in the practice of bond law; improve bond law and practice; provide authoritative educational materials in the field of bond law; speak upon matters of interest and importance to bond law and practice before legislative, administrative and regulatory bodies, to provide forums for its membership to meet and exchange ideas and professional experience; and to cooperate and consult with national, state and local bar organizations, government agencies, issuer organizations, and other groups which have an interest in bond law and practice. These comments were prepared by a committee of the College consisting of Philip C. Genetos, of Ice Miller LLP; Charles S. Henck, Ballard Spahr, LLP; Lisa P. Soeder, Soeder & Associates, LLC and John K. Van Duys, Haynsworth Sinkler Boyd, P.A. These comments represent the views of the committee and have not been approved by the Board of Directors of the College. If you have any questions regarding this letter, please contact John Van Duys at (803) 779-3080.

The comments of the College consist of two parts. The first part relates to the proposed new definition of "issue price" and urges the proposed regulations to be withdrawn. The second part relates to the rest of the provisions in the proposed regulations, with suggestions for improvement and clarification.

PART ONE

Issue Price.

The College submits that the Service has not made the case that the “expectations” test of the Existing Regulations should be abandoned. Although proposed to provide “greater certainty”, we suggest that the opposite will be the case, to the detriment of the State and local governments. The proposed issue price regulation suffers from a type of “false precision” that loses sight of the very objective sought by the rule, namely, “certainty.”

The College submits that certainty is more important in this context than precision since almost every substantive measurement under Sections 103-150, 265 and 1001 depends on knowing, on or before the issue date of such obligations, the issue price of an issue of tax exempt debt obligations. These provisions, of course, include yield restriction, rebate and multi-purpose issue allocations. But they also include volume cap allocations and carry-forwards, TEFRA approval, private use and payment analyses, cost of issuance limitations, computation of weighted average maturity, information reporting, advance refunding limits, bank qualification and re-issuance. All of these rules are written with the unstated expectation that the issue price of the bonds is a known quantity at or before closing.

Further, Treasury has not provided a compelling reason for abandoning a rule that has been in place for decades. What are the practical failings of the current issue price rule? There has been no indication that the issuers have gamed the current rules to obtain a material financial benefit. The preamble states that “increasing transparency about pricing information in the municipal bond market . . . has led to heightened scrutiny of issue price standards.” Treasury appears concerned that the current process by which municipal bonds are marketed allows the interposition of speculators and other intermediaries between the issuer of the bonds and the final long-term investor. Any mark-ups along the way are taxable ordinary income to the market participants. There is no indication that this is a recent development, only that as pricing is more transparent it is easier to notice. Underwriters who sell bonds at a loss are not long in business.

The proposed regulations appear to be premised upon a concern that the issuers and underwriters have colluded to price the bonds at a higher yield than the market requires. There is no evidence of that provided. Further, there is ample reason to believe that the issuers have considerable reason to seek to achieve the best pricing, as reinvestment rates for at least the last five years have afforded no opportunity to arbitrage proceeds, whether the issue price was correct or marginally off market. And the increased market transparency, albeit imperfect, has provided issuers with some capacity to assure themselves of the fair-pricing by the underwriters and allow competing underwriters to bring any past instances of unfair pricing to the attention of issuers for future issues.

The proposed issue price rule does not purport to dictate to the municipal underwriting community that they sell directly to retail “buy-and-hold” owners. Instead, the rule provides a safe harbor for municipal bonds issued for money. Under the safe harbor, the issuer “may treat” the first price at which a minimum of 25% of the bonds is sold to the Public as the issue price; but only if all orders at such sale price during the offering period are filled, and “Public” excludes a broad range of market participants directly or indirectly participating in the distribution or related to such a direct or indirect participant. There are many practical problems with this structure.

