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April 24, 2007

John J. Cross III
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Department of the Treasury
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RE: Guidance Recommendations Relating to Qualified Hedge Provisions

Dear John:

In January, at the Board of Directors Meeting of the National Association of Bond Lawyers ("NABL"), Rebecca Harrigal and you discussed the status of the Treasury Department and the Internal Revenue Service ("IRS") 2006-2007 Guidance Priority List regarding tax-exempt bond projects. You both mentioned a likely subject of future guidance regarding a specific issue within the arbitrage priority guidance project – technical comments relating to the qualified hedge provisions applicable to tax-exempt bonds under Section 148 of the Internal Revenue Code.

In response to this discussion, enclosed are administrative guidance recommendations prepared by a working group of NABL members. *See* Exhibit A for a list of members of the working group. As with other NABL guidance submissions, NABL's interest in this matter is to clarify and facilitate compliance with the tax law and regulations. If Treasury or the IRS would be interested in discussing these 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 949/725-4237 or through email at clew@sycr.com or Elizabeth Wagner, Director of Governmental Affairs, at 202/682-1498 or through email at ewagner@nabl.org.

National Association of Bond Lawyers

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

Sincerely,

Carol L. Lew

Carol L. Lew

Enclosure

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National Association *of* Bond Lawyers

RECOMMENDATIONS BY THE
NATIONAL ASSOCIATION OF BOND LAWYERS
FOR THE
DEPARTMENT OF THE TREASURY OFFICE OF TAX POLICY
AND THE INTERNAL REVENUE SERVICE
RELATING TO
QUALIFIED HEDGE PROVISIONS IN CONNECTION WITH
TAX-EXEMPT BONDS UNDER INTERNAL REVENUE CODE SECTION 148

April 24, 2007

The following guidance recommendations are submitted on behalf of the National Association of Bond Lawyers ("NABL"). These recommendations relate to the qualified hedge provisions under the arbitrage rules applicable to tax-exempt bonds under Section 148 of the Internal Revenue Code of 1986, as amended (the "Code"). These recommendations suggest clarifications, in order to improve compliance and administrability, to the "primary purpose rule" of Treas. Reg. §1.148-4(h)(2)(i)(A), the significant investment element rule of Treas. Reg. §1.148-4(h)(2)(ii), the "hedged bonds rule" of Treas. Reg. §1.148-4(h)(2)(iv), the "interest based contract rule" of Treas. Reg. §1.148-4(h)(2)(v), the "deemed termination rule" of Treas. Reg. §1.148-4(h)(3)(iv), the "super integration rule" of Treas. Reg. §1.148-4(h)(4), the "anticipatory hedge rule" of Treas. Reg. §1.148-4(h)(5), and hedge insurance treatment under Treas. Reg. §1.148-4(f)(1).

I. Introduction

The issuance of tax-exempt bonds is generally governed by the restrictions of Sections 103, and 141 through 150 of the Code, which include the arbitrage provisions of Section 148 of the Code. The purpose of the arbitrage provisions is to minimize the incentive for issuing tax-exempt bonds for the purpose of earning an arbitrage profit by restricting the amount of earnings on investments allocated to proceeds of tax-exempt bonds that the issuer can both receive and retain to the "yield" on the applicable tax-exempt bonds, subject to certain exceptions. For compliance with the arbitrage

provisions of Section 148, issuers must ascertain the "yield" on the tax-exempt bonds. Treas. Reg. §1.148-4 contains detailed rules for computing yield on tax-exempt bonds, including special rules for the treatment of hedges.

Municipalities and conduit borrowers[1] utilize various types of derivative products, including swaps and caps, to hedge their interest rate risks with respect to tax-exempt debt. Treas. Reg. §1.148-4(h) provides that, if certain requirements are met, a hedge contract can be "integrated" (*i.e.*, taken into account) with the terms of the bonds in calculating the "yield" on the tax-exempt bond issue for purposes of the arbitrage restrictions under Section 148 of the Code, and whether payments under the hedge can be financed with proceeds of the tax-exempt bond issue.

