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Unofficial Transcript Available of IRS Hearing on Arbitrage Restrictions on Tax-Exempt Bonds.

An unofficial transcript is available of the February 5 IRS hearing on proposed regulations (REG-148659-07) on the section 148 arbitrage investment restrictions applicable to tax-exempt bonds and other tax-advantaged bonds.

UNITED STATES DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

PUBLIC HEARING ON PROPOSED REGULATIONS

26 CFR PART 1

“ARBITRAGE RESTRICTIONS ON TAX-EXEMPT BONDS”

[REG-148659-07]

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* * * * *

PROCEEDINGS

(10:00 a.m.)

MR. BELL: Well good morning everyone and thank you for coming out in this bad weather to attend our public hearing. This is the public hearing on proposed regulations under 26 CFR Part 1, Arbitrage Restrictions on Tax Exempt Bonds, REG 148659-07. The notice of proposed rulemaking and notice of public hearing were published in the Federal Register on Monday, September 16th, 2013. The hearing panel today, my name is Lewis Bell; I'm a tax attorney in Financial Institutions and Products, Branch Five, that's the bond branch with the IRS, Chief Counsel's Office.

To my immediate left is Johanna Som de Cerff, Senior Technical Advisor on Financial Institutions and Products, Branch Five, and to my far left is Vicky Tsilas, Attorney Advisor, Office of Tax Policy in the Treasury Department. Thank you again for attending today and thanks everyone who submitted written comments and/or requests to speak. Your participation is essential in the proposed regulation process so that it can function as it's intended. Now you have received at the sign-in desk an agenda handout.

This hearing will be conducted pursuant to the statement of procedural rules, 26 CFR Part 601, relating to hearings on proposed regulations. Prior to the close of the comment period on December 16th, 2013, we received a total of sixteen comments and four requests to speak. After the comment period ended, we received additional comments and all of these will be reviewed thoroughly by the appropriate persons and taken into account. Of course, those that were received timely, before the comment period ended, we had a longer period of time to digest those, but all comments will be reviewed. The comments have been very good and extremely helpful to us.

Now, how we will proceed, is that each speaker will have ten minutes for his presentation and they will be called — I will call the person, the entity and the person's name to the extent that I know it, to come up and speak. After that ten minute period has ended here, then the panelists can ask questions. We request that the answers to our questions try to stay on point and responsive to the question as asked rather than going into really a new presentation.

Here, to my right, where you will be speaking — where the speakers will be speaking, rather — there are three lights and once you are ready to begin, the green light will come on, signaling the start of your ten minutes. When three minutes remain, the yellow light will go on, and then within three minutes after that has elapsed, the red light will go on and your time period will have ended and you should try to complete your sentence, whatever you're speaking about, and then the panelists will have an opportunity to ask questions is they choose.

And in your handout, on the second page, there is a list of the speakers of which we're aware at this point. And if you go down to the third one, under GFOA, the speaker is going to be Mark Kim, for GFOA. Stephen Wisloski for the State Debt Management Network, had travel problems, understandably, and is not going to be here. Now we have had a request to speak at the desk of the Bond Dealers of America, Susan Collet, is going to speak for the Bond Dealers of America, and therefore, since this was a late request to speak but appropriately entered at the front desk, so long as we have time and we certainly should have time, then Ms. Collet will have, will go through the same process as everyone else coming forward and making her presentation.

On the third page of the agenda, it gives you detailed information on how to obtain copies of the outlines of oral comments, how to obtain the public comment files, and finally, in the last paragraph sentence, how to obtain a copy, if you choose, of the unofficial transcript from Tax Analysts. And so, with all of that housekeeping out of the way, Johanna and Vicky, do you all have any comments you want to make before the first speaker comes up?

MS. TSILAS: No.

MS. SOM DE CERFF: No.

MR. BELL: Well in that case then, Mr. Robertson, representing the National Association of Bond Lawyers, listed on the agenda, will be our first speaker. And Allen, just tell me when you're ready.

MR. ROBERTSON: Okay. All right. Thank you and good morning. My name is Allen Robertson and I'm a shareholder in the law firm of Robinson Bradshaw and Hinson in Charlotte, North Carolina. I'm speaking to you today in my capacity as the President of the National Association of Bond Lawyers, which consists of approximately 2700 members from across the country. NABL was incorporated 35 years ago today, on February 5th, 1979, as an Illinois non-profit corporation and one of our purposes is to provide advice and comment with respect to proposed Federal regulations affecting state and municipal obligations.

