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August 25, 2006

John J. Cross III
General Attorney
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Department of the Treasury
1500 Pennsylvania Avenue, N.W., 4212 B MT
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RE: Guidance Recommendations Relating to Definition of Issue Price under Internal Revenue Code Section 148(h) and Treasury Regulation § 1.148-1(b)

Dear John:

Enclosed is a discussion of guidance recommendations by the National Association of Bond Lawyers (NABL) for the determination of the "issue price" of a tax-exempt bond for purposes of Sections 103 and 141 through 150 of the Internal Revenue Code. A list of the NABL Issue Price Study Group who participated in the preparation of the recommendations is also enclosed.

NABL's interest in this matter is to clarify and facilitate compliance with the tax law and regulations. To the extent that Treasury or the IRS have tax policy concerns with the proposals, NABL would welcome the opportunity to assist in developing alternatives that would achieve clarity, certainty and administrability for our members.

If you have questions, please contact me at 617/239-0389 or through email at wstonge@eapdlaw.com or Elizabeth Wagner, Director of 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 Issue Price Study Group.

Thank you for the opportunity to submit NABL's recommendations. We look forward to working with you.

Sincerely,

Walter J. St. Onge III

Enclosures
cc: Eric Solomon
Michael J. Desmond
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NABL Issue Price Study Group Members

National Association *of* Bond Lawyers

RECOMMENDATIONS
BY THE
NATIONAL ASSOCIATION OF BOND LAWYERS
ISSUE PRICE STUDY GROUP
FOR THE
DEPARTMENT OF THE TREASURY
OFFICE OF TAX POLICY
AND THE
INTERNAL REVENUE SERVICE
COMMENTS RELATING TO THE DETERMINATION OF THE "ISSUE PRICE" OF TAX-EXEMPT BONDS FOR PURPOSES OF INTERNAL REVENUE CODE SECTIONS 103 AND 141 THROUGH 150
AND TREASURY REGULATION § 1.148-1(b)

AUGUST 25, 2006

The following comments are submitted on behalf of the National Association of Bond Lawyers (NABL) Issue Price Study Group ("Study Group"). These comments relate to the definition of the "issue price" of a tax-exempt obligation for purposes of Sections 103 and 141 through 150 of the Internal Revenue Code of 1986, as amended (the "Code"), and the specific definition contained in Treasury Regulation § 1.148-1(b).

Recently, questions have arisen about the interpretation of the definition of the issue price of bonds, particularly in situations in which the facts surrounding the sale of the bonds do not neatly fit within the exact parameters of the regulations. In such situations, uncertainty has existed among issuers and bond counsel as to, for example, whether or to what extent one should look to the regulations and guidance under Sections 1273 and 1274 of the Code to determine the issue price. Concerns have also been raised about the accuracy of certificates customarily provided by underwriters in connection with the issuance of tax-exempt bonds regarding the issue price of the bonds for purposes of Section 148 of the Code.[1]

The Study Group was formed to recommend changes to the current regulations that would provide clarification regarding the determination of the issue price of bonds, in light of existing practices and potential interpretation of the current rules.

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[1] For example, one academic paper states that "a substantial fraction of the issues [examined by the authors] show less than the required 10% of the issue being sold at or below the [documented] reoffering price." The authors suggest that, depending on the methodology employed, between 7.3% and 20% of the "issues" they examined failed to meet the 10% threshold. The Study Group takes no position on the validity of the market-related conclusions stated in this paper. The Study Group does note, however, that this paper <u>does not</u> accurately state the requirements of the tax law; specifically, there <u>are no</u> "IRS requirements that 10 percent of the bonds are sold at the reoffering yield." Green, Hollifield & Schurhoff, "Dealer Intermediation and Price Behavior in the Aftermarket for New Bond Issues," p. 4 (October 5, 2005).

Executive Summary

The Study Group believes that any examination of the legal issues surrounding the definition of the "issue price" of a bond take into account how bonds are structured and sold — including the underwriting and distribution processes. An overview of those processes, particularly as they relate to negotiated and to competitively bid underwritings of bonds, appears below.

Largely because of the need to ascertain the arbitrage yield on bonds when structuring tax-exempt bond issues, the Study Group strongly recommends that the "reasonable expectations" provisions of the regulation be given substantive meaning by providing one or more "safe harbors" to the effect that, if certain standard marketing procedures are followed, the initial offering price at which the bonds are offered to investors by the underwriter shall be deemed to be the issue price of a bond, regardless of the prices at which they are actually sold, and regardless of prices at which other trades may occur.