Treas. Reg. §1.148-4(h) generally provides that if a hedge contract satisfies an eight-part test, then the contract will constitute a "qualified hedge," and payments and receipts on the hedge may be taken into account – "integrated" – in calculating bond yield. The tax-exempt bond issue generally will be treated as a "variable yield issue," the yield upon which (for purposes of the restrictions of Section 148) is computed in "snap shots" based on the actual payments made on the bonds and payments made or received on the hedge, over certain prescribed computation periods. This type of integration is typically referred to as "simple integration."[2]

Treas. Reg. §1.148-4(h)(2) sets forth the eight conditions that must be satisfied in order for a hedge (*e.g.*, a swap) to be characterized as a "qualified hedge" that may be integrated (under simple integration) with the hedged bonds for purposes of computing yield on the tax-exempt bond issue. Generally, these eight conditions are designed to assure a close relationship between the bonds and the hedge. Thus, in general, (i) the hedge contract's primary purpose must be to modify the issuer's risk of interest rate

[1] For purposes of this letter and for simplicity, NABL assumes that the bond issuer is entering into the hedge contract. However, NABL intends its guidance recommendations to apply equally where a conduit borrower has entered into the hedge contract.

[2] Under special rules discussed in II F below, the bond issue may generally be treated as a "fixed yield bond issue" for purposes of computing the yield on the issue under Section 148, if certain additional requirements are met; this type of integration is typically referred to as "super integration." The yield on fixed yield bond issues is generally computed up-front as of the bond issue date.

changes with respect to the bonds (Treas. Reg. §1.148-4(h)(2)(i)); (ii) the contract must not contain a "significant investment element" (Treas. Reg. §1.148-4(h)(2)(ii)); (iii) the counterparty must not be related to the bond issuer (Treas. Reg. §1.148-4(b)(2)(iii)); (iv) the contract must generally cover a group of substantially identical bonds (Treas. Reg. §1.148-4(h)(2)(iv)); (v) the contract must be primarily interest based (Treas. Reg. §1.148-4(h)(2)(v)); (vi) payments on the hedge must "closely correspond" in time to related payments on the bonds (Treas. Reg. §1.148-4(h)(2)(vi)); (vii) payments on the hedge must come from the same source as payments on the bonds (Treas. Reg. §1.148-4(h)(2)(vii)); and (viii) within 3 days after the parties enter into the contract, it must be "identified" by the actual issuer on its books and records (Treas. Reg. §1.148-4(h)(2)(viii)). In addition, certain provisions specifically address the accounting for hedges (Treas. Reg. §1.148-4(h)(3)), termination of hedges (Treas. Reg. §1.148-4(h)(3)(iv)), treating a hedged bond as a "fixed yield bond" (Treas. Reg. §1.148-4(h)(4)), and contracts entered into prior to the issuance date of bonds (Treas. Reg. §1.148-4(h)(5)).

NABL believes that the rules relating to qualified hedges have generally been a great success. However, the practical, day-to-day application of certain of these provisions is sometimes difficult, particularly in light of market developments since the promulgation of the regulations. NABL also believes that certain technical changes to these provisions, as described below, would promote compliance by providing bond issuers and their counsel with greater clarity and would provide for more efficient administration by the IRS. Therefore, NABL recommends the following technical clarifications, generally ordered based upon the sequence of the Treasury Regulation provision.

II. Specific Recommendations

A. Primary Purpose Rule.

General Rule. Treas. Reg. §1.148-4(h)(2)(i)(A) provides that a qualified hedge, which can be integrated for purposes of determining bond yield, must be entered into "primarily to modify the issuer's risk of interest rate changes with respect to a bond (a

hedge). For example, the contract may be an interest rate swap, an interest rate cap, a futures contract, a forward contract, or an option."

"Basis swaps" are being frequently utilized, in a variety of contexts, with respect to tax-exempt bonds, and uncertainty exists regarding their treatment as a qualified hedge, particularly with respect to satisfaction of the primary purpose rule of Treas. Reg. §1.148-4(h)(2)(i)(A).

A basis swap is a contract where an issuer agrees to make payments based on one floating rate index in return for receiving payments based on another floating rate index. The term "basis" refers to risk that the difference between the two floating rate indices may change over time. A counterparty may enter into a basis swap to effectively convert a stream of floating rate cashflows into a different floating rate stream. Basis swaps are utilized in a variety of ways.

A common transaction utilizing basis swaps involves a State or local governmental unit which issues variable rate bonds and enters into an interest rate swap where the governmental issuer pays a fixed rate and receives a variable rate based on an index (*e.g.*, LIBOR). At the same time or later, the issuer also enters into a basis swap (*e.g.*, a swap where the issuer pays a variable rate based on LIBOR and receives a variable rate based on the SIFMA index). The net result of the two swaps is the same as if the issuer had entered into a single variable to fixed swap based on the SIFMA index (which clearly could be subject to simple integration under Treas. Reg. §1.148-4(h)). NABL understands, however, that some counsel are uncertain whether such a basis swap meets the primary purpose rule stated above. Therefore, NABL recommends clarification that, where the basis swap is entered into for the purpose of hedging the interest rate changes with respect to a bond subject to a qualified hedge, the transaction meets the primary purpose rule, because it is economically similar to an issuer hedging interest rate changes on the bonds; the treatment of the two types of transactions should be the same.

