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Bond Lawyers Suggest Withdrawal of Proposed Issue Price Definition.

Allen Robertson of the National Association of Bond Lawyers has commented on proposed regulations (REG-148659-07) on arbitrage investment restrictions applicable to tax-exempt bonds, suggesting that the definition of issue price be withdrawn and that any other change in the issue price definition be reproposed.

December 16, 2013

Internal Revenue Service

CC:PA:LPD:PR (REG-148659-07)

P.O. Box 7604

Ben Franklin Station

Washington, DC 20044

www.regulations.gov (IRS REG-148659-07)

Re: Proposed Arbitrage Regulations Addressing Definition of "Issue Price" for Tax-Exempt Bond Purposes (REG-148659-07)

Ladies and Gentlemen:

The National Association of Bond Lawyers ("NABL") respectfully submits the enclosed comments relating to the definition of "issue price" in the proposed arbitrage regulations, REG-148659-07, which were published in the Federal Register on September 16, 2013 (the "Proposed Regulations"). NABL is separately submitting comments on other aspects of the Proposed Regulations. These comments were prepared by members of NABL's Tax Law Committee listed on Appendix I, and were approved by the NABL Board of Directors.

NABL appreciates the substantial efforts made by the Department of the Treasury and the Internal Revenue Service in the preparation of the Proposed Regulations and, as explained in its separate comments, believes that other aspects of the Proposed Regulations should be finalized as soon as possible; however, as explained in the enclosed comments, NABL respectfully suggests that the proposed definition of "issue price" be withdrawn and that any other change in the issue price definition be re-proposed.

NABL requests an opportunity to speak at the public hearing to be held on February 5, 2014 at 10:00 AM. An outline of the topics to be discussed is attached as Appendix II.

NABL exists to promote the integrity of the municipal market by advancing the understanding of and compliance with the law affecting public finance. We respectfully provide this submission in furtherance of that mission.

If you have any questions regarding the enclosed comments, please contact Bill Daly in our Washington, D.C., office at (202) 503-3300.

Sincerely,

Allen K. Robertson

President

National Association of Bond

Lawyers

Washington, DC

* * * * *

COMMENTS OF THE NATIONAL ASSOCIATION OF BOND LAWYERS

ON THE DEFINITION OF “ISSUE PRICE”

IN THE PROPOSED ARBITRAGE REGULATIONS

PUBLISHED ON SEPTEMBER 16, 2013

EXECUTIVE SUMMARY

On June 18, 1993, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (“IRS”) published comprehensive final regulations on the arbitrage investment restrictions and related provisions for tax-exempt bonds under sections 103, 148, 149 and 150 of the Internal Revenue Code of 1986, as amended (the “Code”).

On September 16, 2013, Treasury and IRS published proposed regulations that would amend the existing regulations in a number of respects, including significant revisions to the definition of “issue price” that eliminate the “reasonable expectations” standard for determining the issue price of publicly offered municipal bonds as of the sale date in favor of an “actual sales” approach.

For the following reasons, the National Association of Bond Lawyers (“NABL”) respectfully suggests that the definition of “issue price” in the proposed regulations be withdrawn and that any other change in the issue price definition be re-proposed.

The proposed definition of “issue price” is not required or appropriate to address the policy objectives and stated concerns of Treasury and IRS.

The preamble to the proposed regulations, the proposed definition of “issue price” in the proposed regulations and public comments made by Treasury and IRS officials after publication of the proposed regulations emphasize that the amendments to the issue price definition are intended to make that definition more consistent with current regulations under sections 1273 and 1274 of the Code, which implies that such consistency, including an “actual sales” approach, is required by the cross-reference to sections 1273 and 1274 in section 148(h) of the Code. A review of the history and purpose of the arbitrage statutes and regulations, including the existing regulations, confirms that an “actual sales” approach is not required.

In the preamble to the proposed regulations, Treasury and IRS also state that the significant amendments to the issue price definition would "address [certain] concerns" and "provide greater certainty." As discussed below, NABL believes that the proposed definition is not administrable by issuers and, therefore, will result in less certainty. The concerns described in the preamble generally relate to the manner in which municipal securities are offered and distributed, and imply that the conduct of municipal underwriters is sometimes inappropriate and perhaps illegal. Concerns about the offering and distribution process for municipal securities should be addressed by working with municipal securities regulators, not through tax policy. Treasury and IRS should share their concerns with the Securities and Exchange Commission, the Municipal Securities Rulemaking Board and the Financial Industry Regulatory Authority and request that they investigate and take appropriate regulatory and enforcement action.

The proposed definition of "issue price" is not administrable by issuers under existing law and market practices.

The proposed definition of "issue price" is not administrable by issuers because issuers and bond counsel do not have access to the information necessary to determine issue price based on actual sales to the "public" as defined under the proposed regulations.

The proposed definition of "issue price" also is not administrable by issuers because it does not assure that the issue price of publicly offered municipal bonds can be determined as of the sale date. To be administrable by issuers, any definition of "issue price" of publicly offered municipal bonds must enable issue price to be determined as of the sale date, when the terms of the issue are established. Determination of issue price as of the sale date is important for three reasons. Issuers may violate applicable State law, policy or authorizing resolutions if issue price cannot be determined as of the sale date. Because compliance with numerous other provisions of federal tax law depends on the determination of issue price, issuers may unintentionally violate those provisions if issue price cannot be determined as of the sale date. Finally, bond counsel must confirm on the sale date whether they can give an unqualified approving opinion at closing.

Attempts to comply with the proposed definition of "issue price" will impose substantial additional expense on issuers and alter longstanding practices in the municipal market.

If the proposed definition is adopted and municipal bonds continue to be marketed in ways that result in unsold maturities on the sale date, issuers will bear substantial additional expense attempting to determine issue price based on actual sales to the public. To eliminate unsold maturities on the sale date in negotiated underwritings, issuers would be forced to accept lower prices and higher yields. Because issuers may not be able to eliminate the possibility of unsold maturities in competitively sold deals, the ability of issuers to sell bonds competitively may be limited.

INTRODUCTION

Under section 103(a) of the Code, interest on a State or local bond (i.e., an obligation of a State or political subdivision thereof) is excludable from the gross income of the owner thereof; however, section 103(a) does not apply to any "arbitrage bond" within the meaning of section 148.

The original and principal purpose of the restrictions relating to arbitrage bonds is to prevent issuers from earning a profit by investing the proceeds of tax-exempt bonds in higher yielding taxable investments (e.g., Treasury securities). In light of this purpose, section 148(a) defines "arbitrage bond" as follows:

For purposes of section 103, the term "arbitrage bond" means any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bonds) to be used directly or indirectly —

(1) to acquire higher yielding investments, or

(2) to replace funds which were used directly or indirectly to acquire higher yielding investments.

For purposes of this subsection, a bond shall be treated as an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue of which such bond is a part in a manner described in paragraph (1) or (2). [Emphasis added.]

Under section 148(a), the prima facie determination regarding whether a bond is an arbitrage bond must be made no later than the date on which the bond is issued, based on the issuer's contemporaneous reasonable expectations.

Section 148(b)(1) defines "higher yielding investments" as any "investment property which produces a yield over the term of the issue which is materially higher than the yield on the issue."

To determine whether bond proceeds have been used to acquire higher yielding investments, one must compare the yield on the bond issue to the yield on the investments. Section 148(h), which was added to the Code as part of the Tax Reform Act of 1986,1 provides that:

For purposes of [section 148], the yield on an issue shall be determined on the basis of the issue price (within the meaning of sections 1273 and 1274).

On June 18, 1993, Treasury and IRS published comprehensive final regulations on the arbitrage investment restrictions and related provisions for tax-exempt bonds under sections 103, 148, 149 and 150, which generally became effective in 1993.2 Since that time, those final regulations have been amended in certain limited respects. The regulations issued in 1993 and the amendments thereto are collectively referred to herein as the "Existing Regulations."