First, and most significantly, it sacrifices certainty on the altar of precision. Even if all of the information necessary to actually determine the issue price of an issue of municipal bonds under the safe harbor is accessible by the issuer (which it is not), the structure of the regulation makes it impossible to ascertain that figure on the issue date, not to mention the pricing date on which plans must be settled in order to efficiently close the bond sale. The proposed regulations realize this flaw and attempt to assuage it by allowing yield reduction payments to “true up” the actual and expected issue price. This is an inadequate solution because it only affects one aspect of the role issue price may have in a bond issue. Due to trading activities in the municipal market, over which the issuer has no control, the search for precision calls into question a host of substantive tax restrictions before the actual issue price is determined. The higher issue price may have blown through the cost of issuance limitation, required additional volume cap or exceeded the bank qualification limit. All the multi-purpose issue allocations may be incorrect, resulting in advance refunding portions larger than permitted under Section 149. The proposed regulations have no solution for these problems.

Secondly, it assumes a level of transparency and cooperation between antagonistic market participants that does not now and may never exist. Even the Treasury has admitted that the MSRB EMMA or other reporting services do not provide sufficiently reliable information to provide the certainty needed. Issuers of debt obligations have an interest in minimizing their cost of funds and have strong reasons to require the underwriters to sell their bonds at the lowest yield possible. Underwriters make their living by selling municipal bonds at prices higher than they paid. These interests are diametrically opposed. Both parties rely on market competition to ensure that their interests are protected. The increased information on bond pricing has afforded the issuers a greater opportunity to inform themselves about the process. Nevertheless, the proposed issue price regulation requires the issuer to determine the identity of the purchasers of its municipal bonds and whether those purchasers are (i) direct or indirect participants in the underwriting, or (ii) related to such direct or indirect participants. Our experience is that after issuers sell their bonds to underwriters, either in competitive transactions (in which the issuer has effectively no leverage to extract information from the buyers) or in negotiated sales (in which the issuer has bargained hard to sell the bonds at the lowest yield), the underwriters are not interested in telling the issuer about their resales and the lead underwriter is often in no position to require other broker/dealers who acquire bonds to disclose how those bonds have been resold. How major securities firms deal with their own property is their own business and their distribution channel is a trade secret. There is no reliable public source for the information needed by an issuer to apply the safe harbor contained in the proposed issue price regulation. There is currently no expectation that such information will become available in the future. Far from bringing “more certainty” the proposed issue price regulation is unworkable. Furthermore, there is no means by which the issuer could demonstrate that all aspects of the safe harbor are satisfied, other than from a certificate or representation of the lead underwriter. The proposed regulations do not permit that form of documentation as being dispositive of those conditions.

Third, given the import of providing certainty to the issuer and its bond counsel, the proposed regulations will force the pricing and marketing of the bonds to be driven by the need to satisfy these restrictions, i.e., to assure that all of the bonds are sold on the sale date, rather than to provide the issuer with the best pricing available at the time, which may mean that the underwriter holds unsold bonds for resale when market conditions require.

This is not the first time Treasury has attempted to fine tune this definition to make it more precise. Par. 11 of Notice 89-78, Arbitrage Restrictions on Tax-Exempt Bonds Under Section 148 of the Code, 1989-2 C.B. 390; 1988-27 I.R.B. 6; 1989-30 I.R.B. 6; added the following to Regulation 1.148-8T(c)(2)(ii):

“(ii) Bonds offered at a discount. If substantially identical bonds are initially offered at one price to the general public and at a discount from that price to institutional or other investors, the issue price of each bond shall be the average offering price of all the bonds. For purposes of the preceding sentence –

(A) The offering price of each bond sold to institutional or other investors at a discount on or before the date of issue (as defined in § 1.150-1T(c)(2)) is the discounted initial offering price at which the bond was sold, and

(B) The offering price of every other bond is determined on the basis of the initial offering price to the general public at which price a substantial amount of the bonds was sold."

This language was removed by T.D. 8345 after "much comment." Such removal was prudent.

Treasury should consider the purpose of the issue price definition as it applies to Sections 103 – 150, 265 and 1001, the practical necessities of tax compliance and the current relationships in State and local government finance. The "expectations" standard is not perfect and the actual trade information could result in a more precise number. This proposal does not purport to establish the issue price of the purchased bond for purposes of the holder's tax liability. The fact that the issue price under Section 148 may be different from that under 1273 should not be repugnant to the Service.1 The expectations standard has stood the test of time, is capable of implementation in the current market and addresses the legitimate concerns of the Treasury. Absent collusion between the issuer and its underwriter, the expected re-offering price should be sufficient.