Specifically, to address the above issue, NABL recommends that Treas. Reg. §1.148-4(h)(2)(i)(A) be modified to read as follows—

> The contract is entered into primarily to modify the issuer's risk of interest rate changes with respect to a bond (a hedge). For example, the contract may be an interest rate swap, an interest rate cap, a futures contract, a forward contract, or an option. A contract entered into primarily to modify an issuer's risk of interest rate changes with respect to a bond and an existing qualified hedge can be a qualified hedge. (*Underlined portions added.*)

Basis swaps are utilized for other purposes which raise issues under the primary purpose rule. For example, Issuer 1, with outstanding fixed rate bonds, may enter into a basis swap, because it may be able to obtain some interest rate savings by reason of the swap without refinancing its bonds. An example of such a basis swap would be where the issuer pays a SIFMA based rate and receives a LIBOR based rate. The issuer could have savings in this transaction because it is assuming the "tax risk" that the spread between the SIFMA index and the LIBOR index could decrease, *e.g.*, as a result of tax law changes, and the issuer could have lower overall payments as a result of taking on this risk. After entering into the basis swap, Issuer 1 may be in a similar economic position as Issuer 2, who refunds the old fixed rate bonds with new variable rate bonds and enters into a hedge where it pays a fixed rate and receives a variable rate based on the LIBOR index. Issuer 1 would have, however, saved the costs of issuing new debt and the support costs associated with variable rate bonds. However, whether payments made or received pursuant to a basis swap in this context may be integrated with the yield on an issuer's outstanding tax-exempt bonds remains unclear.[3] Payments under a basis swap reflect the changes in two floating rates, not a fixed rate and a floating rate. Given the economic similarity in this example to issuing variable rate debt and entering into a hedge where the issuer pays a fixed rate and receives a rate based on a variable rate index (which can be a qualified hedge), NABL recommends that an issuer be permitted to integrate such a basis swap. To permit the integration of such basis swaps, NABL recommends that Treas. Reg. §1.148-4(h)(2)(i) be amended by adding: "A hedge contract entered into to reduce the issuer's cost of borrowing can be a qualified hedge." after the last sentence of NABL's suggested language described above.

[3] Basis swaps may also raise issues under other provisions such as the "interest based contract" provision of Treas. Reg. §1.148-4(h)(2)(v)(B).

Permitting integration of basis swaps would also provide much needed certainty. Under the current regulations, issuers and their counsel are not certain that basis swaps may be integrated (as described above), but at the same time are also concerned that the IRS could "force" integration under Treas. Reg. §1.148-10(e). Thus, issuers are in the untenable position of having to assume the "worst case scenario" in terms of integrating or not integrating.

Acquisition Payments. Treas. Reg. §1.148-4(h)(2)(i)(C) provides that, based on a certificate of the hedge counterparty, a single nonperiodic payment from the counterparty to the bond issuer may be separated from the hedge component of the contract so that what remains is a qualified hedge.[4] Many issuers desire to contract for two, three or four payments to be received on different dates. Such contracts have posed a problem under the current regulatory framework due to the single nonperiodic payment requirement. NABL believes that multiple-date payments are not inherently abusive, and therefore, should not be treated differently from a single nonperiodic payment. Thus, NABL recommends that the single payment rule be expanded to allow a limited number of fixed payments on different dates to the issuer. To reduce compliance burdens, NABL also recommends that the evidence permitted to justify treating a portion of such a contract as a qualified hedge (Treas. Reg. §1.148-4(h)(2)(i)(C)) be expanded to include third party certifications and verifiable market information, rather than the current rule that only a certificate from the counterparty is sufficient.

B. Investment Element Rule.

General Issues. Treas. Reg. §1.148-4(h)(2)(ii) provides that a "qualified hedge," which can be integrated for purposes of computing the yield on the tax-exempt bond issue, must not contain a "significant investment element." The Treasury Regulation further provides that a contract contains a significant investment element if "a significant portion of any payment by one party relates to a conditional or unconditional obligation by the other party to make a payment on a different date." Treas. Reg. §1.148-

[4] The theory of this provision is that, in substance, by making the payment, the hedge provider is providing a deemed loan to the issuer, which must be separated from the portions of the contract that constitute a qualified hedge for purposes of computing yield on the bonds.

4(h)(2)(ii)(A) provides the following examples of contracts that contain a significant investment element: a debt instrument held by the issuer, an interest rate swap requiring any payments other than periodic payments within the meaning of Treas. Reg. §1.446-3, and an interest rate cap with a single up-front premium. Applying these rules to the swap market creates several issues.