In § 1.148-1(b) of the Existing Regulations, "issue price" is defined as follows:

Issue price means, except as otherwise provided, issue price as defined in sections 1273 and 1274. Generally, the issue price of bonds that are publicly offered is the first price at which a substantial amount of the bonds is sold to the public. Ten percent is a substantial amount. The public does not include bond houses, brokers or similar persons or organizations acting in the capacity of underwriters or wholesalers. The issue price does not change if part of the issue is later sold at a different price. The issue price of bonds that are not substantially identical is determined separately. The issue price of bonds for which a bona fide public offering is made is determined as of the sale date based on reasonable expectations regarding the initial public offering price. If a bond is issued for property, the applicable Federal tax-exempt rate is used in lieu of the Federal rate in determining the issue price under section 1274. The issue price of bonds may not exceed their fair market value as of the sale date. [Emphasis added.]

The issue price definition under the Existing Regulations generally follows the issue price definition used for computing original issue discount on debt instruments under sections 1273 and 1274, with certain modifications. Specifically, consistent with section 148(a), the issue price definition under the Existing Regulations applies a reasonable expectations standard, determined as of the sale date, for determining the issue price of bonds that are publicly offered, not a standard based on actual sales. Under this standard, the first price at which a substantial amount (using ten percent as a safe harbor) of the bonds is reasonably expected to be sold to the public is treated as the issue price and is used in determining the yield on the issue, provided that all of the bonds of that maturity (and with the same terms) are offered to the public in a bona fide public offering.

In 1995, the Municipal Securities Rulemaking Board ("MSRB")3 began the limited dissemination of prices for the municipal securities market, and increased price transparency in a series of measured steps. By 2000, MSRB was making all trade data public with a one-day delay. On January 31, 2005, MSRB began disseminating "real-time" (or more accurately, contemporaneous) municipal bond prices (within 15 minutes of a trade).4 The resulting public availability of trading data enabled municipal market participants and academics to analyze trading and pricing in newly issued municipal bonds.5 Analysis of the trading data confirmed two general conclusions: (1) for many municipal new issues, it takes some amount of time (days or weeks) for the bonds to settle into the hands of investors, such as individual or "retail" buyers, whose intent is to "buy and hold"; and (2) during this "settling out" process in the secondary market, there is an often an upward trend in the prices of the bonds (referred to as "trading up"). Analysis of the trading data also confirmed that some investors (generally institutional investors) purchase bonds from the underwriters and then, a short time after that initial sale (including prior to the closing of the bond issue, or even prior to the date of the signing of the bond purchase agreement between the issuer and the underwriters (the "BPA")), resell some or all of the bonds they purchased to broker/dealers (who may or may not have been part of the original underwriting group) or other investors. These resales are referred to as "flipping."6

By 2006, IRS, in certain audits of publicly offered municipal bonds, began to challenge the determination of issue price, questioning the accuracy of certificates regarding issue price customarily provided by underwriters in connection with the issuance of the bonds. The resulting uncertainty among issuers and bond counsel led NABL to create an issue price study group, which in August 2006 submitted to Treasury and IRS its recommendations for changes to the Existing Regulations that would provide clarification regarding the determination of issue price in light of existing practices and potential interpretation of the Existing Regulations. The August 2006 recommendations of the NABL issue price study group are attached hereto as Exhibit A. The principal recommendation was that the reasonable expectations provisions of the Existing Regulations be given substantive meaning by providing guidance and/or safe harbors as to what constitutes a bona fide public offering, as well as greater clarity around sales to parties that are not clearly members of the "public."

For municipal market participants, Treasury and IRS, questions about issue price naturally began to receive less attention as the credit crisis and "Great Recession" began to unfold in 2008; however, the popularity of taxable, direct-subsidy "Build America Bonds" ("BABs"), authorized to be issued in 2009 and 2010 under the American Recovery and Reinvestment Act of 20097 ("ARRA" or the "Stimulus Act") brought the issue back to the forefront because of the requirement that BABs not be sold with more than a de minimis amount of original issue premium. The struggles of issuers and others in the municipal marketplace with matters regarding the issue price of BABs led the Government Finance Officers Association ("GFOA"), NABL, the Regional Bond Dealers Association ("BDA") and the Securities Industry and Financial Markets Association ("SIFMA") to jointly submit a request to Treasury for guidance regarding issue price. The August 2010 submission by GFOA, NABL, BDA and SIFMA is attached hereto as Exhibit B. This joint submission included data compiled by SIFMA that demonstrated that all markets (corporate, tax-exempt and BABs) have upticks in secondary market trading, and that compared to other markets, there was nothing unusual about trading in the BABs market. (In fact, observed changes in BABs pricing were actually lower than in other markets.) Like the 2006 NABL submission, this multi-association submission requested that separate safe harbors for competitive and negotiated transactions be established under the Existing Regulations. Again, not surprisingly, after the Stimulus Act provisions authorizing the issuance of

BABs expired on December 31, 2010, concerns about issue price became somewhat less acute.8

On September 16, 2013, Treasury and IRS published proposed regulations (the "Proposed Regulations")9 that would amend the Existing Regulations in a number of respects,10 including significant revisions to the definition of "issue price" that eliminate the "reasonable expectations" standard for publicly offered municipal bonds in favor of an "actual sales" approach. Under the Proposed Regulations, issue price would be defined as follows:

(f) Definition of issue price —

(1) In general. Except as otherwise provided in this paragraph (f), issue price is defined in sections 1273 and 1274 and the regulations under those sections. In determining the issue price under section 1274 of a bond that is issued for property, the adjusted applicable Federal rate, as computed for purposes of section 1288, is used in lieu of the applicable Federal rate in determining the issue price.

(2) Tax-exempt bonds issued for money —

(i) In general. 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 (as defined in paragraph (f)(3)(i) of this section). See paragraph (f)(4)(ii) of this section for an issue including bonds with different payment and credit terms.

(ii) Safe harbor for determining issue price of tax-exempt bonds issued for money. For purposes of paragraph (f)(2)(i) of this section, the issuer may treat the first price at which a minimum of 25 percent of the bonds is sold to the public as the issue price. However the preceding sentence applies only if all orders at this sale price received from the public within the offering period are filled to the extent the public orders at such price do not exceed the amount of bonds sold.

(3) Definitions. For purposes of this paragraph (f), the following definitions apply:

(i) Public. Public means any person (as defined in section 7701(a)(1)) other than an underwriter.

(ii) Underwriter —

(A) In general. Except as otherwise provided in paragraph (f)(3)(ii)(C) of this section, the term underwriter means any person (as defined in section 7701(a)(1)) that purchases bonds from an issuer for the purpose of effecting the original distribution of the bonds or that otherwise participates directly or indirectly in such original distribution. An underwriter includes a lead underwriter and any member of a syndicate that contractually agrees to participate in the underwriting of the bonds for the issuer. A securities dealer (whether or not a member of an underwriting syndicate for the issuer) that purchases bonds (whether or not from the issuer) for the purpose of effecting the original distribution of the bonds is also treated as an underwriter for purposes of this section.

(B) Certain related parties included. Except as otherwise provided in paragraph (f)(3)(ii)(C) of this section, an underwriter includes any related party (as defined in § 1.150-1(b)) to an underwriter.

(C) Holding for investment. A person (as defined in section 7701(a)(1)) that holds bonds for investment is treated as a member of the public with respect to those bonds.

(iii) Securities dealer. Securities dealer means a dealer in securities, as defined in section 475(c)(1).

(4) Special rules. For purposes of this paragraph (f), the following special rules apply:

(i) Subsequent sale at a different price. The issue price as determined under paragraph (f)(1) or (2) of this section does not change if part of the issue is later sold at a different price.

(ii) Separate determinations. The issue price of bonds in an issue that do not have the same credit and payment terms is determined separately.