The Study Group believes that, in the context of a negotiated offering, the offering prices established by the underwriter, as part of a bona fide offering to the public and as set forth in a bond purchase agreement (the "BPA"), be used to establish the amount of the "underwriters' commissions" that Section 148(h) of the Code was intended to address. The Study Group recommends the use of this offering price regardless of other facts relating to the sale of the bonds, including: (i) whether the bonds are actually sold by the underwriter at those prices (*i.e.*, if less than 10% of the bonds are actually sold at the offering price); and/or (ii) whether the buyers at those prices subsequently re-sell the bonds to other investors (*e.g.*, place the bonds in a so-called "tender option bond" ("TOB") program trust, or resell them to other broker/dealers).

Using the offering price that is shown to investors as the issue price of a bond would have the virtue of simplicity and transparency: in almost all negotiated underwritings, the offering price (or corresponding yield) of a bond being offered is disseminated virtually immediately upon its establishment by the senior underwriter to the broker/dealer and investor community via Dalcomp (to other members of the underwriting syndicate) and The Bond Buyer (TM3) and/or Bloomberg news wires. This process provides substantial assurance that the offering price is exposed to a variety of investors, allowing other potential investors to place an order for the bonds if they feel the offering price is too low. Further, the pricing wire is a readily ascertainable document for purposes of the conduct of due diligence by bond counsel; attaching a copy of the final pricing wire to a "tax certificate" as part of the due diligence documentation generally would be a simple matter.

With respect to competitive underwritings, the Study Group recommends that, if the underwriter has reoffered a bond to the public and has disseminated the offering price via a Dalcomp wire to other members of an underwriting syndicate or to other members of the municipal bond investing community via The Bond Buyer (TM3) and/or Bloomberg news wires, the price shown on the pricing wire be deemed the issue price of the bond.

The Study Group also recommends guidance on the following points, which have broad application to all underwritings: (i) that a bona fide sale to an entity that is not, on its face, an underwriter or a broker/dealer (as defined and regulated by the National Association of Securities Dealers ("NASD") and the Securities and Exchange

Commission ("SEC") should be deemed to be a sale to the general public, even if that entity later re-sells the bonds to other parties; and (ii) that trust programs and similar repackagings of a bond are disregarded.

DISCUSSION

Background – The Distribution Process for Municipal Bonds

The Study Group believes that any examination of the tax questions surrounding the definition of the "issue price" of a bond should take into account how bonds are structured and sold – including the underwriting and distribution processes. Broadly speaking, municipal bonds are sold through one of three methods: (i) a negotiated underwriting; (ii) a competitive bid underwriting; or (iii) a private placement. In 2005, some 69% (measured by number of issues) to 80% (measured by par amounts) of the long-term tax-exempt bonds issued were sold in negotiated underwritings; most of the balance were sold though a competitive bid process, with approximately 1% sold through the private placement mechanism.[2] There are significant distinctions among these three methods of distribution of municipal bonds to investors that will affect the prices at which bonds are offered and sold to the public; accordingly, set forth below are brief outlines of the negotiated and competitive bid processes.[3] The Study Group has not separately discussed private placements because, in general, the issue price in a private placement is established by the price at which the bonds are actually sold in the private placement, and, therefore, many of the ambiguities in interpretation of issue price discussed herein do not arise in a private placement.

Negotiated Underwriting. In a typical negotiated underwriting, an issuer of municipal bonds selects one or more investment banks and broker/dealers (collectively, the "underwriters") to distribute the bonds to municipal bond investors. One of the underwriters is usually selected as the "book running" or "senior managing" underwriter for the bond issue; the senior managing underwriter acts on behalf of the entire group of underwriters (generally referred to as the underwriting "syndicate"). The senior managing underwriter is typically the party responsible for the structuring of the transaction based upon consultations with the issuer and its advisors and upon market feedback from both its own customers and the other underwriters. The senior managing underwriter is also generally responsible for the bookkeeping details of the distribution process – tracking orders and allotments of bonds among the syndicate members and customers, and making the final decision, in consultation with the issuer and its advisors, and the other underwriters, of the prices and yields at which the bonds are to be offered to investors.

Prior to the marketing of the bonds, many discussions will be held among the underwriters (led by the senior managing underwriter), the issuer, and its advisors as to the sizing and structure of the transaction. This process will reflect a wide variety of

[2] Source: The Bond Buyer, "Year-End Review Table," p. 2A (February 13, 2006).

[3] For a more extensive discussion of the municipal bond underwriting and distribution process, *see* The Bond Market Association, "Fundamentals of Municipal Bonds," pp. 90-103 (5th ed. 2001) (copy attached), which notes that the underwriting process, including syndicate practices, are governed by a number of rules and regulations promulgated by the Securities and Exchange Commission, the National Association of Securities Dealers, and the Municipal Securities Rulemaking Board.

factors: tax law constraints, state law constraints on how bonds must be structured, and probable investor demand (*e.g.*, bonds in "specialty" states such as New York, California, and Massachusetts may have a more retail-oriented focus), among others. Preliminary discussions as to the amount of underwriters' spread (or "commissions") generally will also take place. Thus, many of the expected terms of the bond issue will be broadly defined by the issuer and the underwriters before any distribution of information to the investor community.