First, interest rate swaps often provide for one party to make monthly payments and the other party to make quarterly or semi-annual payments. To clarify that such insignificant differences in the timing of payments do not raise issues under the "no significant investment element" rule, NABL recommends that the Treasury Regulations allow mis-matching of the payment dates to correspond with existing market practices.[5]

To address the above-raised concern, NABL specifically recommends that Treas. Reg. §1.148-4(h)(2)(ii)(A) be modified to read as follows—

> The contract does not contain a significant investment element. Except as provided <u>in this paragraph (h)(2)(ii)(A)</u> or paragraph (h)(2)(ii)(B) of this section, a contract contains a significant investment element if a significant portion of any payment by one party relates to a conditional or unconditional obligation by the other party to make a payment on a <u>significantly</u> different date. <u>For this purpose, a date that is within 200 days of another date does not constitute a significantly different date.</u> Examples of contracts that <u>may</u> contain a significant investment element are a debt instrument held by the issuer; an interest rate swap requiring any payments other than periodic payments, within the meaning of § 1.446-3 (periodic payments) (e.g., a payment for an off-market swap or prepayment of part or all of one leg of a swap); and an interest rate cap requiring the issuer's premium for the cap to be paid in a single, up-front payment. (*Underlined portions added.*)[6]

[5] Similarly, Treas. Reg. §1.148-1(e)(2)(i)(A)(2) specifically treats prepayments of less than 90 days as not creating investment property. NABL recommends that accommodation be made for a longer *de minimis* period of up to 200 days for quarterly (actual calendar quarters can have up to 93 days) and semi-annual payments, in order to accommodate the common circumstance of swaps with semi-annual fixed payments and monthly variable payments.

[6] The last example regarding caps should be deleted if NABL's comment provided below on interest rate caps is adopted.

Alternatively, the regulations could be modified to specifically provide that a swap, the payments on which consist exclusively of periodic payments within the meaning of Treas. Reg. §1.446-3, does not contain a significant investment element.

Second, the paradigm qualified hedge is one in which the hedge provider pays the borrower the actual rate of interest on its bonds. Because of ambiguities in the definition of periodic payments in Treas. Reg. §1.446-3,[7] if the language of Treas. Reg. §1.148-4(h)(2)(ii)(A) pertaining to the examples of contracts containing "investment elements" were read strictly, the payment by a hedge provider of the issuer's actual interest rate payments on its bonds may not be periodic payments for purposes of that section and thus cause an investment element to arise for qualified hedge treatment. To remedy such issue, NABL recommends the addition of the word "may" to the fourth sentence of the Treasury Regulations (as suggested above).

Third, to better effectuate understanding of the Treasury Regulations, NABL recommends placing the "acquisition payments" rule in Treas. Reg. §1.148-4(h)(2)(i)(C) (previously discussed), which allows a hedge provider to, in substance, make a deemed loan to an issuer by making an up-front payment to the issuer (which is an "investment element" by the hedge provider) under the provisions relating to the investment element rule in Treas. Reg. §1.148-4(h)(2)(ii).

Interest Rate Caps. With respect to the "no significant investment element restriction," Treas. Reg. §1.148-4(h)(2)(ii)(B) contains a special rule regarding interest rate caps. The Treasury Regulation provides that such a cap will not be considered to have a significant investment element if (1) all payments to the issuer by the hedge provider are periodic payments, (2) the issuer makes payments on the cap at the same time as periodic payments are made by the hedge provider, and (3) payments on the cap are made by the issuer generally under a formula which requires the payment of cap premiums to be spread over the life of the cap.

[7] Treas. Reg. §1.446-3(e) defines "periodic payments" by cross-referencing Treas. Reg. §1.446-3(c)(2)(i), (iii), and (iv) which refer only to certain fixed rates or indexes.

In the existing financial market, payments on caps are customarily made in single up-front payments. Consequently, under present law, interest rate caps seldom qualify for integration, because an interest rate cap purchased by payment of an up-front premium is deemed to include an impermissible "significant investment element." Additionally, bond counsel are concerned that, by reason of the up-front premium, such an imputed element (which is treated as an investment)[8] may be considered part of a sinking fund subject to arbitrage yield restriction under Treas. Reg. §1.148-2. Issuers could be faced with the difficult task of attempting to ascertain the yield on the imputed investment element for purposes of determining compliance with yield restriction (or determining yield reduction payments). Consequently, NABL recommends that the rules related to interest rate caps be changed to allow commercially customary interest rate cap transactions with up-front premiums be treated as qualified hedges.