The preamble to the Proposed Regulations, the proposed definition of "issue price" in the Proposed Regulations and public comments made by Treasury and IRS officials after publication of the Proposed Regulations emphasize that the amendments to the issue price definition are intended to make that definition more consistent with current regulations under sections 1273 and 1274 of the Code, which implies that such consistency, including an "actual sales" approach, is required by the cross-reference to sections 1273 and 1274 in section 148(h) of the Code. In the preamble to the Proposed Regulations, Treasury and IRS also state that the significant amendments to the issue price definition would "address [certain] concerns" and "provide greater certainty." Treasury and IRS state that their general concern is "that certain aspects of the Existing Regulations for determining the issue price of tax-exempt bonds are no longer appropriate in light of market developments since those regulations were published." In particular, Treasury and IRS state the following concerns:

The ten-percent test does not always produce a "representative price for the bonds," because underwriters may be executing the first ten percent of sales at the lowest price (and thus the highest yield) and thereby causing the issue price to be a lower price than is representative of the prices at which the remaining bonds are sold;

The reasonable expectations standard may not produce a "representative issue price," based on pricing data that shows actual sales to the public at prices that differ significantly from the issue price used by the issuer; and

Based on reported trade data, sales to underwriters and security dealers may be included as sales to the public in determining issue price in certain instances.

As discussed below, the definition of "issue price" contained in the Proposed Regulations should be withdrawn and any other change in the issue price definition should be re-proposed. To understand why the proposed definition of issue price should not be adopted, it is helpful to review the history and development of the arbitrage restrictions and some key differences between the municipal and corporate bond markets.

BACKGROUND

History and Development of the Arbitrage Statutes and Regulations

Treasury and IRS first addressed the problem of arbitrage bonds in a technical information release which announced that IRS would not issue rulings about whether interest on certain State or local bonds was exempt from federal income taxation. These bonds were:

issued by . . . governmental units where a principal purpose is to invest the proceeds of the tax-exempt obligations in taxable obligations, generally United States Government securities, bearing a higher interest yield. The profit received by the governmental units on the difference between the interest paid on the exempt obligations and the interest earned on the taxable obligations is in the nature of arbitrage.11

This release effectively resulted in a moratorium on most advance refundings, which remained in effect until the passage of the Tax Reform Act of 1969.12

As part of the Tax Reform Act of 1969,13 Congress addressed the problem of arbitrage bonds by adding section 103(d) to the Internal Revenue Code of 1954. Section 103(d) was redesignated section 103(c) in the Tax Reform Act of 1976.14 That section provided, in pertinent part, that:

the term "arbitrage bond" means any obligation which is issued as part of an issue all or a major portion of the proceeds of which are reasonably expected to be used directly or indirectly —

(A) to acquire securities . . . or obligations . . . which may be reasonably expected at the time of issuance to produce a yield over the term of the issue which is materially higher (taking into account any discount or premium) than the yield on obligations of such issue[.]

To compute yield on a bond, one must know the purchase price of the bond, its coupon (i.e., stated interest rate), the principal and interest payment dates and its stated redemption price at maturity. Following passage of the Tax Reform Act of 1969, Treasury consistently proposed that the purchase price paid to the issuer, taking into account any costs of issuing the bonds, should be used in computing yield on the bonds.15 Treasury's earliest view, reflected in Temp. Reg. § 13.4(a)(5), was that "an amount equal to the sum of the reasonably expected administrative costs of issuing, carrying and repaying [an] issue of obligations shall be treated as a discount in the selling price of such issue" for computing "yield." Thus, yield was initially determined based on the price paid to the issuer by the underwriter for the bonds, which already reflected the "underwriter's spread" (also referred to as the "underwriter's discount"), minus any other costs of issuance paid directly by the issuer (e.g., attorneys' fees, printing and delivery costs, preparation and distribution costs).

By 1978, because States and municipalities were advance refunding bonds in increasingly large numbers, Treasury concluded that permitting an issuer in an advance refunding to earn enough arbitrage to cover "most or all" of its administrative costs encouraged issuers to advance refund bonds in marginal situations and resulted in "inflated and excessive fees to lawyers, accountants, underwriters, and others."16 As a consequence, Treasury changed its position regarding calculation of yield and proposed, effective September 1, 1978, that yield would be computed based on the "purchase price" of the bonds, with no reduction for an issuer's costs. For bonds that were to be publicly offered, "purchase price" would be the "initial offering price to the public (excluding bond houses, brokers, and other intermediaries)."17 The proposal was adopted in the so-called "final arbitrage regulations" of 1979.18

The 1978 change in the regulations was intended to require yield to be computed without deducting the underwriter's spread or other costs of issuance paid directly by the issuer, Arithmetically, this meant that the purchase price would be determined by adding the underwriter's spread back to the price paid to the issuer by the underwriter for the bonds. MSRB, in its Glossary of Municipal Securities Terms, defines "underwriter spread," with respect to a new issue of municipal securities, as "the difference between the price paid by the underwriter to the issuer for the new issue and the prices at which the securities are initially offered to the investing public."19 Thus, by defining purchase price to be the "initial offering price to the public," the 1978 change in the regulations was requiring that the underwriter's spread be included in the purchase price in computing yield on the bonds.

The State of Washington challenged the 1978 change in the computation of yield and, in State of Washington v. Commissioner, 692 F.2d 128 (D.C. Cir. 1982), the United States Court of Appeals for the District of Columbia held that the regulations went beyond the permissible rulemaking authority of the Treasury and interpreted the statute in a way that was plainly inconsistent with the purpose of

Congress in enacting the statute.

In response, Treasury turned to Congress, and in the Tax Reform Act of 1986, Congress specifically overruled State of Washington by adding section 148(h) to the Code, which requires that "yield on an issue shall be determined on the basis of the issue price (within the meaning of sections 1273 and 1274)." The primary purpose of section 148(h) was to assure that an issuer would not be able to recover any of its costs of issuance (other than bond insurance and similar guarantee fees) through the investment of the bond proceeds at a higher yield. The Senate Report stated:

The committee believes that it is important for issuers of tax-exempt bonds to pay the costs associated with their borrowing. The bill provides that the costs of issuance, including attorneys' fees and underwriters' commissions, must be paid by the issuers or beneficiaries, rather than recovered through arbitrage profits. . . .20

The House Report described the change as requiring that yield on an issue be determined based on the issue price, "taking into account the Code rules on original issue discount and discounts on debt instruments issued for property (sections 1273 and 1274)."21 The Conference Report described the change in the following way:

Yield on bonds is determined on the basis of the original issue discount rules of the Code rather than as under the present general arbitrage restrictions. Thus, yield is determined based on the price at which a substantial number of the bonds are sold to the public and must reflect a current market price.22

By adopting section 148(h) and referencing the original issue discount provisions of sections 1273 and 1274, Congress clearly intended to prevent issuers from deducting the underwriter's spread in computing the yield on tax-exempt bonds.23

Treasury's first attempt at implementing section 148(h) was the temporary regulations adopted in 1989 (the "1989 Temporary Arbitrage Regulations").24 The definition of "issue price" in the 1989 Temporary Arbitrage Regulations was revised several times before reaching its final form in 1993 in the Existing Regulations. The original definition of "issue price" in the 1989 Temporary Arbitrage Regulations took more of an "actual sales" approach, requiring the issue price for substantially identical bonds sold at one price to the general public and to institutional or other investors at a discount from that price to be determined separately.25 Importantly, however, even these initial temporary regulations provided that the issue price for bonds that were publicly offered would be determined "based on actual facts and reasonable expectations as of the sale date and shall not be adjusted to take into account actual facts after such date."26 The scope of the reasonable expectations test for publicly offered bonds was limited by allowing it to be applied only to bonds actually offered to the general public in a bona fide public offering at those issue prices.27

The 1989 Temporary Arbitrage Regulations were viewed, in general, as being far too complex, and Treasury undertook a simplification of the regulations. Notice 89-7828 issued July 24, 1989 provided that future regulations would eliminate separate books for public and institutional sales, and instead look at the average offering price of the bonds. The notice also provided that issue price would be based upon the initial offering price at which a substantial amount of the bonds was actually sold.