On December 16th, 2013, NABL submitted two sets of written comments on the September 2013 proposed arbitrage regulations. One focused solely on the proposed definition of issue price and the other on the balance of the proposed regulations. Before turning to the proposed definitions of issue price, which will be the principal focus of my comments this morning, I want to make three comments about the proposed regulations generally. First, NABL appreciates the substantial efforts made by Treasury and IRS in the preparation of the proposed regulations. Second, the provision in the proposed regulations relating to working capital, grants, qualified hedges, and valuation offer substantial improvements over the existing regulations, and the technical corrects and comments we made in suggestion in our written comments should be viewed in light of our overall appreciation of the approaches taken in these provisions. Third, while NABL respectfully suggests that the proposed definition of issue price and the proposed change in the anti-abuse rule be withdrawn, we recommend that further work on these issues not delay finalizing the provisions relating to working capital grants, qualified hedges, and valuation. We also recommend that the proposed arbitrage regulations published on September 26, 2007 be finalized, subject to comments we previously submitted, simultaneously with the provisions in the proposed regulations relating to qualified hedges.

With respect to the proposed definition of issue price, our comments fall into three broad categories. First, NABL believes that 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, 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 the current regulations under sections 1273 and 1274 of the code, with the implication being that such consistency including an actual sales approach is required by the cross reference in sections — two sections 1273 and 1274 in section 148H of the code. Our review of the history and purpose of the arbitrage statutes and regulations, including the existing regulations in our written comments, however, confirms that an actual sales approach is not required.

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. Over the course of 4 years, from 1989 to 1993, Treasury exercises broad authority proposing and revising the definition of issue price multiple times while 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, quote, “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 bond subsequently will be sold to the general public may not be known,” unquote. 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 148A requires that arbitrage compliance be determined as of, that is 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 148A.

More importantly, as the existing issue price definition recognizes, the determination of issue price of publicly offered municipal bonds must occur by the sale date, when the terms of the bonds are fixed. 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 entire 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. 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 clarity. As I'll discuss later, NABL believes that the proposed definition is not administrable by issuers and therefore will result in less certainty. Moreover, because the concerns described in the preamble generally relate to the manner in which municipal securities are offered and distributed, and apply that the conduct of municipal underwriters is sometimes inappropriate and perhaps illegal, those concerns should be addressed by working with municipal securities regulators, not through tax policy.

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 the 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 spread, profits of 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, which is their upper limit on their investment earnings, without increasing the proceeds they receive from the sale of the bonds, all 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 the issuers have no control. Moreover, this result conflicts with the determination of underwriter spread and under MSRB rule G32, that is required to be disclosed to investors in the final official statement for negotiated underwriting.

Our second category of comments relates to our conclusion that 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 buying counsel do not have access to the information necessary to determine issue price based on actual sales to the public as defined in the proposed regulations. The proposed definition of issue price is also 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. Determination of issue price as of the sale date is important for three reasons. First, issuers may violate applicable state law, policy, or their own authorizing resolutions, if issue price cannot be determined as of the sale date. Second, 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 cancel must confirm on the sale date whether they can give an unqualified approving opinion at closing.

Our third category of comments relates to our concern that any attempts to comply with the proposed definition of issue price will impose substantial additional expense on issuers and alter long standing 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 substantially 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. And 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. In conclusion, NABL respectfully suggests the definition of issue price in the proposed regulations be withdrawn and that any other change to issue price definition be re-proposed. 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 municipal bonds continue to be marketed in ways that result in unsold maturities on the sale date, however, issue price cannot be determined as of the sale date based on actual sales. 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. Thank you.

MR. BELL: Thank you Mr. Robertson. At this time, the panelists have an opportunity to ask questions.

MS. TSILAS: Okay. I have a question on the third category of comments, on the additional expenses. I understand that it — that our proposed definition presents challenges for competitive — but can you elaborate on negotiated? I mean, over the years, the comments we had heard were that when an underwriter prices the bonds, or in the pre-sale situation, 80 percent of the bonds in the maturities are sold. So the, the idea of having unsold maturities, while that certainly happens, we were told is a very very small percentage. And so, you know, this question — I'd be curious to hear about that.