For a hedge to have a significant investment element, that investment element should be properly classified as investment property. NABL notes that under Treas. Reg. §1.148-1(e)(2)(i)(A)(1), a prepayment is not investment property, if it is customary. In today's derivative market, the vast majority of interest rate caps purchased by for-profit corporations and others not benefiting from tax-exempt bonds involve single purchase premiums paid before the effective dates of the hedges. Thus, NABL believes that single payment premiums for caps are customary and should not result in an imputed investment element, with the exception of caps which, by their terms, clearly indicate an investment element as described below.

If the strike rate for a cap is low enough, the cap may, in substance, be similar to an obligation. For example, if the rate on a cap agreement was 1% in a market where the capped variable rate was 3% and expected to remain above 2% for a considerable period of time, the 1% cap would, in effect, be a promise of the counterparty to pay 1% to 2% or more, and would, in effect, be a debt instrument. The principal reason to purchase such a low interest rate cap would be to achieve a return. However, if in the same environment, a variable rate bond issuer purchased a 9% cap, there would be no expectation of return.

[8] Treas. Reg. §1.148-1(e)(3) provides that the investment element of a hedge is treated as investment property for purposes of the yield restriction and rebate limitations of Section 148.

The principal purpose of such a purchase would be to protect the bond issuer against an unexpected contingency (*i.e.*, unexpected and dramatic increase in interest rates), much as an insurance policy provides protection. Thus, NABL recommends that the Treasury Regulations distinguish, on the basis of the strike rate of the cap vis-à-vis the expected rate on the hedged bonds, between up-front payment caps that do and do not have significant investment elements.

To assure that the cap is not being purchased for a principal purpose of generating a return, NABL notes that a strike rate must be sufficiently high (a test requiring some subjectivity). The 1993 version of the Treasury Regulations did include such a rule: Treas. Reg. §1.148-4(h)(2)(i)(B) provided that the cap rate should be at least the "on market swap rate" for the period covered by the cap. NABL believes that this is a fair rule and recommends it be added back to current Treasury Regulations.[9]

NABL believes that interest rate caps are common and routine and that as a result, the regulatory provisions relating to them are in need of change to align the provisions more closely to general market practice and to provide simple, administrable rules.

C. Hedged Bonds Rule.

To be a qualified hedge, Treas. Reg. §1.148-4(h)(2)(iv) provides that the contract must cover "in whole or in part, all of one or more groups of substantially identical bonds in the issue (*i.e.*, all of the bonds having the same interest rate, maturity, and terms). Thus, for example, a qualified hedge may include a hedge of all or a pro rata portion of each interest payment on the variable rate bonds in an issue for the first five years following their issuance. For purposes of this paragraph (h), unless the context clearly requires otherwise, hedged bonds means the specific bonds or portions thereof covered by a hedge."

[9] If this recommendation is not adopted, NABL notes that other criteria could be included in the Treasury Regulations as alternatives, such as: (i) the cap rate should be at least 1% above the current value of the variable rate; (ii) the cap rate should be at least as high as the highest value for the variable rate for the historical 5-year period ending on the purchase date of the cap; or (iii) the bond issuer or obligor purchasing the cap should reasonably not expect to receive payments under the cap in excess of the cap premium.

The current wording of the above paragraph implies that a qualified hedge must cover the entire principal amount of whole maturities of bonds in an issue, but not all of the interest on those maturities. This treatment has led to unnecessary drafting complexity, as well as interpretive questions, such as whether two hedges that together meet the rule (but not separately), can be qualified hedges.

To eliminate this needless constraint, NABL recommends that Treas. Reg. §1.148-4(h)(2)(iv) be modified to read as follows—

> The contract covers, in whole or in part, all of one or more groups of substantially identical bonds in the issue (i.e., all of the bonds having the same interest rate, maturity, and terms). Thus, for example, a qualified hedge may include a hedge of all or a pro rata portion of each interest payment on the variable rate bonds in an issue for the first 5 years following their issuance, or may include all or a pro rata portion of the interest on a portion of the principal amount of particular maturities of bonds of an issue. For purposes of this paragraph (h), unless the context clearly requires otherwise, hedged bonds means the specific bonds or portions thereof covered by a hedge. (*Underlined portions added.*)

D. Interest Based Contract Rule.

Treas. Reg. §1.148-4(h)(2)(v) provides that an integrated qualified hedge must be "interest based." Specifically the regulation provides—