In 1991 Treasury further simplified the regulations.29 The 1991 changes provided that issuers and underwriters were no longer required or permitted to identify and segregate bonds expected to be publicly offered to the general public at one price from those publicly offered to institutions at a concession. This simplification represented a trade-off for issuers: a lower arbitrage yield in exchange for a lesser administrative burden. Most significantly in the current context, the simplification was also a departure from theoretical perfect adherence to section 1273 for the apparent purpose of administrability. In making the 1991 changes, Treasury explained why a reasonable expectations test for publicly offered bonds was appropriate:

For a publicly offered bond, the issue price is the initial offering price to the general public and not the price paid by the underwriter. This is the same definition of issue price as is used in section 1273 and section 1274. A reasonable expectations test is used to determine the initial public offering price because, on the date of issue, the exact price at which the bonds subsequently will be sold to the general public may not be known. [Emphasis added.]30

In May 1992 Treasury published final arbitrage regulations (the "1992 Regulations").31 The 1992 Regulations implemented the changes described above and adopted a definition of "issue price" that is substantially the same as in the Existing Regulations, including the reasonable expectations test for publicly offered bonds. The 1992 Regulations, however, required that the issue price of bonds be adjusted to take into account sales to the public after the date of the issue. When the Existing Regulations were published, they further simplified the determination of issue price by specifically providing that issue price would not be adjusted if portions of the issue later sold for different prices.

As discussed in the "INTRODUCTION" above, the Existing Regulations generally became effective in 1993. The definition of "issue price" has not been amended in the twenty years since then.

Differences between the Municipal and Corporate Bond Markets

The municipal bond market and the corporate bond market are different in a number of important respects.

First, on average, the aggregate principal amount of a municipal bond issue is much smaller than that of a corporate bond issue. In 2011, there were over one million different municipal bond issues outstanding, totaling $3.7 trillion in principal, in comparison to fewer than 50,000 corporate bond issues, totaling $11.5 trillion in principal (including foreign bonds).32

Second, municipal bond issues often have a 30-year final maturity, consisting of serial bonds maturing in each of the first ten years or so and two or more term bonds with required annual redemptions; these issues often provide the issuer with the option to redeem the bonds after ten years with little or no redemption premium. This structure may reflect legal requirements and/or the need of government issuers and many conduit borrowers to have relatively equal annual debt service payments on their bonds (e.g., for budgeting or covenant purposes). In contrast, corporate bond issues typically have a shorter final maturity (e.g., 5 years, 10 years), consist of a single, bullet maturity (i.e., no required principal payments prior to final maturity) and can be optionally redeemed only pursuant to a "make-whole" redemption provision which limits the ability of the issuer to refinance the debt to obtain interest savings.

Third, the essentially exclusive means by which corporate bonds are sold are negotiated underwritings and private placements.33 In contrast, a substantial portion of municipal bonds are sold through competitive bidding,34 often because some types of municipal securities, including general obligation bonds, may be required by State law to be offered under competitive bidding. For example, during 2011, 42.4% of the 13,463 municipal securities issuances were done through competitive sales,35

Fourth, underwriters of corporate bonds rarely agree to purchase the bonds unless they have orders to re-sell all of the bonds. Municipal bond underwriters, however, regularly purchase bonds for which they do not have orders (e.g., because they purchased bonds in a competitive sale for which they were able to do little or no premarketing due to the inherent uncertainty as to whether they will be successful in their bid to purchase the bonds or because insufficient or no orders were received for certain maturities in a negotiated underwriting). As discussed above, because of legal, covenant and other considerations relating to municipal bonds, an underwriter may not be able to avoid structuring a transaction with unsold maturities, whereas the maturity and other terms of a corporate bond generally can be adjusted based on prevailing market conditions and investor demand.

Finally, municipal securities, particularly tax-exempt municipal securities, are largely held by individual or “retail” investors. As of the end of 2011, approximately 50.2% of the outstanding principal amount of municipal securities was held directly by individuals and up to 25% was held on behalf of individuals by mutual, money-market, closed-end and exchange-traded funds.36 In contrast, the corporate bond market is dominated by institutional investors. For example, as of the third quarter of 2013, households held only approximately 17.7% of corporate debt.37

COMMENTS

I. The proposed definition of “issue price” is not required or appropriate to address the policy objectives and stated concerns of Treasury and IRS.

A. The issue price of publicly offered municipal bond issues is not required to be, and based on how municipal bonds are sold cannot be, determined through an “actual sales” approach.

The preamble to the Proposed Regulations, the definition of “issue price” in the Proposed Regulations and public comments made by Treasury and IRS officials after publication of the Proposed Regulations emphasize that the amendments to the issue price definition are intended to make that definition more consistent with current regulations under sections 1273 and 1274 of the Code, which implies that such consistency, including an “actual sales” approach, is required by the cross-reference to sections 1273 and 1274 in section 148(h) of the Code. In analyzing whether determination of “issue price” for purposes of the arbitrage rules should be the same as under the original issue discount rules, it is helpful to consider the very distinct purposes of section 148 and sections 1273 and 1274 and the differences between the municipal and corporate bond markets.

The original and principal purpose of the restrictions relating to arbitrage bonds is to prevent issuers from earning a profit by investing the proceeds of tax-exempt bonds in higher yielding taxable investments. The need for section 148 arose from the fact that an issuer of tax-exempt bonds could receive a yield from taxable investments (acquired with bond proceeds) that exceeded the yield being paid by the issuer on its tax-exempt bonds. The purpose of section 148(h) is to specify how the issue price of the bonds, which is an essential component of the computation of yield on the bonds, is to be determined. Thus, determining issue price under section 148, which sets the upper limit on an issuer’s permitted investment earnings, is focused on, and impacts, issuers.

Sections 1273 and 1274 were inserted into the Code to ensure that the accruals of original issue discount on taxable debt instruments are treated consistently with interest paid on taxable debt instruments; thus, the focus of a determination of issue price under sections 1273 and 1274 is on holders, not issuers. Congress recognized that, for example, a debt instrument with a zero coupon sold at a discount resulting in a yield of 6% is economically equivalent to a debt instrument sold at par with a 6% coupon; however, without current recognition of income accruing, a cash-basis holder of the instrument purchased at a discount would not only defer recognition until receipt of the principal amount at maturity (or earlier sale), but might also be able to treat the income received as capital gain. This treatment is in contrast to the holder of a par instrument, who would have ordinary income in each year. Sections 1273 and 1274 are designed to solve this disparate treatment problem by identifying original issue discount that is directly comparable to current interest and, together with sections 1271 and 1272, providing for current inclusion of accruing original issue discount (and appropriate adjustments to the holder's basis in the instrument). By determining issue price based on purchase price paid by the original public investors in a debt instrument, instead of the purchase price paid by the underwriter to the issuer, the underwriter's spread is not treated as original issue discount, which means investors are not required to recognize the underwriter's spread as ordinary income. (The underwriter, of course, must recognize the spread as ordinary income.) Although the focus of the original issue discount rules is on taxable debt instruments, original issue discount on municipal bonds also must be computed under sections 1273 and 1274. Under section 1272(a)(2)(A), however, such original issue discount is treated as additional tax-exempt interest (i.e., the accruing income is not required to be included in the gross income of the owner).

Because corporate bonds are sold in relatively large principal amounts with bullet maturities, largely or even exclusively to institutional investors, in negotiated underwritings (pursuant to a "fixed price" rule)38 or private placements, it is relatively easy to apply the actual sales approach in determining issue price under the original issue discount rules. For example, in a $300,000,000 corporate debt offering that consists of a single five-year bullet maturity, it is not difficult to determine the initial offering price to the public at which a substantial amount was sold. In contrast, in a $10,000,000 municipal bond offering (whether negotiated or competitively sold) that includes serial bonds maturing in the first ten years and term bonds maturing in years 20 and 30 (with required annual sinking fund redemptions), there may be particular maturities for which no orders are received as of the sale date ("orphan maturities") and yet, contrary to practice in corporate bond underwritings, the underwriters will agree to deploy some of their capital and purchase all of the bonds.

