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April 12, 2006

John J. Cross III
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Department of the Treasury
1500 Pennsylvania Avenue, N.W., 4212 B MT
Washington, D.C. 20220

RE: Comments relating to Qualified Hedging Transactions under Treasury Regulation §1.148-4(h)

Dear John:

As stated in the National Association of Bond Lawyers (NABL) letter transmitting the Guidance Priority List to you on March 21, 2006, enclosed is a more complete discussion of NABL's guidance recommendations for qualified hedging transactions, prepared by the NABL Derivatives Task Force. A list of Task Force members who participated in the preparation of the enclosed recommendations is also enclosed.

Representatives of NABL are available to discuss these recommendations and to assist with guidance implementation, if appropriate. Ideally, a subset of members of the NABL Derivatives Task Force would welcome the opportunity to meet with Treasury and IRS for these purposes.

If you have questions, please contact me at 617/239-0389 or through email at wstonge@eapdlaw.com or Elizabeth Wagner, Director, Governmental Affairs at 202/682-1498 or through email at ewagner@nabl.org. We will also follow up with you regarding a meeting with members of the NABL Derivatives Task Force.

Thank you for the opportunity to submit NABL's recommendations for guidance on qualified hedging transactions. We look forward to working with you.

Sincerely,

Walter J. St. Onge III

Enclosures

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RECOMMENDATIONS BY THE NATIONAL ASSOCIATION OF BOND LAWYERS MUNICIPAL DERIVATIVES TASK FORCE FOR THE DEPARTMENT OF THE TREASURY OFFICE OF TAX POLICY AND THE INTERNAL REVENUE SERVICE COMMENTS RELATING TO QUALIFIED HEDGING TRANSACTIONS UNDER TREASURY REGULATION §1.148-4(h)

APRIL 12, 2006

The following comments are submitted on behalf of the National Association of Bond Lawyers (NABL) Municipal Derivatives Task Force. These comments relate to the application of the "qualified hedge" rules contained in Treasury Regulation §1.148-4(h) to interest rate swaps and other derivative products frequently used in the municipal market. These comments are the product of various discussions among members of the Task Force, as well as input from NABL's membership, representatives of dealers in the municipal derivatives market, and representatives of issuers of tax-exempt bonds that frequently use derivative products to manage interest rate risk.

The use of derivative products in connection with tax-exempt bonds and the variety and sophistication of those products have grown significantly over the past 10 to 15 years. At the time the qualified hedge rules were originally drafted, most interest rate swaps entered into by municipal issuers were "cost of funds" swaps, meaning that the floating leg of the swap payable by the swap provider was equal to the issuer's actual cost of funds on the underlying debt. Since that time, the growth of the market has led to far more cost effective alternatives for municipal issuers, such as the Bond Market Association's Municipal Swap Index ("BMA") and percentage of LIBOR swaps. In addition, the variety and sophistication of the underlying debt instruments to which these swaps relate have evolved (*e.g.*, auction rate bonds). In light of this growth and evolution of the market, the Task Force was created to review the application of the qualified hedge rules in connection with transactions involving these products and suggest changes as necessary to assist issuers and practitioners in this area.

Background

The use of interest rate swaps and other derivative products to hedge interest rate risk on tax-exempt bonds is subject to the federal arbitrage rules and regulations in Section 148 of the Internal Revenue Code of 1986, as amended (the "Code") and Treasury Regulations §§1.148-1 through –10 (the "Regulations"). The requirements for integration of interest rate swaps and other derivative products with the related bonds (the "qualified hedge rules") are found in Regulation §1.148-4(h), with related rules contained in Regulation §§1.148-5, 1.1275-4(d)(2), 1.1275-5 and 1.1275-7.

Regulation §1.148-4(h)(2) sets forth a series of eight conditions that must be met in order for a swap to be characterized as a "qualified hedge," thereby having terms that may be integrated with those of the bonds for purposes of computing yield on the bonds (so called "simple" or "general" integration). Generally speaking, these eight conditions are designed to assure a close relationship between the bonds and the swap. Under these rules, unless the requirements of Regulation §1.148-4(h)(4)(i) are also met (the so-called "super integration" requirements), variable rate bonds that are subject to an integrated floating-to-fixed swap continue to be treated as variable yield bonds. Bond yield on a variable yield issue is required to be recalculated at least once every five years if there are any bond proceeds subject to federal arbitrage investment yield restrictions. If the super integration requirements of Regulation §1.148-4(h)(4)(i) are met, the bonds are treated as fixed yield bonds.

