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State Debt Management Group Seeks Withdrawal of Proposed Issue Price Definition.

David Lillard Jr. of the State Debt Management Network has commented on proposed regulations (REG-148659-07) on arbitrage investment restrictions applicable to tax-exempt bonds, suggesting that the proposed changes to the definition of "issue price" be withdrawn for further study, noting the negative impact the changes would have on the municipal market.

December 13, 2013

Internal Revenue Service

PO Box 7604

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Washington, DC 20044

Re: Comment on Arbitrage Restrictions on Tax-Exempt Bonds Proposed Rulemaking (REG-14865--07)

To whom it may concern:

The State Debt Management Network ("SDMN"), an affiliate of the National Association of State Treasurers ("NAST") appreciates the opportunity to provide comments on the proposed rulemaking by the Treasury of the United States (the "Treasury") to amend certain provisions of its arbitrage regulations applicable to tax-exempt bonds (the "Arbitrage Regulations") (REG 148659-07). SDMN welcomes the Treasury's efforts to clarify the Arbitrage Regulations and to facilitate issuer compliance with the substantive requirements of the Internal Revenue Code, We believe that several of the proposed amendments will further these goals.

The proposed change to the definition of the term "issue price" for purposes of the Arbitrage Regulations, however, cannot be effectively implemented by issuers except by structuring the marketing of their bonds for this purpose. This proposed change would be likely to have significant and adverse unintended consequences for the municipal market. Accordingly, we urge the Treasury to withdraw this portion of its amendment proposals for further study. We would be happy to work with the Treasury in developing an alternative proposal to address the concerns that are identified in the Notice of Proposed Rulemaking in a manner that more fully reflects the actual working of the municipal underwriting process.

SDMN was founded in 1991, and is the leading non-partisan organization representing state level debt issuers throughout the United States. As officers of States and state level debt issuing agencies, SDMN's membership is involved in bond issuances and recordkeeping for billions of dollars in state level debt issuances. They have a direct stake in their respective States' financial well-being as well as in the health of the nation's economy, SDMN seeks to provide educational conferences and webinars, publications, working groups, policy advocacy and support that enable state level issuers to pursue and administer sound financial policies and practices of benefit to the citizens of the nation with regard to debt issuances.

As representatives of state level issuers, SDMN members have a unique understanding of how policy changes can impact the issuance of municipal bonds at the state and local level. We strongly believe that the proposed changes to the definition of "issue price" are unnecessary in connection with many, if not all, municipal bond issues. Such changes, if implemented, would significantly increase the cost of capital for States and other municipal market issuers, disrupt competition in the market for their bonds, and impose substantial new burdens on these issuers. Issuers would not be able to assure compliance with the proposed requirements at the time that their bonds are issued and, in some instances, may not be able to assure compliance at all.

Our comments highlight several negative outcomes that would result from the proposal. In sum, the proposed changes to the rules for determining issue price would unnecessarily burden the debt issuance process with uncertainty and legal risk and increase the cost of borrowing for States, counties, cities, and municipal authorities, thereby increasing the costs of infrastructure and other end-uses to the States as well as the tax expenditure cost to the federal government as the total amount of tax exempt interest rises.

In regard to the proposed Arbitrage Regulations, SDMN offers the following comments, which have been approved by the SDMN Board of Directors:

The Current Reasonable Expectation Test Should Be Retained.

The proposed regulations will change the way bond issues are priced. While this disruption would be most clearly felt with respect to yield sensitive bond issues (such as advance refundings), the pricing of all issues may be expected to be impacted. SDMN believes the changes will almost certainly increase costs for issuers and will decrease certainty and transparency, while not necessarily reducing arbitrage. We further believe that the current reasonable expectation test has generally worked well for over 20 years and should be substantially retained. SDMN offers to work with the Treasury to develop appropriate refinements to the application of the current rule in order to further limit the possibility of inappropriate arbitrage. Any such refinement must be within the confines of the reasonable expectation test to assure issuers and their bondholders, underwriters and advisors that compliance may be determined with certainty upon the date of bond issuance.

We note that the proposed regulations do not appear to address competitive sales. Competitive sale procedures are dictated by state law to result in the lowest available cost of borrowing. The nature of the competitive sale process substantially limits the issuers' ability to obtain information from its bond purchasers.

Issuers and bondholders cannot be at risk for the post-issuance actions of negotiated sale underwriters and competitive sale purchasers. We agree with the Honorable James McIntire, Washington State Treasurer [see, comment letter dated November 27, 2013] in his belief that the current rules, coupled with prudent IRS enforcement, are and will continue to be highly effective in achieving the interrelated goals of minimizing borrowing costs for issuers as well as minimizing arbitrage.