> (A) The hedged bond, without regard to the contract, is either a fixed rate bond, a variable rate debt instrument within the meaning of § 1.1275-5 provided the rate is not based on an objective rate other than a qualified inverse floating rate or a qualified inflation rate, a tax-exempt obligation described in § 1.1275-4(d)(2), or an inflation – indexed debt instrument within the meaning of § 1.1275-7; and
>
> (B) As 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 within the meaning of § 1.1275-5 provided the rate is not based on an objective rate other than a qualified inverse floating rate or a qualified inflation rate, a tax-exempt obligation described in § 1.1275-4(d)(2), or an inflation – indexed debt instrument within the meaning of § 1.1275-7. For this purpose, differences that would not prevent the resulting bond from being substantially similar to another type of bond include a difference between the index used to compute payments on the hedged bond and the index used to compute payments on the hedge where one index is substantially the same, but not identical to, the other; the difference resulting from the payment of a fixed premium for a cap (e.g., payments for a cap that are made in other than level installments); and the difference resulting from the allocation of a termination payment where the termination was not expected as of the date the contract was entered into.

The current wording of the second prong ("(B)") of the "interest based contract rule" has led to uncertainty among counsel on whether actual rates on the hedge contract and on the hedged bond must correspond, the degree to which they must correspond, and when they must correspond. For example, one common test applied by some bond counsel is whether the value of the index used on the hedge is within 25 basis points ("bps") of the rate that would be on the bonds on the pricing date of the hedge (by analogy to Treas. Reg. §1.1275-5). Other bond counsel might require pricing studies to demonstrate an expected correspondence within 25 bps (or some other measure) throughout the term of the hedge or pricing studies to show high correlation (*e.g.*, not more than 25 bps difference) for some historical period (*e.g.*, ten-year period prior to the effective date).

NABL notes that, under basic integration, the payments on the bonds and the hedge will all be taken into account in the bond yield, so potential basis differences (the differences between the hedge payments by the provider and the payments on the bonds) will be reflected in the yield calculation and will not provide any arbitrage advantage to

the issuer. Moreover, the hedged bonds rule of Treas. Reg. §1.148-4(h)(2)(iv) explicitly permits hedging less than all of the interest rate risk on bonds, so doing partial hedging through a partial hedge or through a hedge index which involves basis risk should make no difference.

Thus, NABL recommends that Treasury and the IRS consider replacing the "substantially similar" rule with a much simpler rule providing that a hedge will be considered "interest based" if all non-fixed payments are based on a formula that would be a qualified floating rate under Treas. Reg. §1.1275-5(b). Alternatively, if the "substantially similar" rule is not replaced, NABL recommends that Treas. Reg. §1.148-4(h)(2)(v)(B) be modified to read as follows—

> As 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 within the meaning of § 1.1275-5 provided the rate is not based on an objective rate other than a qualified inverse floating rate or a qualified inflation rate, a tax-exempt obligation described in § 1.1275-4(d)(2), or an inflation-indexed debt instrument within the meaning of § 1.1275-7. For this purpose, differences that would not prevent the resulting bond from being substantially similar to another type of bond include a difference between the index used to compute payments on the hedged bond and the index used to compute payments on the hedge where one index is ~~substantially the same~~ similar, but not identical to, the other (in general, any interest rate index that would be a qualified floating rate under § 1.1275-5 is similar to any other index that would be a qualified floating rate under that section); the difference resulting from the payment of a fixed premium for a cap (e.g. payments for a cap that are made in other than level installments); and the difference resulting from the allocation of a termination payment where the termination was not expected as of the date the contract was entered into. (*Underlined language added.*)

In any event, NABL recommends that the "interest based contract" requirement set forth in Treas. Reg. §1.148-4(h)(2)(v)(B) be clarified to permit the integration of basis swaps. Some bond counsel are concerned that an issuer cannot integrate a basis swap with a fixed rate bond (as previously discussed). Specifically, the question remains whether a bond hedged by a basis swap would be substantially similar to a fixed rate bond or a variable rate bond within the meaning of Treas. Reg. §1.1275-4(d)(2). Consequently, NABL recommends that the hedge regulations contain an example that a basis swap executed in connection with a fixed rate bond meets the "interest based contract" requirement of Treas. Reg. §1.148-4(h)(2)(v)(B), because it believes that basis swap transactions are economically similar to other permitted transactions.

E. Deemed Termination Rule.

Treas. Reg. §1.148-4(h)(3)(iv) contains rules regarding the accounting of termination payments relating to qualified hedges. The Treasury Regulations define what constitutes a "termination" and provide that a "termination of a qualified hedge includes any sale or other disposition of the hedge by the issuer or the acquisition by the issuer of an offsetting hedge. A deemed termination occurs when the hedged bonds are redeemed or when a hedge ceases to be a qualified hedge of the hedged bonds."