Treasury has been granted broad authority in the context of section 148 to draft regulations that are designed to accomplish the goals of limiting arbitrage bonds. At the time of the enactment of the Technical and Miscellaneous Revenue Act of 1988,39 the House Ways and Means Committee outlined this authority:

The bill further deletes and re-inserts the term "necessary" in the specific regulatory authority granted the Treasury Department under the arbitrage restrictions. This amendment is intended to clarify that Treasury's regulatory authority is to be interpreted broadly, rather than in a literal, dictionary manner. . . . That regulatory authority is intended to permit Treasury to eliminate any devices designed to promote issuance of bonds either partially or wholly as investment conduits in violation of the provisions adopted by Congress to control such activities and to limit the issuance of tax-exempt bonds to amounts actually required to fund the activities for which their use specifically has been approved by Congress. Further, that regulatory authority is intended to permit Treasury to adopt rules (including allocation, accounting, and replacement rules) necessary or appropriate to accomplish the purpose of the arbitrage restrictions, which is to eliminate significant arbitrage incentives to issue more bonds, to issue bonds earlier, or to leave bonds outstanding longer.40

Over the course of four years, from 1989 to 1993, Treasury exercised this broad authority, proposing and revising the definition of "issue price" multiple times, before settling on the definition in the Existing Regulations that has now been in effect for twenty years. Beginning with the 1989 Temporary Arbitrage Regulations, Treasury recognized that a special rule was needed for the determination of issue price of publicly offered municipal bonds. As Treasury explained in making the 1991 changes to the arbitrage rules:

A reasonable expectations test is used to determine the initial public offering price because, on the date of issue, the exact price at which the bonds subsequently will be sold to the general public may not be known.41

Unless Treasury believes that it lacked authority to adopt the Existing Regulations, then determination of the issue price for publicly offered municipal bonds is not required to be determined based on an "actual sales" approach. And because section 148(a) requires that arbitrage compliance be determined as of (i.e., no later than) the issue date, any definition of "issue price" that does not ensure that issue price can be determined no later than the issue date conflicts with section 148(a).42 More importantly, as the existing issue price definition recognizes (and as discussed in more detail below), the determination of issue price of publicly offered municipal bonds must occur by the sale date (i.e., when the terms of the bonds are fixed) and, for so long as the marketing of municipal bonds continues to result in unsold maturities as of the sale date, it will be impossible to determine the issue price of such maturity (and, therefore, the issue) based on an actual sales approach. Said differently, an actual sales approach as of the sale date cannot work for maturities for which there are no actual sales as of the sale date.

B. Concerns about the offering and distribution process for municipal securities should be addressed by working with municipal securities regulators, not through tax policy.

In addition to attempting to make the determination of issue price under section 148 more consistent with the determination of issue price under sections 1273 and 1274, the preamble to the Proposed Regulations makes clear that the proposed definition of issue price is intended to "address [certain] concerns" and "provide greater certainty." As discussed below, NABL believes that the proposed definition is not administrable by issuers and, therefore, will result in less certainty. NABL also believes that the concerns described in the preamble should be addressed by municipal securities regulators, not through tax policy.

The concerns described in the preamble generally relate to the manner in which municipal securities are offered and distributed, and imply that the conduct of municipal underwriters is sometimes inappropriate and perhaps illegal. While NABL does not have access to the information that has given rise to these concerns, NABL takes them seriously and believes that, if problematic, they should be addressed. Because the activities of municipal underwriters are regulated by SEC, MSRB and FINRA, however, NABL believes that Treasury and IRS should share their concerns with these regulators and request that they investigate and take appropriate regulatory and enforcement action. Issuers do not have the resources to police these perceived activities, nor do they benefit from the perceived manipulation; nevertheless, the Proposed Regulations would force issuers to bear the penalty for perceived misconduct of others.

We believe it may be helpful to provide an illustration of how the concerns cited in the preamble may be more appropriately addressed through municipal securities regulation than tax policy. The preamble states that one concern is that, in some cases, underwriters may make a public offering of only 10% of a maturity to establish a lower issue price, holding back the remaining 90% to be sold at higher prices. If this practice is in fact happening, then even under the Existing Regulations the use of the "reasonable expectations" test would not be permitted, since such an offering is not a "bona fide public offering" of the bonds. Moreover, it would be inconsistent with contractual obligations that underwriters generally have with issuers and may violate securities law and rules. This concern is more properly addressed by enforcement of existing law and contracts against the offending underwriters, rather than establishing a new regulatory requirement that will inevitably result in additional costs to issuers.

In attempting to address concerns about the municipal bond offering and distribution process through tax policy, the proposed definition of issue price is not only unfair to issuers, but conflicts with securities law rules governing this process. The effect of the proposed definition would be to include, as part of the underwriter's spread, profits from sales of bonds that may be earned by entities or persons outside of the underwriting syndicate with which the issuer has contracted. This result is unfair to issuers because it would lower their arbitrage yield on the bonds (i.e., the upper limit on their investment earnings) without increasing the proceeds they receive from the sale of the bonds, as a result of actions taken by third parties with whom issuers have no contractual relationship. In some cases, this unfairness would be compounded by the fact that all or a portion of such profits resulted from fluctuations in the market after the sale date, changes over which issuers have no control. Moreover, this result conflicts with the determination of underwriter's spread under MSRB Rule G-32 that is required to be disclosed to investors in the final official statement for a negotiated underwriting.43

II. The proposed definition of "issue price" is not administrate by issuers under existing law and market practices.

A, Issuers and bond counsel do not have access to the information necessary to determine issue price based on actual sales to the "public."

The proposed definition of "issue price" is not administrable by issuers because issuers and bond counsel do not have access to the information necessary to determine issue price based on actual sales to the "public" as defined under the Proposed Regulations. The best way to illustrate this problem is through an example. Assume an underwriter is unable to sell a particular bond maturity to the public for any one of a variety of commonly occurring reasons (e.g., small principal amount of a particular maturity, yield curve on a particular day) and, therefore, the underwriter sells 100% of that maturity to a broker (who is not a member of the underwriting syndicate) at the initial offering price on the sale date. Under the Proposed Regulations, to determine issue price, an issuer and bond counsel would need to know to whom and at what prices that broker sold the bonds, as well as whether the persons who bought the bonds did so for the purpose of investment (i.e., were they members of the "public"). Neither the broker nor its customers are required by law or contract to provide that information to the issuer and bond counsel, so the question becomes whether the information is otherwise available.

The preamble to the Proposed Regulations does not specify any particular source for this type of information. Currently, EMMA is the only free and public platform for detailed municipal bond trading data, and the operating assumption (apparently based on the use of EMMA by the IRS, which includes access to some data that is not publicly available) appears to be that EMMA is in fact a reliable source of such data. However, EMMA data is not sufficient to determine issue price under the Proposed Regulations.44 While EMMA provides some information about actual sales, it is difficult to correctly interpret this information within the constraints of the Proposed Regulations. More importantly, EMMA does not provide all of the information required to determine issue price under the Proposed Regulations (e.g., record of orders as opposed to completed trades, true timing of trades, information necessary to determine whether a purchaser is an "underwriter" or a member of the "public").

Before requiring that issue price be determined based on actual sales, Treasury and IRS should first make sure that issuers will have access to the data necessary to make this determination. Significant lead time (e.g., two to three years) should be provided to ensure that data bases, whether through EMMA, from underwriters or by other means, are in place to establish dates, times, and prices of actual sales to ultimate investors. Prior to effectiveness of the regulations, Treasury and IRS should review the data bases (and undertake "dry runs") to ensure that compliance with an actual sales standard can be satisfied.

B. To be administrable by issuers, any definition of "issue price" of publicly offered municipal bonds must enable issue price to be determined as of the sale date, when the terms of the issue are established.

1. Issuers may violate applicable State law, policy or authorizing resolutions if issue price cannot be determined as of the sale date.