MR. ROBERTSON: Right, so Vicky, I think that's the point. Unfortunately, I think what we are saying is the need for a special rule for publicly offered municipal bonds, so that the issue price can be determined as of the sale date. In many deals, there is a book built. There are actual sales. There are orders. It would be possible to comply both with our existing rule and perhaps even the new rule. So what we're really talking about are those cases that are the exceptions. And so we do know that there are negotiating transactions even with proper marketing, trying to build the book where you may have an unsold maturity — a serial bond in year 8 for example, for which there are no orders — and so that's where the issue comes in. And then obviously there could be deals where there are multiple unsold maturities where you're having to try to follow up then under the proposed regulations after the sale, potentially after the issue date to try to determine issue price.

MS. SOM DE CERFF: Just to make sure, because my question was similar. These unsold maturities, they are more prevalent in competitive than in negotiated? Do they happen really at all in negotiated, or —

MR. ROBERTSON: They do. So clearly in competitive sales, there are deals where there's the, of course, there's limited ability to pre-market. And so there may be in fact particular maturities within the issue for which there were no pre-orders and so you would have an entire maturity that's unsold and, as you know since issue price has to be determined for each maturity, building to the issue price in the entire issue, the inability to determine issue price on a single maturity then prevents you from determining issue price for the entire issue, and in negotiated transactions there are deals in which particular maturities may be unsold and therefore the underwriters have to make a decision. Do they deploy their capital to underwrite that bond and take the economic risk of selling it after the BPA's been ordered?

MS. TSILAS: But what we had heard over the years is that that percentage is very, very small, of the underwriters being forced to sort of hold bonds. They're not in a position of holding bonds. I mean, when they — in a negotiated, on the pre-sale, they know that they're pricing — they should be pricing it as such that they can sell 80, 90 percent. That's what we had been told over the years, that, you know –

MR. ROBERTSON: Well I'm going to — may let Mr. Decker over to our — truly — in this part of —

MS. TSILAS: (inaudible) percentage —

MR. ROBERTSON: Again, I think what the question is, in many deals, is the book built, are there the orders? From my experience, yes. Are there deals, particularly in the credit crisis in the last five years, where underwriters have said we've had difficulties, we are willing to underwrite certain maturities or take down bonds? Yes, I think to the benefit of issuers. And again I think one of the examples that we give, in terms of benefits, we think, to issuers and to the marketplace as a whole, is if you have, you know, the serial bond in year eight, for which you have no orders, do you set a scale that is logical, right, that the yield in serial bond in year seven is lower than year eight and then the yield in year nine is a little bit higher, and you deploy your capital and you underwrite that? You don't have orders but that seems to be rationale. It seems to make sense to price it that way. The alternative might be to delay pricing, delay the signing BPA, continue to market, potentially have to raise the whole scale, I mean, is that a benefit to issuers? It doesn't appear to be a benefit to issuers. So both the issuers and the underwriters, you know to underwrite that maturity in a logical fashion, and I think to the underwriter then to say I had a reasonable expectation — that's what's economically rational here, is where we are. We're not suggesting — we're suggesting that this is the minority, this is the exception. Unfortunately the rules don't have special rules to deal with those exceptions, and so, that's what generates our comments. Again, in many deals, we may be able to comply with these rules. There will certainly be deals where we could not. As of the sale date, leading to the expense, back to your question — leading to the expense for issuers and bond counsel or FA's, to try to follow the chain, to try to determine actual sales, after the sale date.

MR. BELL: Thank you so much Mr. Robertson. Good comments. Okay, and this speaker is representing SIFMA, the Securities Industry, excuse me, and Financial Markets Association — Mr. Decker, Michael Decker.

MR. DECKER: Good morning.

MR. BELL: Good morning. Tell me when you're ready, Michael.

MR. DECKER: I'm ready.

MR. BELL: All right. Go ahead.

MR. DECKER: Good morning. As you said, my name is Michael Decker and I'm here this morning representing the Securities Industry and Financial Markets Association. SIFMA's the principle trade group representing banks and securities firms active in the capital markets, including the tax-exempt bond market. Our municipal securities division is comprised of approximately 60 dealer firms of all sizes and different models who underwrite, trade, and sell tax-exempt bonds and other municipal securities and related products.

My comments this morning focus exclusively on the issue price portion of the rule. We didn't comment on either the working capital or the hedging provisions of the proposed rule.