The College urges the Treasury to withdraw the proposed issue price regulation.

PART TWO.

Working Capital.

The College applauds the elimination of the provision in the Existing Regulations preventing the direct or indirect financing of a working capital reserve as the previous lesser of average amount maintained and 5 percent of prior year expenditures regime penalized those issuers in the greatest financial distress. The College also supports the imposition of a 13-month maturity safe-harbor for short-term working capital financings (making the regulation consistent with Rev. Proc. 2002-31 and the temporary period rules) and strongly supports the new safe harbor for long-term working capital financings (which makes the regulation consistent with relevant private letter rulings in the working capital arena). We suggest that the final regulations include a modification to the definition of Available Amounts in Section 1.148-6(d)(3)(iii) to ignore any amounts invested in municipal obligations not subject to alternative minimum tax. This is consistent with the approach taken by the proposed regulation, but simpler, leaving the redemption of bonds as a possible remedial action.

Qualified Hedges.

Section 1.148-4(h)(3)(iv)(B) of the Proposed Regulations states that a deemed termination of a qualified hedge occurs, inter alia, "if the hedge ceases to meet the requirements for a qualified hedge of the hedged bonds; . . ." Read literally, this requires a continuous monitoring of the hedge to determine that the requirements of Section 1.148-4(h)(2) are met. Most of the requirements for qualified hedge status are clearly accomplished one time at the time the hedge is identified to the Bonds. Under the 2007 Proposed Regulations, Section 1.148-4(h)(2)(v)(1)(i) requires analysis of the correlation between the variable rate on the hedged Bonds and the variable leg of the hedge (i.e., 25 basis points) on a "snap shot" and a 3-year historical basis. We do not believe that this correlation must be continuously monitored and suggest that the quoted language in the Proposed Regulations be revised. Such sentence also states that a deemed termination occurs when the issuer makes a modification "that results in a deemed exchange of the hedge and a realization event to the issuer under Section 1001; . . ." As written, the sentence is circular and provides little practical guidance. It is also unclear whether or not a deemed exchange under 1001 is a necessary prerequisite for any deemed termination. We assume the Treasury intended such provision to result in a deemed termination if the hedge is modified (within the meaning of the prior paragraph) and the modified hedge does not meet the requirements for qualification (which is provided in the next paragraph). We suggest the sentence be revised to clearly indicate its intent.

Section 1.148-4(h)(3)(iv)(B) of the Proposed Regulations provides that a modification of a qualified hedge does not result in a deemed termination if the hedge would quality on the modification date and “the fact that the existing qualified hedge is off market as of the date of the modification is disregarded.” We interpret this as meaning that the integrated yield of the hedged bond is not changed, i.e., that the off market component is included in the yield computation. The Existing Regulations are unclear as to the precise meaning of an “off market” component. In a typical variable to fixed rate swap, the “off market component” usually refers to the fixed leg of the swap. Is it the intent of this provision to excuse compliance with 2007 Proposed Regulation Section 1.148-4(h)(2)(v)(1)(i) in determining whether the modified hedge is qualified? An example would clarify the intent of this provision. If the proposed regulation requirement of close correlation of the variable leg is intended to apply, the example would be similar to the following: “On June 1, 2010, Issuer entered into a 15 year variable to fixed swap agreement with Bank under which Issuer will pay a fixed rate of 3.75% on a notional amount of $10,000,000 and the Issuer will receive from Bank payments equal to 70% of one month LIBOR plus 25 basis points on such notional amount. On June 15, 2010 Issuer properly identified the swap as a qualified hedge of its $10,000,000 variable rate Series 2010 Bonds maturing June 1, 2025. On June 1, 2015 Issuer refunded the Series 2010 Bonds in whole with its new variable rate Series 2015 Bonds. On June 15, 2015, Issuer identified the swap to the Series 2015 Bonds. At that time, the variable component of the swap and the expected variable rate on the Series 2015 Bonds were closely correlated within the meaning of Section 1.148-4(h)(2)(v)(1)(i). At such time, the fixed leg of the swap for its remaining 10 year term would be 3.15%. The swap is a qualified hedge of the Series 2015 Bonds and all payments under the swap will be taken into account for purposes of computing the yield on the Series 2015 Bonds.”