After the broad terms of the transaction are agreed upon, a Preliminary Official Statement ("POS") typically is completed by the issuer for distribution to prospective investors that are the customers of the underwriters; the POS is either mailed to the investors or made available electronically. After a period of time allowing the investor community to digest the data in the POS, the underwriters, working with the issuer and its advisors, commence an order period. Commonly, larger transactions have a one- or two-day "retail" order period followed by a one-day order period for institutional investors (*e.g.*, mutual funds, property and casualty insurance companies, banks, and hedge funds). These order periods are typically commenced with a preliminary pricing of the bonds (*i.e.*, tentative maturities, amounts, prices, and yields) based upon the underwriters' judgment of prospective investor demand and interest rate levels. The preliminary pricing of the bonds is disseminated via a "preliminary pricing wire" distributed to the underwriting syndicate via the Dalcomp system, and often to the larger investor and broker/dealer community via the The Bond Buyer (TM3) and/or Bloomberg news wires. During the order period, based on a wide variety of factors, including the "book" of preliminary orders from investors, general market tone, and comparable trades that might be executed in the secondary market, the underwriters (again, in consultation with the issuer and its advisors) will adjust (up or down) the pricing of the bonds, and orally agree on: (i) the price at which the underwriters will buy the bonds; and (ii) the prices and yields at which the bonds will be reoffered to the investors. At the end of the order period, the issuer and the underwriters orally agree to these terms, subject to the actual signing of a BPA, which typically occurs one to two days later. The revised pricing of the bonds is disseminated via a "final pricing wire," again distributed to the underwriting syndicate via the Dalcomp system, and often to the larger investor and broker/dealer community via the The Bond Buyer (TM3) and/or Bloomberg news wires.

One important aspect of this process to note is that, even though an investor's order is, as a legal matter, subject to the signing of the BPA, and, in theory, could be withdrawn at any time prior to the actual signing of the BPA, investors honor their oral commitments almost without exception and do not withdraw the orders prior to the signing of the BPA, even in situations in which it might be to their advantage to do so (*e.g.*, an increase in interest rates between the oral order and the actual signing of the BPA). Thus, the actual pricing and sales of bonds is based on orders received by the underwriters and on market conditions at the time of the oral agreement between the issuer and the underwriters and at the end of the order periods, rather than the date on which the BPA is signed.[4]

[4] The Study Group believes that this area is one in which the current issue price definition may not correspond to the marketplace, seemingly focusing on the date of the signing of the BPA. *See* Treas. Reg. § 1.148-1(b) ("The issue price of bonds may not exceed their fair market value as of the sale date."); Treas. Reg. § 1.150-1(c)(6) ("The sale date of a bond is the first date on which there is a binding contract in writing for the sale or exchange of a bond."). Please note, however, the Study Group's comments above are made in the context of the federal tax issues raised by the transactions between underwriters and investors and not in the context of any securities or contract law issues that may arise.

The difference between the price at which the underwriters will agree to buy the bonds and the prices and yields at which the bonds will be reoffered to bond investors is the "underwriting spread" (or "commission"). Rather than taking the form of a direct payment by the issuer, the underwriting spread is usually in the form of a price difference between that which the bonds are bought by the underwriters and that which they are offered to the public. This underwriting spread is set forth in the BPA and, pursuant to Municipal Securities Rulemaking Board ("MSRB") Rule G-32, must also be disclosed to investors and is typically included in the final official statement of the terms of the bonds. Thus, the underwriting spread – the "commission" to which the issuer has agreed as part of the process of issuing its bonds – is a known and defined amount.

Moreover, under standard negotiated underwriting syndicate agreements, members of the underwriting or selling group generally are under an obligation during the underwriting period (*i.e.*, the period before the actual signing of the BPA) to offer and attempt to sell the bonds at (not higher than, not lower than) the agreed-upon offering prices that have been negotiated with the issuer.[5] In addition, an underwriter has a strong incentive to retain as much of the underwriting spread for itself, rather than to allow other broker/dealers, who are not party to the BPA, to obtain a portion of the spread from marketing the bonds. Thus, in general, the underwriting spread: (i) is a known amount, determined as part of the negotiations between the issuer and the underwriters; and (ii) generally defines a maximum amount of expected underwriting profit for the underwriters as a group.