We recognize that the Treasury Department and the IRS are concerned 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 that respect, SIFMA and the community of tax-exempt bond underwriters want to be a constructive contributor to updating and streamlining issue price rules. We urge an open discussion process among stakeholders to come up with an approach to issue price regulation that meets the Treasury's and IRS' goals and is consistent with best market practices. However, we disagree with the approach to determining issue price embodied in the proposed regulations, which appear to seek to formalize policies previously applied through unofficial statements and actions by IRS enforcement personnel. We believe it would be inappropriate to abandon the well-accepted, favorably regarded, and longstanding principle that allows the issue price of tax-exempt bonds to be established through the reasonable expectations of transaction participants of the price at which the bonds will be sold pursuant to a bona fide public offering.

The proposed regulations, while well intentioned, represent an approach to defining and documenting issue price, which is unworkable based on limitations on the ability of issuers, underwriters, and others to monitor the sale of bonds during the order period. We urge the IRS to maintain the reasonable expectations principle and make refinements that take into account the reality of marketing functions reflected in best market practices and securities law regulations applicable to municipal bonds.

We support the general notion of a compliant safe harbor for issue price regulation. While we feel the safe harbor in the proposed rule is not workable, the concept of a bright line and certain means of compliance is welcome. In fact, the biggest weakness with the current rule is the subjectivity that can sometimes come into play with regard to enforcement. Unfortunately, the safe harbor in the proposed rule is unworkable and would impose insurmountable compliance burdens.

There are two elements of the proposed rule, which are key to understanding why compliance with the proposed rule would be impossible. First, the proposed rule would dispense with the current reasonable expectation standard for determining issue prices and would instead specify that issue price is the price at which a substantial amount of the bonds is sold to the public rather than expected to be sold. Second, the proposed rule would define “underwriter” as any person that purchases bonds from the issuer for the purpose of effecting the original distribution of the bonds or otherwise participates directly or indirectly in the original distribution regardless of whether that person is actually in the underwriting syndicate.

Looking at those two provisions, there’s simply no way to comply with the rule as proposed. The proposal would require bond issuers or others to track actual bond sales to the public by nonsyndicate underwriters. No source for this information exists. Some have suggested that the MSRB’s EMMA system may provide information that would allow issuers to track bond sales by nonsyndicate members. However, the EMMA system was never designed for that purpose, and the MSRB does not collect or disseminate certain trade information that would be necessary to comply with the rule. For example, the EMMA system does not distinguish between sales to underwriters, as defined in the proposal, and sales to the public. And EMMA’s classification of customer and interdealer sales is not a proxy for distinguishing sales to underwriters and the public. For example, any bond sale to a bank or broker-dealer is displayed on EMMA as an interdealer sale. There’s no way to know if the buyer in that case is buying the bonds for the purpose of investment or redistribution.

Also, EMMA does not disseminate actual trade sizes for trades larger than $5 million, making it impossible to track when the 25 percent threshold is made. In addition, under the MSRB real-time trade reporting rules and system, dealers are required to report list offering price or take- down transactions only at the end of the day, not in real time, which could make it difficult to determine when the 25 percent threshold is met. There are other examples of trade, which are not required to be reported in real time.

Finally, the MSRB does not require the reporting of certain presale marketing activities, which, while they may not include firm trade commitments, may be material in establishing the yields at which new bonds are offered.

There are other weaknesses in the proposed rule apart from the inability to track bond sales. For example, it is not uncommon that an underwriter is unable to sell any portion of a maturity of a bond issue on the sale date or in the days following. Underwriters must sometimes hold entire maturities in their inventory for weeks or months after a bond sale, meaning an issuer would need to wait months to determine the issue price for that maturity. The alternative to holding a maturity in inventory for weeks or months would be for the underwriters to price bonds at prices attractive enough to investors that they would be sure of selling each maturity quickly. Of course, that translates into borrowing costs for issuers that are potentially significantly higher than under the current rule, raising the yield for a single difficult-to-sell maturity in order to attract investors, and could require the underwriter to raise the yields on other maturities in order to comply with MSRB fair pricing rules.

Our comment letter points out other more technical issues with the proposed rule, which could result in confusion or complication. For example, in defining “securities dealer,” the proposed rule references Internal Revenue Code Section 475, which could capture certain investors as well as dealers rather than the definition of “dealer” in the securities laws.