Issuer Monitoring of Secondary Market

Issuer monitoring of secondary market trading is impractical and many issuers do not have the capacity to monitor secondary market trading in their bonds. Even for issuers who might be able to develop the personnel resources necessary to monitor currently available secondary market trading information, such information does not currently constitute a reliable basis for a determination that may result in substantial legal risk. Moreover, secondary market activity, by definition, reflects changes in applicable interest rate levels subsequent to bond pricing. This fact makes such activity an inappropriate basis for determining the issuer's arbitrage compliance. There may well be a difference between an issue price that is appropriately determined at the time a bond is sold by the issuer and the secondary market price obtained by the underwriter, or by another broker-dealer, at a later date, but this difference should not affect the "yield" on the bonds for purposes of the Arbitrage Regulations. Issuers cannot independently determine the degree to which such differences are attributable to changing market conditions and should not be required to as such changes in market condition do not affect their cost of funds.

Risk That Underwriters May Negotiate To Shift Risks of Determining Issue Price Back To the Issuer

The proposal may be expected to change the negotiations for bond issuances in a negative manner for issuers and the public. Specifically, both the proposed substitution of an in fact test for the reasonable expectations test and the proposed higher percentage of bonds of a maturity that must be sold prior to bond issuance to qualify for the safe harbor may be expected to reduce potential underwriters to those that are capable of placing the higher percentage of each maturity with the public by closing (or that are willing and able to hold the bonds as investments if the market does not permit them to do this), thereby reducing the competition for underwriting. Actual experience with bond issuance shows that it isn't always possible for underwriters to sell even 10% of each maturity by closing as was reasonably expected at the time of pricing. This results from the fundamental fact that market clearing rates of interest constantly change. Fewer potential underwriters who can reasonably compete for an issuance will lessen issuers' ability to negotiate competitive terms and ultimately raise borrowing costs for all tax exempt issuers. This may also limit issuers' practical ability to utilize serial maturities in structuring the principal amortization of their debt.

Yield Reduction Payments Increase Issuer Costs

The proposal allowing yield reduction payments is intended to ensure that if the issue price of the bonds is greater than the price originally assumed as of the sale date for the issuance, there would be a mechanism to maintain compliance. However, reliance on these payments by issuers would raise costs and put the burden on issuers to reserve against and monitor potential yield reduction payments. This remedy is deficient as it can only be relied upon by issuers willing to bear the risk and uncertainty of not knowing the issue price and, hence the allowable yield, at closing. Moreover, the mechanism does not address the case where no sale is ever made to members of the public. Efforts to allocate risk between the issuer and underwriter would inevitably result in further lack of competition and increased cost to the issuer.

Impact of Excluding Underwriters from the Definition of "Public"

We share the concerns of the Honorable James McIntire, Washington State Treasurer, who pointed out in his IRS comment letter that the proposed rules may raise the all-in costs to issuers by limiting the ability to have issuances partially or fully underwritten by the underwriting group, limiting issuers' ability to negotiate for lower rates and higher bond prices.

Costs to Federal Government

We remain concerned the proposal could lead to more tax exempt interest expense, translating to higher "costs" to the federal government for the exemption. We expect that the proposed change has the potential to increase yields, for example as issuers strive to meet the higher 25% threshold for the safe harbor and are forced to raise yields and reduce prices to meet the safe harbor. As a result, the proposed change would lead to more interest that is exempt from federal taxation, thereby increasing the tax expenditure cost to the federal government.

In summary, the Treasury's proposed changes to the definition of issue price would he detrimental to States by increasing the cost of capital and imposing new burdensome requirements on issuers of municipal bonds. We do not believe these changes are necessary and believe that they will significantly alter market practice and will introduce uncertainty and risk to a well-established process for determining the yield of bonds for arbitrage compliance purposes. We wish to emphasize that we have grave doubts about the ability of issuers or the IRS to administer the proposed standard based upon currently available secondary market information. Moreover, even if sufficient secondary market information were available, reliance upon it would change the nature of the issue price determination by inappropriately reflecting market change subsequent to issuance, which would introduce unnecessary legal and financial risks that cannot be effectively addressed.

SDMN requests that these changes be withdrawn so that the other proposed amendments may be finalized and implemented while further study is made of any necessary changes to the existing issue price definition. We would welcome the opportunity to assist in this process.

As state debt issuers concerned about the financial strength and integrity of States and all governmental units within our States, we appreciate this opportunity to offer our views on this proposed rulemaking. Thank you for your consideration of our comments.

Sincerely,

David H. Lillard, Jr.

Tennessee State Treasurer and

Chair, State Debt Management

Network, an Affiliate of the

National Association of State

Treasurers

Washington, DC