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## SLGS Sales Halt May Pose Challenges for Small Issues.

WASHINGTON – An expected months-long Treasury Department suspension of sales of state and local government series securities is likely to be most challenging for small issues with short defeasance escrows, market participants said.

The Treasury suspended sales of SLGS on Friday as one of the "extraordinary measures" it takes when the U.S. government reaches its debt limit. The limit was reinstated on Monday after having been suspended since February 2014.

SLGS are special purpose Treasury securities that help municipal bond issuers avoid violating arbitrage rebate or yield restriction requirements. Issuers most often purchase SLGS for advance refunding escrows to ensure their investment yield will not significantly exceed the yield of their refunding bonds.

Issuance of SLGS count against the debt limit and the Treasury halts the sales of them to conserve headroom under the ceiling, the department said. This is the 11th time the SLGS window has been closed during the past 20 years. Often, the window has been closed for two months or less, but this time it is likely to be closed longer.

The Congressional Budget Office estimated earlier this month that Treasury is likely to have sufficient cash to make its regular payments through October or November without a debt limit increase. The Bipartisan Policy Center said Treasury could have cash until sometime in the fourth quarter because the main tax refund season has passed and there likely will be surpluses in some upcoming months. Also, revenues have increased while expenditures are fairly flat.

Treasury doesn't typically reopen the SLGS window until the debt limit is raised or suspended, and Congress doesn't typically take action on the debt limit until the U.S. is close to a default, said Bill Daly, director of governmental affairs for the National Association of Bond Lawyers.

An alternative to SLGS is n to open-market Treasury securities. While SLGS are bought directly from Treasury, open-market Treasuries are purchased after soliciting bids from banks and other financial institutions. Larger issuers often consider buying Treasuries even when the SLGS window is open.

Bond sales are unlikely to be delayed due to the SLGS window closure, some market participants said.

For most issuers, the SLGS window closure is "probably going to be a non-event," said Sam Gruer, managing director of Cityview Capital Solutions.

Bill Glasso, a principal at Causey Demgen & Moore, which provides bidding agent services, said his firm was involved in escrow transactions for seven issuers on Tuesday. Every one of the issuers did better than they would have if they had purchased SLGS, he said.

But market participants cautioned that purchasing open-market Treasuries rather than SLGS can make things more complicated, especially for small bond issues with short refunding escrows.

Open-market Treasuries are “less user-friendly” than SLGS, said Michael Decker, managing director and co-head of municipal securities for the Securities Industry and Financial Markets Association.

Moody’s Investors Service considers the SLGS window closure to be negative for municipal issuers overall. Nick Samuels, Moody’s vice president and senior credit officer, said that using open market securities “makes doing some refundings for some issuers more costly, somewhat more complex.”

For small deals, acquiring open-market Treasuries could be more costly than just keeping the proceeds in cash, said David Cholst, a partner at Chapman and Cutler in Chicago. For short escrows, acquiring Treasuries may similarly be counterproductive for short escrows, he said.

Amy Kron, a senior investment officer with BLX group, an escrow bidding agent, said that issuers with smaller, shorter deals may consider holding bond proceeds in cash or delaying deals.

And the providers of the open-market Treasuries don’t have the capacity to deal with every bid they receive. As a result, “they’re being more selective” and are picking the deals that they think they can receive the most profit from and that they think they can win, said Glasso.

It may be hard for small issuers with short escrows to excite bidders, and the issuers may receive few or no bids, Gruer said. “SLGS just work better” for these kinds of transactions, Cholst said.

Receiving fewer than three bids for open-market Treasuries can lead to tax questions, market participants said. Under Treasury rules, issuers must establish that yield-restricted investments are valued at fair market value. The rules provide a safe harbor under which the fair market value of investments in a defeasance escrow can be established if the issuer receives bids from at least three disinterested parties.

There is no bidding requirement for SLGS, since they are treated as purchased at fair market value because they are purchased directly from Treasury.

Bob Eidnier, a partner at Squire Patton Boggs in Cleveland, said that the SLGS window closure may mean tax lawyers and issuers will have to accept fair market value on a basis other than by meeting the safe harbor. They may have to accept the better of two bids. In other cases, parties may accept that investments were at fair market value based on a certificate from the underwriter.

If an issuer gets no bids, it could keep its bond proceeds in cash. But this is costly because the issuer will not receive any return and the IRS could still impute a yield on the escrow. If that yield is higher than the bond yield, there could be a problem, Gruer said.

The SLGS window closure also makes things more complicated in cases where the returns on escrow investments are supposed to be rolled over into SLGS with zero yield. Under IRS guidance, if SLGS are not available, the issuer should buy other investments that should have maturities of no more than 90 days. Any return on those investments has to be paid to the federal government, Cholst said.

In May, NABL recommended that Treasury continue to allow subscriptions for 0% SLGS during periods of extraordinary measures and that only larger SLGS purchases be suspended. In July, Treasury declined to adopt the recommendations but did not explain its reasoning.

Jessica Giroux, general counsel and managing director of the Bond Dealers of America, said the SLGS window closure could present a compliance hardship for small issuers who have not engaged MAs.

“If SLGS are not available, the small issuer may suddenly need advice on investing bond proceeds, which their underwriter is not going to be able to provide per the MA rule," she said. "So, if they have not engaged an MA, they may need to employ and pay an MA for advice or forgo investment advice altogether, whereas creating a SLGS escrow does not constitute advice and is routinely done by their underwriter in compliance with the MA rule."

Under the municipal advisor rule, someone who provides particularized advice about escrow investments would be an MA. An underwriter can provide advice about structuring refunding escrow cash flow requirements, but it can't provide recommendations about what to invest in unless it relies on the independent registered municipal advisor exception, according to the rule. Someone merely providing the brokerage of escrow investments would not be an MA.

Teri Guarnaccia, a partner at Ballard Spahr in Baltimore, said that it's unlikely that the information an underwriter would provide about purchasing open-market Treasuries would be considered investment advice.

THE BOND BUYER

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