NABL recommends that the acquisition of an "offsetting hedge" not be treated as a deemed termination. NABL believes that the deemed termination rule could be interpreted as more punitive than the treatment of hedge terminations under the "super integration" rule of Treas. Reg. §1.148-4(h)(4). Treas. Reg. §1.148-4(h)(4)(iii)(C) seems to provide that, if a qualified hedge that is super integrated is terminated, the issuer can use any termination payment made or received to acquire a replacement hedge without affecting the bond yield. *See* Treas. Reg. §1.148-4(h)(iii)(C) (the general termination rule does not apply if "based on the facts and circumstances (e.g., taking into account both the termination and any qualified hedge that immediately replaces the terminated hedge), there is no change in yield."). Thus, NABL believes that one could infer that a super integrated swap can be terminated and replaced without adversely affecting the bond yield for arbitrage or rebate purposes.

One of the most difficult aspects of the deemed termination rules is that the term "offsetting hedge" is not defined in the Treasury Regulations under Section 148 (or elsewhere in the Code or Treasury Regulations). As a result, bond counsel are concerned that an issuer's execution of a second swap transaction to hedge interest rate risk on a hedged bond issue, where simple integration is utilized, will cause a deemed termination of the original swap. This concern is heightened because the consequences of a deemed termination are unclear: a deemed termination payment made by the hedge counterparty to the issuer could affect the bond yield; a deemed termination payment made by the issuer to the hedge counterparty could be treated as investment property. And, the fair market value rules set forth in Treas. Reg. §1.148-5(d) are difficult to apply to deemed hedge termination payments. These problems are particularly acute with respect to the acquisition of a "basis swap" to hedge a bond subject to a qualified hedge where the issuer makes fixed payments in return for receiving floating payments. Thus, in order to provide needed certainty in this area, NABL recommends that the acquisition of an offsetting hedge not be treated as a termination of the hedge, and in order to prevent any potential abuse, that issuers be required to integrate any offsetting hedge of a previously integrated qualified hedge.[10]

NABL believes that a requirement for integration of offsetting hedges will minimize any potential for improper distortions of bond yield. For example, assume an issuer issues long-term variable rate bonds and enters into an integrated 30-year swap, where the issuer pays a fixed (30-year) rate and receives a LIBOR based rate. Assume several years later, the issuer enters into a second swap ending on the termination date of the first swap. Assume this second swap has the same notional amount and amortization as the first swap, and the issuer agrees under this swap to pay the same LIBOR based rate as on the first swap and receive a fixed rate. NABL believes, in this instance, that the issuer should be required to integrate the payments on the second swap to avoid an improper distortion of bond yield. NABL further believes that any potential abuses under this rule should be dealt with under Treas. Reg. §1.148-10(e). NABL recognizes that the problem of defining an offsetting hedge would still exist, but issuers would take comfort

[10] If the offsetting hedge rule is not eliminated, NABL notes that the term "offsetting hedge" requires clarification, as the Code provides few useful analogies. NABL would be pleased to provide further information regarding possible definitive methods, if requested.

in knowing that, if they integrate the new hedge, they generally will be in compliance (whether treated as an offsetting hedge or simply a new qualified hedge).

F. Super Integration.

Treas. Reg. §1.148-4(h)(4) treats variable rate bonds as fixed yield bonds (subject to super integration), if the issuer hedges those bonds with a qualified hedge meeting certain additional requirements — (1) a maturity requirement, (2) a requirement that payments closely correspond, and (3) a requirement that the aggregate payments on the bonds and the hedge be fixed and determinable. This third requirement, the "aggregate fixed payments requirement," is more stringent for super integration than the interest based contract rule for simple integration.[11]

Treas. Reg. §1.148-4(h)(4)(i)(C) provides that "[t]aking into account all payments made and received under the hedge and all payments on the hedged bonds (i.e., after netting all payments), the issuer's aggregate payments are fixed and determinable … [p]ayments on bonds are treated as fixed for purposes of this paragraph … 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. For example, an objective 30-day tax-exempt variable rate index or other objective index may be substantially the same as an issuer's individual 30-day interest rate."

In recent years, most swaps hedging tax-exempt obligations have been LIBOR based swaps. Due to uncertainty as to the interpretation and application of the above language, particularly with respect to the use of LIBOR based swaps, issuers, advisors, bankers, and counsel have become reluctant to utilize super integration. Instead, simple integration is more frequently utilized. When a variable yield bond issue that is hedged by a LIBOR based swap is issued to advance refund previously issued tax-exempt bonds,

[11] *See* II D for a discussion of simple integration.

a variety of strategies have been employed to maintain escrow yield compliance.[12] The most common strategies are actively managing the escrow yield and/or establishing a sinking fund to blend down yield on investments in the escrow, if necessary. In cases of significant negative arbitrage in the escrow, some counsel have taken the view that no reasonable expectation of violating the yield restriction rules could occur.