Recognizing that this was part of the 2007 Proposed Regulation Section 1.148-4(h)(3)(4)(E), how is the fair market value of the hedge to be determined?

Section 1.148-5(c)(3) of the Proposed Regulations states “(i) through (ix) [Reserved].” Does this mean that such sections of the Existing Regulations and the 2007 Proposed Regulations will be removed? Surely not! See Part One of these comments for our reasons to eliminate subparagraph (x).

In section 1.148-5(d)(3)(ii) of the Proposed Regulations “exclusively” is no longer necessary.

The College questions the validity of Proposed Regulation Section 1.148-10(e) as written which may not comply with substantive due process by providing meaningful guidance to comply with federal tax laws.

Grants.

The Proposed Regulations move the definition of a “grant” from Section 1.148-6(d)(4)(iii) to Section 1.150-1(f) and make it applicable for all purposes of taxation of municipal bonds. The definition continues to provide that “The transfer must not impose any obligation or condition to directly or indirectly repay any amount to the transferor or a related party. Obligations or conditions intended solely to assure expenditure of the transferred moneys in accordance with the governmental purpose of the transfer do not prevent a transfer from being a grant.” The College interprets this to mean that a return of any portion of the grant due to failure to meet the grant conditions is not a private payment for purposes of Section 141(b). Section 1.148-6(d)(4)(2) provides such amounts are “treated as unspent proceeds of the issue.” Many complex issues arise from this. For example, assume City issues bonds to provide a grant to a private, for-profit company to build and operate a health care clinic. The grant requires the grantee to operate the clinic on a qualifying basis for 10 years after completion and to repay scheduled amounts to the City (which may be equivalent to the debt service on the Bonds funding the grant) if the grantee ceases qualifying operation during such period. After 5 years, the company decides to cease qualifying operation and repays one-half of the grant to the City. If City uses the repayment to originate another grant or to partially redeem the Bonds issued to fund the grant, the College contends that the remaining Bonds should not be private activity bonds. There are no rules governing the application of the expenditure tests for temporary period and rebate expenditure exceptions to grant repayments that are used to make additional grants. The College would recommend a springing temporary period similar to the one provided in current regulations for loan repayments, which begins on the date the grant funds are repaid to the issuer. The College would also request that a new expenditure exception from arbitrage rebate begin to run at such time as any grant proceeds are repaid to the issuer.

In summary, the College appreciates the dedication and hard work of the Treasury officials responsible for the drafting and review of the proposed arbitrage regulations and recognizes how difficult it is to navigate the turbulent waters of the arbitrage regulations in a manner that pleases everyone. The College respectfully requests that the redraft of such proposed regulations take into account the principles and concerns set forth in the College's comments, the industry's need for pre-issuance clarity and certainty in the issue price regime, and the fact that the vast majority of market participants are simply trying to comply with the rules governing the municipal industry (rather than attempting to sidestep them).

FOOTNOTE

1 The OID Regulations contain provisions allowing issuers and holders to have inconsistent tax positions. These rules include: Section 1.1273-2(h)(2) permitting issuers and holders to take inconsistent positions regarding the allocation of the issue price of investment units; Section 1.1274-3(d) permitting the holder to take a position inconsistent with the issuer regarding whether the debt obligation is issued in a potentially abusive situation, Section 1.1275-2(h)(5) permitting the holder to take a position inconsistent with the issuer regarding whether a contingency is remote or incidental and Section 1.1275-4(b)(4)(iv) permitting the holder to take a position inconsistent with the issuer regarding the prospective payment schedule for a CPDI whether a contingency is remote or incidental.