In agreeing to sell bonds to the underwriters in a negotiated or competitive offering, the issuer must comply with any applicable State law or policy and the authorizing resolutions it has adopted. For example, in a refunding, the issuer may be required to meet a certain threshold for debt service savings. If issue price cannot be determined as of the sale date, when the terms of the bonds are set and debt service savings are calculated, then the issuer may violate applicable law, policy or resolutions. Even if issue price can be determined after the sale date and before closing, it may not be possible to restructure the terms of the bonds, because the BPA has already been signed (or the bonds have been awarded in a competitive sale). And, if issue price cannot be determined until after closing, there may be no effective way to cure the violation.

The Proposed Regulations do provide one remedy for post-sale issue price changes by allowing yield reduction payments. While making a yield reduction payment may resolve an arbitrage problem under section 148 of the Code, the payment may result in the issuer not obtaining the required level of debt service savings, thereby violating applicable State law or policy or the issuer's authorizing resolutions. Moreover, unlike rebate, where payments to Treasury can be made from investment earnings actually received by the issuer, an issue price-related yield reduction payment will need to come from an additional source of funds, which may not exist or be available (from either a legal and/or an economic standpoint).

2. Because compliance with numerous other provisions of federal tax law depends on the determination of issue price, issuers may unintentionally violate those provisions if issue price cannot be determined as of the sale date.

Although the term "issue price" is used specifically in relatively few places in sections 103, 141-150, and 54AA, it has become central to the meaning of "sale proceeds," "net proceeds," "proceeds," "face amount"45 and "amount," each of which is an important concept in the Existing Regulations as well as Code provisions applicable to municipal bonds. Taken together, these definitions affect most of the tests for determining whether a bond is described in section 103(b)(1), (2) or (3), and thus tax-exempt, or tax-advantaged in more limited instances.46 These tests include the 2% costs of issuance limit, private activity limitations, volume caps, output facility limits, small issue bond limits, weighted average maturity calculations and related tests, debt service reserve fund limits, small issuer status and certain transition rules. Attached as Exhibit C is a more comprehensive list illustrating where the failure to determine the issue price of bonds as of the sale date could result in lack of certainty with respect to, or even unintentional violations of, various provisions of the Code or Existing Regulations as of the issue date. The Proposed Regulations do not provide any means for issuers to remedy these violations.

3. Bond counsel must confirm whether they can give an unqualified approving opinion on the sale date.

If issue price cannot be determined as of the safe date, then, as discussed above, it will not be possible to confirm on the sale date whether the bonds will comply with all of the relevant tests for tax exemption under the Code as of the issue date. A customary condition to issuance and delivery of bonds contained in the BPA (which is signed on the sale date) is that bond counsel delivers an unqualified approving opinion on the closing date with respect to the tax-exempt status of interest on the bonds. If the BPA is signed with this condition, and issue price is determined after the sale date to be different than reasonably expected on the sale date based on the initial offering prices to the public, then in many cases bond counsel will not be able to deliver an unqualified approving opinion. And if issue price cannot be determined until after the issue date, then bond counsel would not be able to be able to deliver an unqualified approving opinion on the issue date. In either case, the bonds would not be issued and the BPA would terminate after it was signed and before closing (often referred to as the "cratering" of a deal between pricing and closing), which historically has almost never occurred in the municipal (or corporate) bond markets.47

III. Attempts to comply with the proposed definition of "issue price" will impose substantial additional expense on issuers and alter longstanding practices in the municipal market.

A. If the proposed definition is adopted and municipal bonds continue to be marketed in ways that result in unsold maturities on the sale date, issuers will bear substantial additional expense attempting to determine issue price based on actual sales to the public.

If the proposed definition of "issue price" were to become final, issuers would bear substantial additional expense attempting to determine issue price based on actual sales to the public if they continue to allow their bonds to be marketed in ways that result in unsold maturities on the sale date. Issuer employees, bond counsel or the issuer's financial advisor would be required to spend additional time obtaining, reviewing and documenting the facts relating to actual sales, in order to attempt to determine issue price under the proposed definition. In certain cases, these efforts could extend from the sale date to the issue date and even beyond the issue date, until issue price is determined or it becomes clear that it cannot be determined. To the extent that issue price is determined to be different than reasonably expected on the sale date based on initial offering prices to the public, the issuer may be required to make a yield reduction payment from its own funds and bear the cost of curing noncompliance with other provisions of the Code.

As discussed above, if issuers are successful in determining issue price under the definition in the Proposed Regulations, the result may be that they are forced to accept a lower arbitrage yield based on profits earned by persons or entities with whom they had no contractual relationship and which may have resulted from fluctuations in the market after the sale date over which issuers have no control.

B. To eliminate unsold maturities on the sale date in negotiated underwritings, issuers would be forced to accept lower prices and higher yields.

To avoid the result described above, issuers may determine that they should alter the ways in which they allow their bonds to be marketed in negotiated underwritings in order to eliminate unsold maturities. Bonds would need to be marketed at lower prices/higher yields to ensure that the 25% safe harbor could be met for each maturity, resulting in higher interest costs for issuers. Further, investors will almost certainly be aware that an issuer in many cases must ensure that at least 25% of each maturity of an issue is sold; if they become aware (or suspect) that certain maturities are not in demand from other investor classes, they will be in a position to ask for — and get — lower prices/higher yields than might otherwise be available. This will fundamentally shift the dynamics of marketing by empowering investors to demand higher yields.

C. Because issuers may not be able to eliminate the possibility of unsold maturities in competitively sold deals, the ability of issuers to sell bonds competitively may be limited.

Issuers also could attempt to require that bidders in competitive sales actually sell 25% of each maturity to the public at the initial offering prices in order to satisfy the safe harbor in the Proposed Regulations. If underwriters were willing to bid under that condition, they would be forced to lower their bids (i.e., increase yields) to the point where they were confident they could satisfy this condition. And, if the winning bidder did not satisfy this condition, the issuer still would be required to bear the costs associated with attempting to determine issue price without the benefit of the safe harbor (if issue price could be determined at all). The greater likelihood of complying with the safe harbor in a negotiated underwriting would probably result in fewer competitive sales, except to the extent competitive sales are required by applicable State law, inappropriately causing issuers to adopt a method of sale based on tax policy.

IV. If Treasury and IRS continue to consider applying an actual sales approach to the determination of issue price for publicly offered municipal bond issues, a revised definition of "issue price" should be re-proposed.

A. Any re-proposed definition of "issue price" for publicly offered municipal bond issues should continue to provide that issue price is and can be determined as of the sale date.

Any re-proposed definition of "issue price" for publicly offered municipal bond issues should continue to provide that issue price is and can be determined as of the sale date. If Treasury and IRS continue to consider applying an actual sales approach to publicly offered municipal bond issues, any re-proposed definition of "issue price" based on actual sales should provide that the relevant offering period ends on the sale date; however, as discussed above, if municipal bonds continue to be marketed in ways that result in unsold maturities on the sale date, issue price cannot be determined as of the sale date based on an actual sales approach. As a result, any attempt to provide greater certainty in the determination of issue price must retain, and provide safe harbors under, the reasonable expectations test in the Existing Regulations.

B. Certain aspects of the proposed definition of "issue price" should be revised and clarified if they are to be included in any re-proposed definition.

If Treasury and IRS consider re-proposing a definition of "issue price" that incorporates aspects of the proposed definition, NABL suggests that the following revisions and clarifications to the proposed definition be considered and that certain collateral consequences be addressed.

1. Revise the Definition of "Public"

Other than the actual sales approach, the most problematic concept in the Proposed Regulations is the definition of "public." For purposes of the section 148 definition of issue price, NABL suggests that Treasury and IRS consider defining "public" to be anyone other than the underwriting syndicate and parties related to any member of the underwriting syndicate, utilizing the concept of privity. Under this definition, as long as (1) 25% of the bonds of each maturity (and interest rate, for split coupons) was sold at the initial offering price to entities outside of the underwriting syndicate (and its related parties), and (2) all orders at the initial offering price were filled to the extent submitted by persons other than registered broker-dealers, the safe harbor under the Proposed Regulations could be met.