Competitive Bid Underwriting. Although many of the mechanics of a competitive bid underwriting are similar to those of a negotiated underwriting, there are several significant differences in the process that bear on the establishment of a bond's issue price. In the competitive bid model, the issuer, working with its advisors alone, establishes in a notice of sale the terms of the bonds (for which the parameters as to maturity, amounts, coupon ranges, etc. are fairly tightly drawn), as well as the bidding terms. The time deadline for submission of the bids typically is fixed in the notice of sale as a date and time certain, and the award of the bonds is based upon the submitted bid that results in the lowest interest cost to the issuer. Bids may be received either electronically or via a paper-based process (fax or signed sealed bid). Underwriters and broker/dealers can either bid alone for the bonds, or can group together into two or more competing syndicates to bid on the bonds. Because of the time certain by which the bids must be submitted, typically the separate underwriting syndicates will compare notes on the bids submitted immediately after the bid submission deadline. Thus, the "winning bid" is usually very quickly known, generally before the formal award. In addition, the formal award of the bonds occurs in a much more expedited fashion than in a negotiated underwriting – normally within minutes of the bid submission deadline.

[5] "Master Agreement Among Underwriters – Negotiated Offerings of Municipal Securities," § VI, p. 14 (2002), available on the web site of The Bond Market Association at http://bondmarkets.com/agrees/master_aau_neg.pdf. Compare "Master Agreement Among Underwriters – Competitive Offerings of Municipal Securities" (2002), available at http://bondmarkets.com/agrees/competitive_aau.pdf, which does not contain comparable language. Please note that, in some cases, a BPA will allow the underwriting syndicate to offer certain investors price "concessions," typically to institutional investors for large purchases or other commitments to other investors which help to support the pricing of the transaction. However, these concessions must be offered by agreement among the syndicate members, and, if granted, will result in a lower underwriters' compensation.

However, unlike a negotiated underwriting, the terms of a competitive bid normally do not require any particular reoffering of the bonds, as evidenced by a typical competitive bid form. Moreover, there is no assurance that a particular underwriter or broker/dealer which is bidding for the bonds will actually have bonds of the issuer available to distribute to its customers; in turn, those investors may be reluctant to commit to purchasing a bond of the issuer without knowing that the order can, in fact, be filled. Underwriters try to mitigate some of the risks involved in bidding for bonds by soliciting conditional orders from potential investors or groups of investors prior to the submission of bids to the issuer. These conditional orders could include orders from institutional investors (who may place such orders with more than one underwriting syndicate); a firm's trading desk, or the retail distribution network within a broker/dealer. When an underwriter is, in fact, awarded the bonds, these orders are given priority, and other underwriters would not offer those bonds to other investors. In Street parlance, these bonds would be "NRO" (not reoffered), even though some may have, in fact, been sold to members of the investing public. Even with such "pre-sale" orders, there often are a substantial number of bonds that would be owned by the underwriters who won the bid at the moment of the award of the bonds. Unlike a negotiated underwriting, in which every member of a syndicate is obligated to offer the bonds during the sale period at the offering price established, a typical competitive bid syndicate has no such constraint. Each syndicate member is liable for the underwriting of a specified portion of the bonds; any unsold balances not sold by the syndicate are distributed proportionately among the syndicate members, each of which is then free to hold the bonds for its own account or offer them to other investors at whatever price it can obtain. Therefore, to the extent that bonds are not actually sold prior to or shortly after the time of the submission of the bid, one conceivably could find as many "offering prices" of bonds as there are members of the syndicate. Finally, in many cases, bonds may be purchased by a brokerage firm single-handedly; in turn, the firm may reoffer the bonds only to its retail and institutional customers; the prices of the bonds at which the bonds are being reoffered would not be available on the Dalcomp syndicate wire or The Bond Buyer (TM3) and/or Bloomberg news wires. In many cases, the process of distributing bonds though a retail system means that large unsold balances may persist for a substantial period of time.

Secondary Market Transactions. Investors (generally institutional investors) may purchase bonds from the underwriters of the bonds and then, a short time after that initial sale (including prior to the closing of the bond issue, or even prior to the date of the signing of the BPA), resell (or flip) some or all of the bonds that they purchased to broker/dealers (who may or may not have been part of the original underwriting group) or other investors. This "flipping" is a secondary market trading practice (in both negotiated and competitive bid underwritings), but not part of the underwriting process itself.

The Study Group knows of no rules or guidelines that define or govern this practice. Moreover, absent a legal restriction imposed by the issuer on the investor's ability to trade the bonds, underwriters cannot directly control the practice nor determine whether or for how long a particular investor intends to hold bonds. Because flipping is not conducted by the underwriters as part of the underwriting process, the Study Group believes that it should have no relevance to the definition of issue price.