We believe it is appropriate and welcome for the IRS to revisit issue price regulation. Moreover, we welcome the notion of a safe harbor as a means of establishing a more certain means of compliance. The safe harbor as proposed, however, is unworkable. Instead, we suggest that the IRS re-propose a safe harbor based on a reasonable expectation that syndicate underwriters will sell a substantial amount of each maturity at the initial offering price set forth by the underwriters pursuant to a bona fide public offering and as set forth in the bond purchase agreement between the underwriter and the issuer.

We appreciate the opportunity to provide comments.

MR. BELL: Thank you so much for your good comments. I have one question. In your written comments and in your oral statements you point out problems that your group perceives with the definition of “underwriter” and “securities dealer,” and you refer to those definitions, those terms, as they are defined in the securities law. So, could you tell me what your proposed — or suggestion would be for the definition of “underwriter” and “securities dealer,” if those terms remain in the regulation and how that would provide better transparency and secondary market trading analysis by the issuer and his agents?

MR. DECKER: So I think that the rule could simply reference the 34 Act definition of broker-dealer as identification for who’s a dealer and who’s not; who’s a member of the public. I think that the definition as proposed could incorporate some non-dealer market participants like active traders in the market, which are not broker-dealers like hedge funds, for example, or even insurance companies or other institutions that trade actively, which could fall under the definition.

MS. SOM DE CERFF: The broker-dealers that are not syndicate members that you’ve commented on in the past as well as recently, can you tell us a little bit about the kinds of deals where those are either necessary or prevalent? Is it a particular structure, a kind of issuer? When do they play a really important role?

MR. DECKER: Right. So I think it’s hard to identify categories of transactions where they’re more prevalent or where they come into play more. The way this issue comes about is when syndicate members are taking orders on a deal. They may receive orders from customers, institutional or retail investors, or they may receive orders from other dealers. There are MSRB rules that establish priority of orders and which orders have to be sold first. But to the extent that a dealer receives orders from non-syndicate dealers at the offering price and to the extent that those are in line with the order priority rules of the MSRB, the dealer has to accept those orders. So I don’t think it’s so much an issue of certain categories of transactions where that comes into play. It’s incumbent on a syndicate member to accept orders from other dealers even if the other dealer may be intending to redistribute the bonds. And there's no way to know what their intention is.

MS. SOM DE CERFF: Right, there's no way to know that, and I guess I'm trying to find out, sort of, when that might happen more frequently. And I mean, the question I think that raises is if there is a significant amount, however we define that, of broker-dealers that are buying at that price, that can then in turn sell that at some kind of a markup, I think that's putting — the question then comes out, like how high is that and is the price really something that the syndicate could have sold it for, I guess is the question that comes up.

MR. DECKER: Sure, sure. So the economics that come into play here, I think, have to do with the idea that it's more expensive to distribute bonds to retail investors than to institutional investors. And that expense is reflected in sometimes different prices that are paid for retail-sized trades versus institutional-sized trades. It's a similar dynamic that you'd see in markets for other kinds of products. If you're buying toothpaste, you're going to pay more per tube if you buy a single tube of toothpaste than if you buy a truckload of toothpaste and the same dynamic applies in the bond market. So to the extent that a firm specializes in retail distribution, they may be able to buy the bonds at the offering price and then resell them to retail investors at a different price, not because there's some gaming going on or because they're taking advantage of a market inefficiency; it's just that the retail market is different from the institutional market.

MR. BELL: Any further questions at this time? Thank you so much for those good comments, Mr. Decker; appreciate it.

MR. DECKER: Thank you.

MR. BELL: Our next group is the Government Finance Officers Association, Mr. Kim, Mark Kim. Ready.

MR. KIM: Good morning. My name is Mark Kim, and I am here today representing Government Finance Officers Association of the United States or GFOA. I also serve as the Chief Financial Officer of the District of Columbia Water and Sewer Authority, commonly known as D.C. Water, which is a frequent issuer of municipal securities.

D.C. Water has issued in excess of $2 billion in tax-exempt municipal securities, and we have plans to issue approximately 3.8 billion more over the next 10 years to finance our capital program. D.C. Water operates the world's largest advanced wastewater treatment facility and we serve approximately 2.2 million people in the District of Columbia and in the neighboring jurisdictions in Maryland and Virginia. One of our very important commercial customers is the Federal Government, including both the Treasury and the IRS. And so it's a pleasure for me to speak in front of our customers, and thank you for paying your bills on time. On behalf of the GFOA and its 17,000 members, many of whom work for state and local governments that issue municipal securities like D.C. Water, I appreciate the opportunity to provide comments at this public hearing on the proposed rulemaking regarding arbitrage restrictions on tax-exempt bonds. Like the preceding speakers, I will tend to limit and focus my comments today on the definition of issue price, but I would refer this panel to the GFOA's letter dated December 16, 2013, for specific comments on other important topics such as qualified hedges and working capital, which we support.