NABL believes that the practical inability to utilize super integration for LIBOR based swaps has produced a great deal of complexity for very little purpose. NABL has previously proposed in its submission, dated April 12, 2006, that yield reduction payments be permitted in connection with advance refundings. If yield reduction payments are not permitted, NABL proposes that the super integration rule be modified so that fixed yield bond treatment under that rule would apply only for purposes of Treas. Reg. §1.148-2 (yield restriction), and not for purposes of Treas. Reg. §1.148-3 (rebate). In that way, an advance refunding escrow would already be largely yield compliant, but positive basis differences between the bonds and the hedge could simply be rebated to the government. NABL also proposes that the preamble to any such change state that, in light of its purpose, the revised super integration rule should be liberally construed.

G. Anticipatory Hedges.

Treas. Reg. §1.148-4(h)(5) provides for special rules for integration of hedges entered into before the issue date of the applicable tax-exempt bond. The current regulatory provisions relating to anticipatory hedges state that the issuer must, at the time of identification, ascertain and state (*i.e.*, certify) whether it anticipates terminating the hedge contemporaneously with the issuance of the bonds. Two common types of anticipatory hedges (each used as an alternative to advance refundings) are a forward starting swap and a swap option (commonly called a swaption).[13] In each case, the bond issuer has a choice of either (a) issuing variable rate bonds and allowing the swap to effectively fix the rate on the bonds, or (b) issuing fixed rate bonds and terminating the

[12] These strategies are necessary because, under simple integration, the bond issue is treated as a variable yield issue, and, as of the date of issue, the bond yield is not fixed and determinable for purposes of restricting the yield on an advance refunding escrow.

[13] A forward starting swap is an interest rate swap that is priced far in advance of its effective date. A swap option is a hedge where the holder of the option has a right to enter into an interest rate swap effective on a future date.

swap as the bonds are issued. The issuer will decide which alternative to pursue based on many market factors, but, not infrequently, at the time that the hedge is entered into, the issuer does not know which action it will take. NABL sees no policy reason for requiring issuers to certify as to an expectation that may or may not exist. Accordingly, NABL recommends that an issuer not be required to certify about which outcome is more likely, when neither is a forgone conclusion.

H. Miscellaneous – Hedge Insurance.

For the past several years, the most common municipal derivative transaction has involved an issuer of tax-exempt variable rate bonds entering into an interest rate swap to reduce the issuer's risk of rising short term interest rates. The situation often arises that a bond insurer will insure both the tax-exempt variable rate bonds and the associated interest rate swap. If the interest rate swap meets all of the requirements of a qualified hedge under Treas. Reg. §1.148-4(h), most counsel treat the entire insurance premium as a qualified guarantee pursuant to Treas. Reg. §1.148-4(f). This treatment is consistent with the treatment of qualified hedge payments and receipts as "payments made or received on the bonds."

Further, NABL understands that the arbitrage yield on tax-exempt bonds would be higher, if the bond insurer only insured the bonds. NABL understands that the bond insurer typically charges a lower premium, when it insures both the bonds and the associated swap, presumably because the bond insurer is taking less interest rate risk, when it also insures the associated swap. Other transaction participants, including the swap counterparty and the liquidity provider for the variable rate bond, may condition their approval of the transaction or lower their fee, if the issuer obtains insurance for the interest rate swap in addition to the bonds.

To clarify existing market practice regarding the arbitrage treatment of insurance premiums allocable to qualified hedges, NABL recommends that Treas. Reg. §1.148-4(f)(1) be modified to read as follows—

> Fees properly allocable to payments for a qualified guarantee for an issue (as determined under paragraph (f)(6) of this section) are treated as additional interest on that issue for purposes of section 148. <u>For purposes of this section, "issue" includes any qualified hedge allocable to the issue.</u> A guarantee is a qualified guarantee if it satisfies each of the requirements of paragraphs (f)(2) through (f)(4) of this section. (U*nderlined language added.*)

III. Conclusion

In conclusion, NABL strongly supports the efforts of the IRS and the Department of the Treasury to revise the regulatory provisions relating to qualified hedges. NABL has suggested clarifying changes to several portions of Treas. Reg. §1.148-4(h). NABL believes that such efforts will lead to both enhanced compliance by issuers and more efficient administration by the IRS.

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