Summary of Issues and Suggested Changes

Although the Task Force considered and discussed a number of topics in this process, we have limited these comments to four principal issues on which there was strong consensus that changes would be relatively straight-forward and useful. A brief summary of these issues and suggested changes is set forth below.

The first issue concerns the use of a floating-to-fixed swap meeting the conditions for simple integration in connection with variable rate advance refunding bonds. Because the underlying bonds are treated as variable yield bonds, yield restriction compliance with respect to escrowed proceeds is a continuing concern. For these transactions, the Task Force focused on changes that would provide greater certainty as to the bond yield calculation and a method for addressing yield restriction compliance. We have suggested (i) a computation period for the bond yield equal to the lesser of 10 years or the life of the escrow, and (ii) permitting the issuer to make a yield reduction payment at the end of the escrow to the extent necessary to establish compliance with the yield restriction rules.

The second issue relates to the degree of correlation required between the floating leg of an interest rate swap and the corresponding floating rate payments to be made on the related bonds in order to achieve integration. The comments first address the timing correlation between bond and swap payments required under Regulation §1.148-4(h)(2)(vi). Issuers and practitioners have observed that differences in bond and swap market conventions, as well as issuers' ability to change interest rate modes, may

lead to bond and swap payments being made on different dates. The only objective standard as to timing of payments is contained in Regulation §1.148-4(h)(4)(i)(B), which for super integration permits a 15 day separation. The Internal Revenue Service recognized in Technical Advice Memorandum 200051001, however, that this standard for super integration should be somewhat more restrictive than the standard for simple integration. With that in mind, the Task Force recommends establishing a permissible period of separation (*e.g.*, 3 months) as a safe harbor for simple integration. The comments next address the degree of correlation required between the floating rate on the swap and the floating rate on the related bonds, particularly with respect to the requirement under Regulation §1.148-4(h)(4)(i)(C) for super integration that such rates be reasonably expected to be "substantially the same" throughout the term of the hedge. The Task Force recommends that Treasury provide guidance for establishing an issuer's reasonable expectations under this requirement, including whether it is reasonable to base future expectations on historical results.

The third issue relates to the integration of multiple qualified hedges. Regulation §1.148-4(h)(2)(i)(A) requires that the contract be entered into primarily to modify the issuer's risk of interest rate changes with respect to a "bond." In certain cases, a hedge agreement may be entered into with respect to a bond that is already subject to an independent qualified hedge (*e.g.*, a basis swap entered into with respect to a variable rate bond that is already subject to a floating-to-fixed swap). Assuming such a subsequent hedge agreement otherwise meets the requirements for integration and does not cause a "deemed termination" of the first qualified hedge, the "bond" to which such subsequent hedge relates should be the synthetic bond created by the integration of the first qualified hedge.

The final issue discussed in these comments relates to the requirement under Regulation §1.148-4(h)(2)(viii) that a qualified hedge be identified on the books and records of the actual issuer of the bonds within three days of entering into such hedge. In order to address certain practical difficulties in connection with conduit financings and anticipatory hedges, the Task Force suggests that the time period be extended somewhat and that a conduit borrower be permitted to make this identification.

DISCUSSION

1. Variable Yield Treatment of Advance Refunding Bonds; Yield Restriction Compliance

General. Issuers often issue variable rate bonds swapped to a fixed rate for the purpose of advance refunding a prior issue. In these circumstances, the issuer could assure yield restriction compliance with respect to the refunding escrow by structuring the swap transaction to comply with the super integration rules and treat the bonds as fixed yield bonds. Without further guidance, however, issuers have found it difficult to apply Regulation §1.148-4(h)(4)(i)(C) (*i.e.*, the requirement that the index used to determine the floating leg of the swap and the floating rate on the related bonds be "substantially the same" throughout the term of the hedge), particularly with respect to LIBOR-based swaps. As a result, issuers often treat the hedge as simple integrated, meaning that the underlying bonds continue to be treated as variable yield bonds with the

payments and receipts on the swap during the relevant computation period taken into account in determining such yield.