2. Provide for Competitive Bid Safe Harbor

As discussed in Section III.C. above, the actual sales approach is least workable for competitively bid bond issues. Because competitive bidding is required by State law in some cases and generally considered to produce a good result for issuers, NABL believes that regulations should not discourage the use of competitive bidding. In other areas where Treasury has been concerned with ascertaining fair market value in an objective manner (such as the pricing of guaranteed investment contracts and open-market securities escrows), competitive bidding was a suitable solution. Therefore, NABL suggests the creation of a safe harbor using initial offering prices for proof of issue price in competitively bid bond sales, assuming that the bonds are awarded to the highest bidder.

3. Provide for Synthetic Markup Safe Harbor

As an alternative to strict tracing of all actual sales to the ultimate investors, NABL suggests a safe harbor where a pre-determined markup could be added to the initial offering price to compute issue price for (1) maturities for which no orders have been received or maturities that would otherwise fail to meet the 25% safe harbor, or (2) sales to brokers or other persons where investment intentions were unknown, such that those sales could be treated as sales to the public.

4. Lower Safe Harbor Standard from 25% to 10%

Municipal market participants are accustomed to the 10% standard for "substantial amount" that has been in place in the Existing Regulations for the last twenty years. Moreover, 10% has long been accepted in the taxable area as a "common law" standard for purposes of sections 1273 and 1274.48 Since the Proposed Regulations already materially depart from longstanding law, NABL suggests maintaining as much constancy as possible by retaining standards where there is no clear reason for change. The tax law pertaining to State and local bonds uses a more-than-5% (and, in some cases, a more-than-10%) standard for substantial amounts in many contexts ranging from private activity tests to working capital tests to public approval amounts.

5. Accommodate Issue Price-Related Yield Reduction Payments

The Proposed Regulations would allow an issuer to make a yield reduction payment to remedy an advance refunding escrow that turns out not to be yield-restricted due to a post-sale revision to the expected issue price. Many issuers may not have funds available to make a required issue price-related yield reduction payment ("IPYRP"), which may cause issuers to choose to finance a contingency IPYRP. Absent additional exceptions to provisions of the Existing Regulations, this may not be feasible.

Currently, under the working capital general de minimis exceptions of Reg. § 1.148-6(d)(3)(ii)(A)(4), an issuer may bond-finance yield reduction payments without complying with the "proceeds spent last" rules typically applicable to the financing of working capital expenditures. Along similar lines, NABL suggests that an exception be added under "excess gross proceeds" (Reg. § 1.148-10(c)(3)) in order that an IPYRP contingency would not count as excess gross proceeds. Further, IPYRPs should be excepted from all definitions of proceeds such that they would not confound the application of other tests (e.g., private activity tests, rebate spending exceptions). Finally, in order to ensure a financed IPYRP contingency did not remain permanently unspent, Treasury and IRS could create a rule requiring all IPYRP contingency remaining after the issue price has been established and the IPYRP has been paid to be spent on debt service.

6. Clarify Offering Period and Original Distribution

The concepts of "offering period" and "original distribution" are pivotal under the Proposed Regulations, yet they are not defined. The exception for unfulfilled orders under the 25% safe harbor only applies during the "offering period," but it is unclear when the offering period begins and ends. Similarly, an underwriter is defined, in part, as any person who participates directly or indirectly in the "original distribution," but it is unclear whether the original distribution is coterminous with the offering period or possibly extends beyond that point. Issuers must have certainty regarding the time at which it will be appropriate to finalize the calculation of issue price under the Proposed Regulations. Therefore, NABL suggests clarification of "offering period" and "original distribution." To maintain consistency among regulatory regimes, we also suggest the definitions equate to the current “order period” under MSRB Rule G-11 and sales that occur during that period.

7. Provide Examples of Issue Price Substantiation

As described in these comments, application of the Proposed Regulations will be confusing and difficult for many issuers. NABL suggests the addition of examples elucidating the process of substantiating issue price under the Proposed Regulations in order to alleviate uncertainty.

8. Address Collateral Consequences of Unknown Issue Price at Sale Date

Unless the Proposed Regulations are revised to ensure computation of issue price as of the sale date, NABL strongly encourages de-coupling of the definition of issue price under section 148(h) from all other tests for determining whether a bond is tax-exempt or tax-advantaged to avoid the collateral (i.e., non-yield related) consequences of an unknown issue price at the sale date.

Many of these collateral problems could be solved by revising the definition of “sale proceeds” to include only amounts actually received by the issuer plus underwriters’ discount or compensation as disclosed pursuant to federal securities laws in the final official statement, or otherwise stated. Ultimately, this would equate sale proceeds with the initial offering price rather than the new definition of issue price, eliminating concerns regarding post-sale recalculation of many required tests for tax-exemption.

An additional set of problems could be solved by clarifying prior guidance that links terms such as “face amount” and “amount” to issue price, replacing issue price in those cases with sale proceeds, as redefined.

Finally, in the cases where the term “issue price” is actually used in statutory or regulatory language, providing that “sale proceeds,” as redefined, may be used as a proxy would effectively maintain the current state of the law, thus reducing uncertainty created by the new definition of issue price.

CONCLUSION

NABL respectfully suggests that the definition of “issue price” in the Proposed Regulations be withdrawn and that any other change in the issue price definition be re-proposed. To the extent that Treasury or IRS is concerned with the manner in which municipal securities are offered or distributed, these concerns should be shared with SEC, MSRB and FINRA, so that appropriate regulatory and enforcement action may be taken. Any re-proposed definition of “issue price” for publicly offered municipal bond issues should continue to provide that issue price is and can be determined as of the sale date in a manner consistent with Congressional intent, i.e., by adding the underwriter’s spread back to the purchase price paid to the issuer by the underwriter for the bonds. Because MSRB rules govern the offering and distribution of municipal securities and require the computation and disclosure of underwriter’s spread, computation of issue price for purposes of section 148 should be consistent with what is computed and disclosed publicly for securities law purposes. If municipal bonds continue to be marketed in ways that result in unsold maturities on the sale date, issue price cannot be determined as of the sale date based on an actual sales approach. As a result, any attempt to provide greater certainty in the determination of issue price must retain, and provide safe harbors under, the reasonable expectations test in the Existing Regulations.

FOOTNOTES

1 Pub. L. No. 99-514 (1986).

2 T.D. 8476, 1993-2 C.B. 33.

3 MSRB is a self-regulatory organization created by Congress in 1975 to write rules regulating the behavior of bank and securities firm dealers in the municipal securities market in order to "protect investors and the public interest." MSRB is subject to oversight by the Securities and Exchange Commission ("SEC"), and its rules, once approved by SEC, have the force and effect of federal law. MSRB rules are enforced by the Financial Industry Regulatory Authority ("FINRA") for securities firms and by the various bank regulatory agencies for bank dealers, as well as SEC.

4 This real-time information was initially posted and available publicly for free on an investor education website, www.investinginbonds.com, maintained by The Bond Market Association (now known as the Securities Industry and Financial Markets Association). Subsequently, MSRB established the Electronic Municipal Market Access ("EMMA") website, www.emma.msrb.org, to increase access to important disclosure and transparency information in the municipal securities market. EMMA provides market transparency data, which includes real-time prices and yields at which bonds and notes are bought and sold, for most (but not all) trades occurring on or after January 31, 2005.

5 See, e.g., Green, Hollifield & Schurhoff, "Dealer Intermediation and Price Behavior in the Aftermarket for New Bond Issues" (June 21, 2006). http://dev3.cepr.org/meets/wken/5/5534/papers/Schurhoff.pdf. Earlier versions of this paper were distributed in 2005.

6 Flipping is not unique to the municipal bond market. Pricing and performance of new corporate bonds has been found to be consistent with a "flipping" hypothesis. See Kozhanov, Ogden & Vaghefu "The Pricing and Performance of New Corporate Bonds: TRACE-Era Evidence" (July 6, 2011), https://secure.northernfinance.org/2011/Submissions/modules/request.php?module=oc_program&action=view.php&id=171.