Definition of Issue Price

The determination of the issue price of tax-exempt obligations is one of the linchpins for measuring compliance with the provisions of Sections 141 through 150 of the Code. A wide variety of the constraints on and rules governing the issuance of tax-exempt bonds use the definition of issue price as their starting point. These rules include, but are not limited to:

- The determination of the arbitrage yield of an issue for purposes of Section 148 of the Code;
- The determination of the amount of "volume cap" required to be allocated to a private activity bond issue under Section 146 of the Code;
- The determination of the amount of allowable private use under Section 141 of the Code;
- The determination of the amount of "bad money" under Section 142 of the Code;
- The 2% costs of issuance limitation under Section 147 of the Code; and
- The limitation on sizing for purposes of Sections 1311 and 1313 refunding transition rules of the Tax Reform Act of 1986.

The definition of issue price is currently contained in Treasury Regulation § 1.148-1(b), and is carried over by an explicit cross reference into the private activity bond rules of Section 141 of the Code, and by implication in other applicable subsections of Sections 142 through 150 of the Code, and the regulations thereunder. Treasury Regulation § 1.148-1(b) defines the issue price of a tax-exempt bond as follows:

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

The need to determine the issue price of the bonds of an issue is mandated by the enactment of Section 148(h) of the Code as part of the Tax Reform Act of 1986; Section 148(h) was enacted by Congress to overturn the holding in the State of Washington[6] decision, which concluded that an issuer's arbitrage yield should reflect the "all-in" costs of its borrowing, including the costs of issuance associated with the issuance of its bonds.

As required by the general provisions of Section 148(h), Treasury Regulation § 1.148-1(b) uses as a starting point the definition of issue price of a bond as measured under Sections 1273 and 1274 of the Code. Moreover, this regulation explicitly provides

[6] State of Washington v. Commissioner, 692 F.2d 128 (1982).

that the sale of at least 10% of a maturity is deemed to be the sale of a substantial amount of the bonds of that maturity. However, this helpful guidance is not contained in Sections 1273 and 1274. Treasury Regulation § 1.148-1(b) provides further useful guidance by clarifying that the sale of a portion of the bonds at a later point in time at a different price does not affect the issue price determined as of the sale date. And finally, the regulation explicitly provides that the issue price of the bonds is "determined as of the sale date based on reasonable expectations regarding the initial public offering price (emphasis added). . . ."

Difficulties of Application of Definition

Notwithstanding the helpfulness of the 10% rule and the reasonable expectations provision of Treasury Regulation § 1.148-1(b), there are many issues that are not addressed by this regulation. Some bond counsel may be reluctant to rely upon the "reasonable expectations" language of the regulation in situations in which it is not self-evident that at least 10% of each maturity of the bonds has actually been sold to members of the general public. A few examples of current market transactions that the regulation does not directly address may help to illustrate this concern:

1. An issue of bonds of Issuer is sold in a competitive sale; as is common with competitively bid sales, there are no constraints on the reoffering of the bonds by Underwriter. Underwriter buys the bonds from Issuer at a price of 98.5 and offers the bonds to its customers at a price of 99, but does not sell any of them at that price on the date of sale. After accepting the winning bid, Underwriter subsequently sells 5% of the bonds to Retail Broker at a price of 98.5; Retail Broker sells the bonds at par.

2. Same facts as in Example 1, except that, because of subsequent changes in interest rates, Underwriter sells the bonds at a price of 96.5, and Retail Broker sells the bonds to its customers at a price of 98.

3. Same facts as in Example 1, except that Underwriter does not sell the bonds to others, but instead continues to hold them in a short-term account through the date of closing of the bond issue.

4. In a negotiated underwriting, Underwriter sells advance refunding bonds to Mutual Fund at a price of 98.5. Four days after the signing of the BPA but before the bond issue is closed, Mutual Fund sells 5% of the bonds to Retail Broker at a price of 99; in turn, Retail Broker sells the bonds to its customers at par. Alternatively, 11% of the bonds are sold by Mutual Fund and Retail Broker. Alternatively, the sales by Mutual Fund and Retail Broker all occur after the closing of the bond issue.

5. In a competitively bid issue, the bonds are sold by Underwriter to Hedge Fund on the date of sale of the bonds. After the closing date on the bond issue, in accordance with its usual practice, Hedge Fund places the bonds in a trust program. As is customary in trust program structures, Hedge Fund sells 99% or so of the interests in the program at par to floating rate investors (typically, money market mutual funds), retaining for its own account a 1% interest. Hedge Fund is not registered or regulated as a broker/dealer with the NASD or SEC. The trust program is treated as a partnership for federal income tax purposes. Due to an increase in market interest rates, the trust program purchases the bonds at a price less than the price paid by Hedge Fund. Alternatively, the depositor and

owner of the 1% interest in the TOB program trust could be the proprietary (long-term holdings) trading desk of the Underwriter.