For the transaction to remain in yield compliance, the variable bond yield must be no less than the escrow yield. The problem, however, is that while the yield on the escrow investments *can* be determined with precision at closing, the bond yield, which is based on the adjusted cash flows from the bonds and the swap, *cannot* be determined at closing. If the escrow yield exceeds the bond yield, and absent some method of simply paying to Treasury the amount necessary to reduce the escrow yield in that circumstance, the issuer must either: (i) restructure the escrow investments as needed during the escrow period to reduce the yield on the escrow to no more than the yield on the bonds for the relevant computation period, or (ii) invest funds in a sinking fund as needed, which are treated as part of a single investment with the escrow in order to reduce the yield on such investments to no more than the yield on the bonds for the relevant computation period. This process of managing the escrow yield is costly and time consuming.

Suggested Changes Regarding Computation Periods. One complication of assuring yield restriction compliance in connection with a variable yield advance refunding is determining the correct computation period or periods with respect to the calculation of bond yield. For escrow periods in excess of 5 years, it is somewhat unclear whether the bond yield should be computed separately for each of the one-year or 5-year computation periods, or whether all such periods should be blended together until the end of the escrow. This issue should be clarified in any event, but one solution would be to allow a computation period, applicable only to variable yield advance refunding bonds swapped to fixed under a qualified hedge, which ends on the last date that escrowed funds are applied to pay or redeem the prior bonds. This change would be consistent with Congressional intent expressed in 1986 when the rebate requirement was first extended to bonds that could be advance refunding bonds. In the General Explanation of the 1986 Act, the Staff of the Joint Committee on Taxation stated:

> Congress further intended that the Treasury Department may modify the requirement that rebate payments be made at 5-year intervals in the case of advance refunding bond proceeds placed in escrow accounts. Such escrow accounts may involve investments at differing yields over the term of the bonds which in the aggregate comply with the arbitrage yield restrictions. This situation is distinguished from non-escrow funds or regular variable rate debt, since the yield on the issue to maturity is determined with certainty when the escrow account is established. Thus, the Treasury Department may determine that, in appropriate circumstances, rebate payments with respect to advance refunding escrow proceeds are not required until the escrow is paid out.

Staff of Joint Comm. on Taxation, *General Explanation of the Tax Reform Act of 1986*, at 1207 (1987); *see also* H.R. Conf. Rep. No. 99-841 (1986). We believe that it would be appropriate to limit this long computation period to the lesser of the escrow period or 10 years. In the case of high to low "savings" refundings, escrow accounts are rarely

invested for more than 10 years. This would allow for a refunding escrow to accommodate non-callable serial bonds which typically mature or are first subject to redemption within 10½ years from their issue date.

Suggested Changes Regarding Yield Reduction Payments. In addition to clarifying the appropriate computation period, the Regulations should permit an easier means of achieving yield restriction compliance for an issue of variable rate bonds subject to a simple integrated hedge and applied to advance refund a prior issue. The Regulations should recognize that the expected bond yield (computed on the sale date of the bonds, usually by assuming that the floating amounts received under the swap and the floating amounts paid on the bonds will be exactly equal) may be greater or less than the actual bond yield. In those circumstances where the floating amounts received under the swap have exceeded the corresponding floating amounts paid on the bonds for the relevant computation period, the yield on the bonds may be less than the escrow yield for that computation period. The Regulations should be revised to permit yield reduction payments in these circumstances, rather than require that the issuer attempt to decrease the escrow yield through a series of open market transactions. Assuming all other requirements for simple integration are satisfied, the Task Force recommends that such payments be permitted only if, as of the sale date of the bonds, the escrow yield is less than the fixed rate payable by the issuer under the swap. Any such yield reduction payment would be paid directly to the federal government at the end of the escrow period.

2. Payment Timing and Rate Correlation Requirements

Timing of Payments. In order for an interest rate swap to be a qualified hedge, Regulation §1.148-4(h)(2)(vi) requires that payments on the swap correspond closely in time to the payments on the bonds. Rate setting and payment timing may of course differ for different types of variable rate bonds, and issuers typically have the ability to change the interest rate mode applicable to the bonds from time to time. This rate setting and payment timing for the bonds, however, may not correspond to typical conventions regarding rate setting and payment timing in the swap market. In any event, the rate setting and payment timing provisions of the swap are determined at the time the swap is entered into and can not be changed to accommodate a change in the interest rate mode on the bonds without amendment of the swap contract.