The definition of issue price is essential for determining the yield of a tax-exempt bond issue for arbitrage compliance purposes. Currently the issue price is determined by a reasonable expectation standard. The proposed rulemaking would amend this standard in two important respects, the first being to redefine "substantial" from 10 percent to 25 percent, and the second to replace the reasonable expectations of sales to the public with actual sales to the public. I will refer to this proposed amendment, to the definition, as the public sales test.

The purpose of the proposed rulemaking is to clarify and simplify existing regulations and to assist issuers like D.C. Water in complying with the arbitrage restrictions on tax-exempt bonds. I'd urge the panel members to consider the unintended consequences of the public sales test and subject, that its adoption will create added complexity and uncertainty for all issuers and may have a significant economic impact on a large number of state and local governments and entities in the form of increased administrative burdens, greater compliance costs, and higher yields on our bonds.

Our shared goal is to define a standard that will produce a fair and accurate representative price for the tax-exempt bond issue. The difficulty of this task is due to the decentralized and fragmented nature of the municipal market and also in the manner and method in which municipal securities are customarily bought and sold.

Let me begin with a hypothetical. Under the efficient-market hypothesis, with perfect information and (inaudible), I would suggest that the public sales test doesn't go far enough. In a perfectly efficient market, all bonds would be priced properly according to supply and demand and the market would clear with every bond and every maturity being sold to the public. In this market, issue price should equal the market-clearing price, which is the price at which the last bond in a particular maturity is sold, not the price at which the first 25 percent are sold.

Unfortunately this hypothetical market does not reflect the reality or the complexities of the municipal securities market that we know, but the fact that the public sales test establishes a safe harbor by defining substantial as 25 percent as opposed to 100 percent or some other number is an explicit acknowledgment that issue price may not be representative of the market price of the bonds. Given the volatility of the municipal market, the first 25 percent of actual sales might be at a price significantly different than the price at which the remaining 75 percent of actual sales are executed. This raises a concern as to whether the public sales test is any more representative of issue price than the reasonable expectations test.

Another equally serious concern arises when an issuer is unable to satisfy the public sales test because there are not enough actual sales to the public to reach 25 percent of a particular maturity. In this situation the central question becomes "How do you establish price in the absence of a market?" Current regulations provide a safe harbor if it's reasonable to expect that a substantial amount of the bonds will be sold to the public at these prices. The proposed regulations would impose a public sales test when there are no public buyers at the time of sale. As a result, the proposed rulemaking will create undue administrative burdens and significantly higher compliance costs for a large number of state and local governments and entities.

For example, the public sales test will impose upon issuers the new regulatory requirement to track sales to public buyers indefinitely until the 25 percent safe harbor is reached; however, it is uncertain how and at what cost issuers will monitor post-sale trading activity and from whom and at what cost they will obtain the necessity customer information. The Municipal Securities Rulemaking Board's EMMA database is not currently capable of satisfying the requirements of the proposed rulemaking.

These administrative burdens will also create the risk of delay in bond sales and closings. Without a definitive issue price at the time of sale, important documents such as the bond purchase agreement, tax certificates, arbitrage yield calculations, and possibly even bond opinions may not be finalized in a timely manner, creating greater uncertainty in the market. Ultimately the public sales test may result from higher costs to issuers and therefore U.S. taxpayers in the form of artificially higher yields on tax-exempt bonds in order to ensure that 25 percent of each maturity has been sold to the public at the time of sale.

I would like to address one final issue regarding the application of the public sales test to competitive sales of municipal bonds. In a competitive sale, there is no opportunity for public buyers to purchase bonds directly as the bidding is restricted to registered broker-dealers who then hope to resell the bonds to the public at a later date. Compliance with the public sales test may require fundamental changes to the bidding parameters of competitive sales in order to require underwriters to have presold at least 25 percent of each maturity to the public in advance of placing a bid or as a condition of placing a bid. These changes may result in fewer firms willing to bid in competitive sales as well as lower prices and therefore higher yields for issuers.