6. In either a competitive or negotiated underwriting, the bonds are offered to the public, but no bonds of a given maturity are sold to the public, and, as a result, all bonds of that maturity are taken into inventory by the underwriter. Underwriter obtains secondary market insurance at its expense and immediately resells the now-insured bonds to the public at a price that differs from the initial offering price.

These examples (and the many variations thereon) serve to highlight some of the issues that confront bond counsel in trying to apply the provisions of Treasury Regulation § 1.148-1(b). Specifically, the following situations are not addressed by the regulation, and the Study Group respectfully requests that there be additional guidance:

- In many instances, all of the bonds of a maturity are offered to the public, but less than 10% of them are actually sold as of the sale date (*i.e.*, the date on which the BPA is actually signed). In this situation, some bond counsel and issuers may be reluctant to determine the issue price of the maturity based upon the underwriter's "reasonable expectations" that it could sell the bonds at the initial offering price on the sale date, particularly if reported trade data show actual sale prices at different prices than the initial offering price.

- Bonds are often sold to parties who may act both as investors for their own account <u>and</u> as traders in the bonds; these investors in turn sometimes will resell the bonds to other investors at higher prices than the prices at which they purchased the bonds. These investors may or may not be regulated by the NASD and SEC as broker/dealers. In such situations, uncertainty exists as to whether those investors should be treated as "bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers" for purposes of Treasury Regulation § 1.148-1(b), particularly when investors' actions "after the fact" arguably could determine their status.

- Bonds are often securitized or "repackaged" through trust programs, floater/inverse floater structures, or similar vehicles, by sophisticated investors and traders. Again, these investors may or may not be regulated as broker/dealers.

Overlaying all of these potentially ambiguous situations is the important (and indeed critical) fact that the structure of a bond issue must be established by the pricing date of the bonds. On that date, the issuer, underwriter, bond counsel, credit enhancer and investors must know whether the bonds to be settled are, in fact, in compliance with the Code and will be issued as planned and in the amount planned. In turn, the determination of the issue price of a bond must be made as of the pricing date, so as to assure that the transaction as planned meets all of the rules and regulations that turn, directly or indirectly, on the definition of issue price. This is particularly true in the context of advance refundings (the type of transaction that is probably the most sensitive to the question of the issue price of the bonds) in large part because the yield-restricted escrow investments typically must be purchased on that date.

Consistency with Congressional Intent

The primary purpose of Section 148(h) of the Code was to assure that an issuer was not able to recover any of its costs of issuance (other than bond insurance and similar guarantee fees) through the investment of the bond proceeds at a higher yield.[7] Thus, in a real sense, the regulation is attempting to define and measure the issuer's issuance costs, and in particular, the underwriting spread that the issuer has agreed to pay for the marketing of the bonds. Further, the regulation does not attempt to define the cost basis in the bond to the investor, nor does it attempt to capture trading or securitization profits of secondary market participants in the arbitrage analysis.

In order to further this legislative intent, the legislative history relating to the Tax Reform Act of 1986 provides for the yield on the bonds to be determined "based on the issue price, taking into account the Code rules on original issue discount and discounts on debt instruments issued for property (sections 1273 and 1274 of the Code)."[8] For this reason, the definition of issue price in Treasury Regulation § 1.148-1(b) references Sections 1273 and 1274 of the Code, but varies from the literal and specific requirements of those sections, for example, by providing that the issue prices for which a bona fide public offering is made is determined as of the sale date based on reasonable expectations regarding the initial public offering price.

The Study Group believes that the definition of issue price and its application should remain focused on the elimination of issuance expenses, primarily underwriters' commissions, from the computation of bond yield, rather than any application of the literal requirements of Sections 1273 and 1274 of the Code. The Study Group believes this recommendation is consistent with the Congressional intent. The focus of the Study Group's recommendations is to identify the underwriter's commissions in the deal struck between the issuer and the underwriter and to avoid taking into account secondary market transactions, transactions by parties other than the underwriter, and other similar factors that are irrelevant to the underwriter's commissions.