7 Pub. L. No. 111-5(2009).

8 In recent years, the inability of issuers to earn positive arbitrage on investments of bond proceeds, e.g., because of historically low interest rates on Treasury securities, also has made determination of issue price and bond yield less important.

9 Notice of Proposed Rulemaking and Notice of Public Hearing, 78 Fed. Reg. 56,842 (Sept. 16, 2013).

10 NABL is separately submitting comments on the remainder of the Proposed Regulations.

11 T.I.R. 840 (Aug. 11, 1966), STAND. FED. TAX. REP. ¶ 6701 (CCH 1966).

12 See Manly W. Mumford, "Arbitrage and Advance Refunding," 1976 Duke L. J. 1239, 1246 (1976).

13 Pub. L. No. 91-172(1969).

14 Pub. L. No. 94-455 (1976).

15 See Temp. Reg. § 13.4(a)(5)(i)(b), T.D. 7072, 35 Fed. Reg. 17,406 (Nov. 13, 1970), as amended by T.D. 7174, 16 Fed. Reg. 10,932 (Jun. 1, 1972) and T.D. 7273, 38 Fed. Reg. 10,927 (May 3, 1973); see also Prop. Reg, § 1.103-13(c)(3)(i)(b)(1972).

16 See Notice of Proposed Rulemaking, LR-1671, 43 Fed. Reg. 39,822 (Sept. 7, 1978).

17 In an earlier Notice of Proposed Rulemaking, LR-1671, 43 Fed, Reg. 19,675 (May 8, 1978), the language was explained as being the same definition of issue price as the one used in Reg. § 1.1232-3 relating to original issue discount. Note that this initial regulation did not require that a substantial amount of the bonds be sold to the public at these offering prices.

18 Reg. § 1.103-13(d)(2) (1979).

19 http://www.msrb.org/glossary/SPREAD.aspx. Note that this definition also does not require that a substantial amount of the bonds be sold to the public at these offering prices.

20 S. REP. NO. 99-313 at 828.

21 H.R. REP. NO. 99-426 at 554 (1985).

22 H.R. REP. NO. 99-841, at 11-745 (1985) (Conf. Rep.).

23 In adopting Section 148(h), Congress did not intend to abandon the “reasonable expectations” methodology. See footnote 42.

24 T.D. 8252, 1989-1 CB 25.

25 Temp. Reg. § 1.148-8T(c)(1).

26 Temp. Reg. § 1.148-8T(c)(2)(i).

27 Temp. Reg. § 1.148-8T(c)(2)(iii).

28 Notice 89-78, 1989-2 CB 390.

29 T.D. 8345, 1991-1 C.B. 33.

30 Id.

31 T.D. 8476, 1993-2 C.B. 13.

32 U.S. Securities and Exchange Commission, Report on the Municipal Securities Market (July 31, 2012) (the “SEC 2012 Municipal Market Report”), at 5.

33 For a brief description of negotiated underwriting, see Exhibit A at 3-5.

34 For a brief description of a competitive sale, see Exhibit A at 5-6.

35 SEC 2012 Municipal Market Report at 15-16 & n.75. In terms of principal amount issued in 2011, competitive sales comprised 26.3%.

36 SEC 2012 Municipal Market Report at 12.

37 See Federal Reserve Statistical Release, Z.1: Financial Accounts of the United States, Third Quarter 2013, www.federalreserve/gov/releases/z1/Currentl/z1.pdf, Table L.100, Line 14 minus Table L.100.a, Line 11, divided by the sum of Table L.2, Line 19 plus Table L.3, Line 5.

38 Publicly offered corporate bonds can be offered only at the stated public offering price to investors, not at “reduced prices,” also referred to as “concessions,” to certain investors. See FINRA Rule 5141. In 1981, one of SIFMA’s predecessors, the Public Securities Association, requested that

MSRB consider adopting a “fixed price” rule for publicly offered municipal securities, which MSRB concluded was not necessary or appropriate. See MSRB Reports, Vol. 1, No.4 (November 1981).

39 Pub. L. No. 100-647, sec. 1013(a)(34)(A), 102 Stat. 3342, 3544.

40 H.R. REP. NO. 100-795 at 327-328.

41 T.D. 8345, 1991-1 C.B. 33.

42 For evidence of Congressional intent regarding the reasonable expectations test under section 148(a), see Joint Committee on Taxation General Explanation of the Tax Reform Act of 1986, JCS-1--87, at p. 1201:

The Act codifies the “reasonable expectations” test of prior law with respect to subsequent deliberate and intentional acts to earn impermissible arbitrage taken subsequent to issuance of the bonds. Under the Act (as under prior law), the determination of whether bonds are arbitrage bonds generally is based upon the reasonable expectations of the issuer on the date of issue. If such subsequent acts are taken after the date of issue to earn arbitrage, however, the reasonable expectations test does not prevent the bonds from being taxable arbitrage bonds. (See, e.g., Rev. Rul. 80-91, 1980-1 C.B. 29; Rev. Rul. 80-92, 1980-1 C.B. 31; and Rev. Rul. 80-188, 1980-2 C.B. 47.)

43 Ironically, the proposed definition may result in a different determination of issue price for municipal bonds under section 148 versus sections 1273 and 1274 because original issue discount on municipal bonds has been, and may continue to be, determined based on the initial offering prices disclosed in the final official statement and reported on EMMA.

44 MSRB rules make it unlikely that EMMA could be used “as is” to calculate issue price in most cases. Specifically, except in the case of short-term notes, MSRB Rule G-34 requires the underwriter to set a “Time to First Execution” for trades by members of the syndicate. That time must be no less than two hours after the underwriter has submitted information about the issue to DTC’s new issue information dissemination system (“NIIDS”). Indeed, the NIIDS submission process generally does not begin until after the “Time of Formal Award” (i.e., the execution of the BPA for negotiated issues or the announcement of a winner for competitive issues), Trades by syndicate members at the initial offering price are reported with an “L” (i.e., list price) indicator beginning at the Time of First Execution until the end of the day. The “L” indicator is not used for trades by non-syndicate members or even by syndicate members on subsequent days. These rules apply only to syndicate members. There are no restrictions on dealers that are not syndicate members trading securities before the Time of First Execution under MSRB rules, despite an industry convention that securities should not trade before the underwriter has declared them “free to trade.” Accordingly, it is not uncommon to see trades reported on EMMA prior to the Time of First Execution and those trades may or may not be at the initial offering price. Only syndicate members bind themselves to offer the securities at the initial offering price. Thus, there can be a curious result that secondary market trades (i.e., trades by customers or dealers that purchased securities from a syndicate member) may be displayed on EMMA as “when issued” trades (with a “W” indicator) even before the primary market trades are displayed. To add to the confusion, even when the primary market trades are reported at the Time of First Execution, the time of trade reported is the time the underwriter reports the trade to EMMA, not the time the underwriter and customer actually agree to the trade. For example, an underwriter and customer might have agreed on Tuesday at 10 a.m. to a trade at the initial offering price, but the time of trade will be no earlier than 2 p.m. that day, assuming a BPA signed by noon and a Time of First Execution of 2 p.m. In the meantime, the customer may have entered into a when-issued trade with a non-syndicate member dealer, which trade may be reported at 1 p.m.

45 In common parlance, “face amount” means stated principal amount and is not linked to purchase or offering price. However, over time in various non-precedential guidance, IRS has determined that face amount and similar terms are more appropriately equated with “issue price.” See, e.g., Letter Ruling 9431007 (Apr. 26, 1994).

46 Notice 2010-35 (2010-1 CB 660) provides that the definition of issue price under Reg. § 1.148-1(b) applies for certain purposes of direct pay bonds under sections 54A and 54AA.

47 The failure to close could have significant adverse consequences for the issuer, including liability for breach of contract and a reduced ability to market bonds in the future.

48 See James M. Peaslee & David Z. Nirenberg, Federal Income Taxation of Securitization Transactions and Related Topics 673, n. 29 (4th ed. 2011).