In conclusion and in consideration of the foregoing comments, the GFOA respectfully requests IRS and Treasury staff to revisit and reconsider the proposed rulemaking to amend the definition of issue price. If, however, a public sales test is ultimately adopted, the GFOA recommends the establishment of a safe harbor for competitive sales and the maintenance of the current definition of substantial as 10 percent. With this, I conclude my remarks and look forward to continuing our dialogue and advancing our shared goal of establishing a fair and reasonable definition of issue price. I thank you again for the opportunity to testify, and I'm happy to answer any questions that you may have.

MR. BELL: Mr. Kim, believe that the GFOA prepares various best practices for its members and those are very good, I've read them before. To what extent do your best practices currently suggest that the member monitor the sales of their securities between the sale date and the closing date and thereafter until — not a defined term, but just a general term — until a significant or substantial amount, if so, to determine — so that they get a feel for how that underwriter has performed on their behalf?

MR. KIM: Thank you for that question. We do not have a best practice on post — providing recommendations to issuers on post-sale monitoring. From an issuer's standpoint, I can say that at the point of the underwriter taking the bonds, the transaction is finished from an issuer's perspective. We have sold our bonds, all of the bonds less the discount to the underwriter, so we have — the sale is complete from the issuer's standpoint. We have received the proceeds that we have negotiated to receive. The risk of the transaction now falls entirely upon the underwriter, and that's what we pay them for, quite frankly — is to take the risk, to transfer the risk from the issuer to the securities dealer, to distribute and take market-price risk on the securities.

So to some extent we don't need to monitor those sales. It's important that we do because we want to ensure — our goal is, incidentally, the issuer's goals are perfectly aligned with Treasury and IRS's goals. We want the absolute highest price and the lowest yield for our bonds. That is our goal when we go into the capital markets. Our interests are not quite as perfectly aligned with the underwriters', which has been well documented, because they are trying to make a market. They are trying to bring buyers and sellers together at a mutually agreeable price.

As an issuer, I just want the highest price. And so our interests are perfectly aligned, and so we do have an interest. And in fact, one of the ways that D.C. Water tracks and monitors post-sale trading activity is to develop a sense of "Did we get the right price for our bonds." And looking at secondary market activity can be helpful in helping us understand whether or not we felt that we got a good price on our bonds, but it's not a perfect measure.

MR. BELL: Thank you so much for your good testimony.

MR. KIM: Thank you.

MR. BELL: We appreciate it very much. And the final group that is going to testify today, as far as I know, is the Bond Dealers of America, Ms. Collet, Susan Collet. Susan, just let me know when you are ready.

MS. COLLET: I am ready. I am Susan Collet. I'm Senior Vice President for Government Relations at the Bond Dealers of America. I had hoped that instead of me standing before you today would have been Matt Davis, a managing director at Janney Montgomery Scott in Philadelphia. Philadelphia is socked in with ice and even Amtrak couldn't get him here this morning. He very much wanted to be here. He is head of underwriting. And this issue is vital for our members, and we feel like it's vital for you to be able to have access to people who are doing this professionally day to day in the underwriting business, and really pick their brains on that issue. So if there becomes another forum for that to happen, we are happy to put some members before you; but also because this is such an important issue, I wanted to recap the testimony that we did submit for the public record and kind of bring you the high points.

Bond Dealers of America represents about 40 middle-market dealers across the country and collectively. Our members are responsible for about a third of the underwriting transactions, if you look at 2012. You know, numbers — priorities one, two, and three for us to convey is that reasonable expectations needs to be restored to your rule. We would be happy, though, to work with you on how to get at some of the problems that you're trying to address in other ways.

The issue price we think should be defined by reasonable expectations at a defined point in time for both competitive and negotiated sales, such as the time of sale in a competitive issue and at final pricing for a negotiated issue, provided that a bona fide public offering of the bonds has been made. We also feel if market participants are compelled to use a 25 percent or even 10 percent safe harbor based on actual sales rather than the reasonable expectation standard that's tied to a point in time, the result is going to be increased borrowing costs for the issuers as the bond issuers are compelled to increase interest rates to establish an issue price. So just in terms of a little more, you know, backdrop on why we believe that, you know, Matt would have given you kind of a sense of, you know, how we look at the marketplace.

The underwriters perform an important function, providing capital and putting — providing liquidity and putting capital at risk.

The bonds are priced to clear the market at a single offering price. The fact that some bonds trade up after initial offering is just reflective of the fact that some investors would have paid more for the bonds, but that doesn't demonstrate that the price for all the bonds was incorrect. And GFOA pointed this out as well. If there's more than one buyer, the price has to be set for all the buyers, and some portion therefore might be resold at a higher price.