The concept of issue price as defined under Treasury Regulation § 1.148-1(b) has been carried over to other Code requirements that affect tax exempt bonds by cross-reference in Treasury Regulation § 1.141-1(a) and by simple analogy or other extension of analysis. However, the Study Group believes that for many of these Code sections, there is not the same policy or Congressional intent that would clearly require that the principle of Sections 1273 and 1274 of the Code be applied. For example, for purposes of applying the 90/10 "private use" test of Section 141 of the Code or the 95/5 "exempt use" test of Section 145 of the Code or determining the amount of volume cap under Section 146 of the Code, developing rules that simply identify the proceeds that are received by the State or local governmental issuer of the bonds would appear to be consistent with Congressional intent. The Study Group does not believe there is any clear legislative policy for requiring that the issue price paid by the public purchaser of

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[7] *See* Senate Report No. 99-313, p. 828 (1986): "The committee believes it is important for issuers of tax-exempt bonds to pay the costs associated with their borrowing. The bill provides that the costs of issuance, including attorneys' fees and underwriters' commissions, must be paid by the issuers or beneficiaries, rather than recovered through arbitrage profits . . . ." The focus on the elimination of costs of issuance in the computation of bond yield and the reversal of State of Washington, supra at fn. 6, is repeated in the House and Conference Committee reports relating to the Tax Reform Act of 1986.

[8] House Report No. 99-426, p. 554 (1986).

the bonds be the basis for measuring these tests. Nevertheless, the Study Group recognizes that applying the concept of issue price for the various purposes of Sections 141 through 150 of the Code is possible, provided the application reasonably recognizes the fundamental purpose of the Code requirements. The Study Group suggests that the focus of the definition and its application should be on identifying the proceeds received by the issuer of the bonds and the amount of underwriters' commission paid by the issuer.

Moreover, (in the words of one IRS official who was involved in the drafting of the arbitrage regulations) Treasury Regulation § 1.148-1(b) was designed to achieve "rough justice" in the prohibition and capture of arbitrage.

Issue Price Verification

Bond counsel typically require and rely upon a certificate from the underwriters to establish the issue price of bonds. Information currently available is not sufficiently detailed so as to permit bond counsel (and others) to independently reach a definitive, reliable conclusion on the issue price question, (*i.e.*, the first price at which bonds are actually sold to the public). Specifically, currently available information (*e.g.*, MSRB trade data) only differentiates among sales to customers, sales from customers, and interdealer trades, and is not designed to address federal income tax issues relating to the establishment of issue price: it is provided on sites such as The Bond Market Association web site and Bloomberg for other purposes.

Additionally, in their current structures, these services do not permit bond counsel to verify the ***first*** price at which 10% or more of a maturity of bonds is sold. This problem is further exacerbated by the fact that sales that occur prior to the execution of the BPA are not reported until after the BPA is signed – a process that can take as many as two or three days. Currently, there is no way to differentiate between the sales by the underwriters that occurred on the date of pricing of the bonds (which are the "first sales" that should determine the issue price) from those trades that occur after the pricing date but before the award date, or from those that occur on the date of the formal award. The tax law analysis may also be complicated by the way "interdealer" trades are reported on the MSRB web site. For example, the Study Group believes that any purchase by an entity that is registered or known to be a dealer is marked as an interdealer trade and would include a purchase by an investment bank for its proprietary trading account (or arbitrage account).

While the MSRB has proposed rule changes designed to differentiate between "conditional" trades (*i.e.*, those that occur before the signing of the BPA or the award of the bonds), and "list offering price transactions/takedown transactions" (*i.e.*, those that occur in connection with the underwriting of the bonds),[9] such rules are not yet in place. Moreover, these rules, when finalized, may or may not provide conclusive public trade reporting data in a manner suitable for establishing the issue price of bonds under Section 148(h) of the Code.

More generally, issuers and underwriters can provide and certify definitive information only with respect to what the issuer or underwriter did in conjunction with

[9] *See* MSRB Notice 2006-10 (April 21, 2006), available on the MSRB web site at http://www.msrb.org/msrb1/whatsnew/2006-10.asp.

the offering and sale of bonds, *but not* with respect to what other investors do or will do in the context of the sale and trading of bonds absent the underwriter. In other words, underwriters and bond counsel cannot reasonably be expected to develop accurate and legally meaningful information for trading activity outside of the underwriting process.

Therefore, the Study Group recommends the following rule: generally, the issue price inquiry ends when the offering price is shown to the prospective investors to whom the underwriters offer the bonds (*i.e.*, not when the BPA is signed). The Study Group also strongly recommends that the concept of "reasonable expectations" continue to be given substantive meaning by the establishment of safe harbors, as provided below.

The Study Group urges that issue price for purposes of Section 148 of the Code not be interpreted as the issue price determined under the original issue discount rules, due to the necessity of identifying the arbitrage yield (and other related measures of tax law compliance) on the bond issue at the time it is structured and priced -- particularly acute for advance refundings.