Suggested Changes Regarding Timing of Bond and Swap Payments. The IRS addressed the timing correlation requirements of Regulation §1.148-4(h)(2)(vi) in Technical Advice Memorandum 200051001. In that case, payments were made on the bonds monthly and payments were made on the swap quarterly. Recognizing that the correlation requirement for simple integration should be less onerous than the 15 day correlation standard for super integration, the IRS determined the payments on the bonds and the swap corresponded closely in time for purposes of Regulation §1.148-4(h)(2)(vi). In light of the foregoing, the Task Force recommends establishing a permissible period of separation, such as 3 months, as a safe harbor with respect to the requirement under Regulation §1.148-4(h)(2)(vi).

Rate Correlation. For general integration, Regulation §1.148-4(h)(2)(v) requires that the swap contract be primarily "interest based." In order for a hedge contract to be primarily interest based, the synthetic bond that results from such integration must be substantially similar to either a fixed rate bond or a variable rate bond described in Treasury Regulation §1.1275-5. For this purpose, a difference between the floating rate under the swap and the floating interest rate on the bonds will not prevent the synthetic bond from being substantially similar to another type of bond if the two rates are "substantially the same, but not identical." In addition, in order to achieve super integration and therefore fixed yield treatment of the bonds, Regulation §1.148-4(h)(4)(i)(C) requires that the issuer's aggregate payments, taking into account all payments made and received under the hedge and all payments on the hedged bonds, must be fixed and determinable as of a date not later than 15 days after the issue date of the hedged bonds. For this purpose, payments on bonds are treated as fixed if payments on the bonds are based in whole or in part on one interest rate, payments on the hedge are based (in whole or in part) on a second interest rate that is "substantially the same as" but not identical to, the first interest rate and payments on the bonds would be fixed if the two rates were identical. Rates are treated as substantially the same if they are reasonably expected to be substantially the same throughout the term of the hedge.

Issuers typically execute integrated swaps under which the floating amount received periodically by the issuer may differ from the amount of interest payable periodically on the issuer's variable rate hedged bonds. The floating leg of an integrated swap is most often determined based on an objective interest rate index such as BMA or one-month LIBOR, presenting some uncertainty as to the actual degree of correlation between the swap rate and the actual rate of interest on the hedged bonds at any point during the term of the hedge. In order to gauge the efficiency of a particular hedge, issuers often use an historical comparison of the relevant swap rates to the rates applicable to bonds of the issuer (or a reasonable proxy) over a designated period of years. While this exercise is designed to show that the swap rate formula has *previously* traced very closely the expected rate on the hedged bonds, correlation over the life of the bonds and the hedge can be adversely affected by a variety of factors outside the issuer's control. The extent to which issuers can rely on such historical correlation in establishing their future expectations remains unclear, and therefore issuers are often reluctant to super integrate.

Suggested Changes Regarding Rate Correlation. While the general integration requirement under Regulation §1.148-4(h)(2)(v) and the additional requirements for super integration under Regulation §1.148-4(h)(4)(i)(C) appear to be similar, they serve somewhat different purposes. The rule of general integration is that the contract be "interest based." Contracts relating to stock market indices, for example, are not interest based and therefore cannot be qualified hedges. The Task Force believes that a contract that refers only to fixed amounts and/or *bona fide* interest rate indices such as BMA or LIBOR is interest based. With respect to the provision contained in Regulation §1.148-4(h)(2)(v)(B) that "[a]s a result of treating all payments on (and receipts from) the contract as additional payments on (and receipts from) the hedged bond, the resulting bond would be substantially similar to either a fixed rate bond, a variable rate debt

instrument…, a tax-exempt obligation…, or an inflation-indexed debt instrument…", practitioners have generally looked for guidance to Regulation 1.1275-5(b)(1) (providing that if a debt instrument provides for two or more qualified floating rates that are within 25 basis points of one another on the issue date, the qualified floating rates are treated as a single floating rate) and Regulation § 1.1001-3(e)(2)(ii) (providing that a modification of the yield on a debt instrument is significant if it exceeds 25 basis points). Based on the foregoing, it is a commonly accepted view that the requirement under Regulation §1.148-4(h)(2)(v)(B) is met if the rate on the swap and the rate (or expected rate) on the bonds are within 25 basis points of one another on the date the swap is priced.