And in terms of marketplaces, you know, bonds, markets move up; markets move down. And the example that Matt was going to bring to you is the Facebook IPO, which was originally priced at 38, went down to 17, and now that stock is at 62 or 63. So you can see that markets move clearly and that point in time as to how the reasonable expectations becomes critical to the work that we are trying to do.

And with negotiated underwriting, the reason we think this is going to increase borrowing costs is — you're going to have to price to clear this whole 25 percent threshold right out of the chute. And then these rules as proposed become even more problematic for competitive sales since the underwriters and bidders haven't resold their bonds, the bidders on the competitive sales haven't resold their bonds at the time of the bids, and they are exposed to both market fluctuations and the risk that they've bid too high.

In order to induce underwriters to participate in those competitive sales, issuers would have to increase their interest rate and provide the bidders with a certainty that they will be able to resell the bonds. So we do agree with the GFOA comments as well that there could become more interest in negotiated sales and less and less interest in competitive sales.

There's another concern that we want to bring to your attention as well — is that, you know, investors are smart. And, you know, with institutional investors, if they can, if they know that a negotiated deal is not going well, is not being sold out to meet the threshold, that's even more incentive to buy at a high yield and cheaper price. So the investors are watching. And so we need to, you know, make sure that the rules take that into account.

And then, you know, so that's sort of the overarching concepts. We have some specific suggestions in our, you know, in our testimony that we submitted prior to this. But just by way of summary, certainly want to work on a better definition of dealer. In particular, mutual funds or others who buy bonds with the possibility that they will resell, depending on a variety of factors, shouldn't be viewed as dealers for this purpose.

We have some concerns about the yield reduction payment regime, such as where will the issuers get the money for the yield reduction payments. And also we do a lot of deals with small-sized issuers, and we would hope that you would be sensitive to their needs as well. Those are not — there's not as much opportunity for arbitrage, and of course those are price sensitive, so we would [be] happy to think through de minimis rules or something like that with you.

So overall, you know, we hope to be available as a resource. We would like to work with you to address your concerns. And that's just a recap of our primary concerns.

MR. BELL: Thank you. Are there some questions?

MS. SOM DE CERFF: When you say small issuers, can you put a number to that?

MS. COLLET: Oh, I don't have —

MS. SOM DE CERFF: Approximately.

MS. COLLET: It could be a school. It could be a —

MS. SOM DE CERFF: Uh-huh.

MS. COLLET: — 10 million or less deal.

MS. SOM DE CERFF: Uh-huh.

MS. COLLET: It could be a school district, is what leaps to mind, and they're trying to make ends meet, balance budgets. And so something that is going to just increase their borrowing costs at this time is just, you know, something that we want to avoid.

MS. TSILAS: I just have a — it goes back to my original question to NABL; is just trying to understand this concept of "it's going to cost issuers a lot more money." I understand there's concerns with what we've proposed for competitive bidding and sort of suggest maybe that we're pushing people into negotiating, but at the end of the day, won't the underwriters factor — or they're in the business of selling the bonds and making sure that the bonds are sold. So isn't that going to, in how they price the bonds — they will take it into account, the various maturities. And they wouldn't — I'm having a hard time understanding necessarily how it's going to cost issuers.

I understand the argument that the bonds will be priced less, but I wonder whether — I mean, that happens now, doesn't it? I mean, to some extent.

MS. COLLET: I mean, my sense, and I think this is only a partial answer and I'd be, you know, happy to respond later in writing or however; but, you know, I think in partial answer just that, you know, if you think about the fact that enforcement comes into our firms to see that we've done everything correctly, and so for the negotiated sales you've got that 25 percent threshold, you're trying to lower those prices to meet that because how you're going to look at an audit becomes very, very important, potentially. So I think that's part of the answer. And happy to expand on that.

MR. BELL: Thank you so much —

MS. COLLET: Thank you.

MR. BELL: — for your testimony and the good written comments by the Bond Dealers of America.

Jim, are there any other groups who have identified themselves at the front door requesting to speak? Okay.

In that case then, I believe that the testimony is completed and we appreciate so much your vital contribution to this proposed reg process, and thank you for coming out in the bad weather to work with us. Thank you very much.

(Whereupon, the HEARING was adjourned.)