Recommended Guidance in Negotiated Underwritings

Given the large number of bond issues that are distributed through a negotiated underwriting process, the Study Group believes that, if workable safe harbor guidelines are crafted to address the situations that arise in negotiated underwritings, much of the uncertainty that currently arises from the interpretation of the definition of issue price could be resolved.

In light of the legislative intent behind Section 148(h) of the Code as well as the business arrangement embodied in a BPA, the Study Group suggests that, in the context of a negotiated offering, the offering price established by the underwriter, as part of a bona fide offering to the public and as established in the BPA, be used to establish the amount of the underwriters' commissions that Section 148(h) was intended to address. The Study Group recommends use of this offering price regardless of other facts, including: (i) whether the bonds are actually sold by the underwriter at that price *(i.e.*, if less than 10% of the bonds are actually sold at the offering price) and/or (ii) whether the buyers at that price subsequently resell the bonds to other investors (*e.g.*, place the bonds in a TOB program trust, or resell them to other broker/dealers).

Using the offering price that is shown to investors as the issue price of a bond would have the virtue of simplicity, transparency and administrability: in almost all negotiated underwritings, the offering price (or corresponding yield) of a bond being offered is disseminated virtually immediately upon its establishment by the senior underwriter to the broker/dealer and investor community via Dalcomp (to other members of the underwriting syndicate) and the The Bond Buyer (TM3) and/or Bloomberg news wires. This process provides substantial assurance that the offering price is exposed to a variety of investors, allowing other potential investors to place an order for the bonds if they feel the offering price is too low. Further, the pricing wire is a readily ascertainable document for purposes of the conduct of due diligence by bond counsel; attaching a copy of the final pricing wire to a "tax certificate" as part of the due diligence documentation generally would be a simple matter.

For a variety of reasons, the Study Group also recommends the issuance of guidance to the effect that trust programs and similar bond repackagings should be disregarded in determining the issue price of bonds. First, in such situations, as a technical matter, the bonds are typically being resold to an entity (or a group within the entity) in which the first purchaser (the trust creator) is a general partner and the owner of the residual interests in the trust, and, thus, maintains a sufficiently continuing interest in the bond as to make the sale to this TOB partnership a transaction that should be disregarded. More generally, treating the placement of the bonds into a TOB program trust as the act that established the issue price of the bonds raises the opportunity for the IRS to be "whipsawed" under current arbitrage regulations: if the value of the bonds increases between the sale date of the bonds and the date of deposit of the bonds into the TOB program trust, the last sentence of the definition of issue price in the regulations would preclude the use of the higher price in computing the arbitrage yield (which would otherwise lower the arbitrage yield on the bond issue). If, however, the market value of the bond at the time of the deposit to the TOB program trust is lower than the fair market value as of the sale date, treating this deposit as the act that establishes the issue price of the bonds would have the effect of increasing the arbitrage yield. An appropriate solution, therefore, would be to focus on the price paid by the TOB program trust creator as establishing the issue price of the bonds.

Exceptions. The Study Group further recommends that this proposed safe harbor rule not cover situations in which an underwriter has a pre-existing arrangement with another broker/dealer in which the second broker/dealer would be allowed to sell bonds during the order or underwriting period at prices higher than the offering price. Instead, the Study Group recommends that, in such infrequent circumstances (to the Study Group's knowledge), the offering prices of the second broker/dealer be reflected in the issue price of the bonds. Also, a negotiated underwriting syndicate may bid out a particular maturity among members of the syndicate; the winning syndicate member can then establish its own offering price for that maturity independent of the guidance of the senior manager. The Study Group suggests that in that case, the offering price of the winning syndicate member is the relevant offering price of the bond, not the price at which the syndicate "sells" the bonds to the winning syndicate member.

Additional Recommended Guidance for Competitive Underwritings

The Study Group believes that many of the principles enumerated above in the context of negotiated underwritings should be equally applicable to competitive bid underwritings. Specifically, the Study Group recommends that, if the underwriter has reoffered a bond to the public and has disseminated the offering price via a Dalcomp wire to other members of an underwriting syndicate or to other members of the municipal bond investing community via The Bond Buyer (TM3) and/or Bloomberg news wires, the price shown on the pricing wire be deemed the issue price of the bond. In addition, the Study Group requests guidance to the effect that a bona fide sale to an entity that is not, on its face, an underwriter or a broker/dealer (as defined and regulated by the NASD and SEC) be deemed a sale to the general public, even if that entity later resells the bonds to other parties.

Summary

As noted above, the main objective of the Study Group is to identify areas with respect to the interpretation of "issue price" which may need clarification and to provide recommendations for such clarification. The Study Group has set forth its recommendations in this paper to further that goal and would welcome the opportunity to be of further assistance, if appropriate, in achieving the clarity, certainty and administrability needed for this important matter.

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