For super integration, Regulation §1.148-4(h)(4)(i)(C) imposes the additional requirement that the issuer's aggregate payments be fixed and determinable within 15 days of the date of issuance of the hedged bonds. Differences in the swap rate and the bond rate do not cause such payments not to be fixed and determinable as long as the issuer reasonably expects such rates to be substantially the same throughout the term of the hedge. This additional requirement with respect to correlation and timing is designed to ensure that the bond yield, after taking payments and receipts on the hedge into account, is essentially fixed from the date of issuance of the bonds. In order to assist issuers in establishing their "reasonable expectations" with respect to this requirement, perhaps some objective standard, such as an historical test for some representative period with a relatively high percentage or absolute correlation requirement, could be added as a safe harbor. Provided the periodicity of the comparison matches the periodicity of reset dates with respect to the rates compared, such an historical comparison should provide a high degree of certainty that, assuming the *status quo*, the rates will correspond quite closely. The foregoing does not, of course, take into account future events such as changes in tax law that may affect the degree of correlation between the swap rate and the bond rate. If it is Treasury's view that it is *per se* unreasonable for an issuer to assume static tax law for the term of the hedge, however, any historical comparison test to demonstrate an issuer's "reasonable expectations" becomes unworkable, and super integration would seem to be unachievable using a LIBOR-based swap. Regardless of where Treasury comes out on this, it should be clarified.

3. Treatment of Multiple Qualified Hedges

The Task Force also recommends that the qualified hedge rules be clarified with respect to the use of multiple qualified hedges in connection with a single bond issue. Regulation §1.148-4(h)(2)(i)(A) defines a hedge as a "contract that is entered into primarily to modify the issuer's risk of interest rate changes with respect to a bond." For any bond subject to an independent qualified hedge, the "bond" to which an additional qualified hedge relates should be the synthetic bond created by the integration of the first qualified hedge, unless the deemed termination rule in Regulation § 1.148-4(h)(3)(iv)(A) otherwise applies. This clarification is particularly important in connection with basis swaps which, assuming all of the requirements of Regulation §1.148-4(h)(2) are otherwise met, should be integrated with the original bond and the first hedge.

4. Identification of a Qualified Hedge

General. Regulation §1.148-4(h)(2)(viii) requires that a qualified hedge be identified in some detail on the books and records of the issuer within three days of entering into such hedge and its existence noted on the first subsequent form relating to the hedged bonds filed with the Internal Revenue Service. Compliance with this requirement is relatively straight-forward in connection with a swap executed at or about the time the related bonds are issued, since the identification can simply be included in the bond transcript and the existence of the hedge noted on the Form 8038 filed with respect to the bonds. The requirement can be problematic, however, with respect to hedge contracts that are not entered into contemporaneously with the issuance of the bonds, even if the hedge is not considered by the market to be a true "anticipatory" hedge. The rule becomes more even more complicated with respect to hedges entered into by conduit borrowers independent of any action by the actual issuer of the bonds.

Suggested Changes to Qualified Hedge Identification Requirement. The Task Force recommends extending the three day (presumed by most practitioners to be three calendar days, not business days) time period for identification set forth in Regulation §1.148-4(h)(2)(viii). While prompt identification is important, a longer period (such as 5 or 7 business days) would be a welcome change. Perhaps more importantly, however, with respect to a hedge entered into by a conduit borrower independent of any action by the actual issuer, particularly where the hedge is not entered into contemporaneously with the sale of the bonds, the conduit borrower should be permitted to make the identification. In these cases, the conduit borrower is the party economically at risk under the hedge and should therefore be the party making the identification in its books and records. The conduit borrower would report the hedge to the actual issuer so that the actual issuer could identify the hedge on the next filing with respect to the bonds, or a separate filing requirement could be established to be sure all qualified hedges could be identified with the bonds to which they relate within some reasonable period of time following the effectiveness of the application of such hedges to such bonds. This is particularly important for 501(c)(3) borrowers who may be able to issue bonds through various conduit entities and are not otherwise required to seek inducement or reimbursement resolutions from those conduit entities prior to acting on their financing plans and capital programs.

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