National Association of Bond Lawyers

PHONE 202-682-1498
FAX 202-637-0217
www.nabl.org

601 Thirteenth Street, N.W.
Suite 800 South
Washington, D.C. 20005

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Executive Director
KENNETH J. LUURS
230 West Monroe Street
Suite 320
Chicago, IL 60606-4715
Phone 312-648-9590
Fax 312-648-9588

October 6, 2008

John J. Cross, III
Associate Tax Legislative Counsel
Department of the Treasury
1500 Pennsylvania Avenue NW
Room 4212B MT
Washington, DC 20220

RE: Measures to Alleviate Current Market Hardships for Issuers of Tax-Exempt Bonds

Dear John:

Thank you again for your participation in the Bond Attorneys' Workshop (Workshop) in Chicago. We appreciated tremendously your effort and contribution to the Workshop.

I have enclosed recommendations by the National Association of Bond Lawyers (NABL) for action by the Department of the Treasury and Internal Revenue Service to relieve various difficulties caused by current market conditions in the tax-exempt bond market.

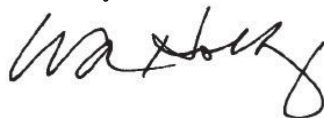
NABL applauds the actions already taken by the government with respect to the federal guarantee rule and the rules relating to issuer purchases of their own bonds. Both these matters are discussed further in the enclosed, but this discussion does not in any way detract from our thanks for the big steps you have already taken.

Primary drafting responsibility for the recommendations was assumed by Frederic L. Ballard, Jr., Perry E. Israel, and Scott R. Lilienthal, of NABL’s Tax Committee. Other participants in preparing the recommendations are identified in an attachment to the recommendations.

If you have any questions, please contact me at 404-572-4663 or through email at bholby@kslaw.com, or Frederic L. Ballard, Jr., at 202-661-2210 or through email at flb@ballardspahr.com.

Thank you again for the opportunity to submit these recommendations.

Sincerely,



William A. Holby

Enclosures

cc: Eric Solomon
Donald L. Korb
Clifford J. Gannett
James A. Polfer
Members of the NABL Task Force on Current Market Conditions

RECOMMENDATIONS BY THE
NATIONAL ASSOCIATION OF BOND LAWYERS
TO THE
DEPARTMENT OF THE TREASURY
OFFICE OF TAX POLICY
AND THE
INTERNAL REVENUE SERVICE
REGARDING
MEASURES TO ALLEVIATE CURRENT MARKET HARDSHIPS
FOR ISSUERS OF TAX-EXEMPT BONDS

OCTOBER 6, 2008

The National Association of Bond Lawyers ("NABL") submits the following recommendations for measures that could alleviate the hardship for issuers of tax-exempt bonds from current conditions in the financial markets. These comments were prepared by a task force the members of which are listed on the attached.

Hedge Counterparty Difficulties

If the counterparty to a qualified hedge suffers a ratings downgrade or files in bankruptcy, the bond issuer may have to take a variety of steps in order to protect itself, including arranging an assignment of the hedge to a new counterparty. Treas. Reg. § 1.148-4(h)(3)(iv)(A) provides that an assignment or any other modification is treated as terminating the hedge if it results in a deemed exchange of the hedge for purposes of section 1001. Treas. Reg. § 1.1001-4(a) provides in turn that an assignment of a notional principal contract is not treated as a deemed exchange if both the assignor and the assignee are dealers and the terms of the contract permit the assignment. This regulation does not impose an explicit requirement that there be no change in the provisions for the fixed or floating rates, but this requirement appears to be implicit in the concept of an assignment: *i.e.*, no change in terms.

Notice 2008-41, section 5.1, is helpful in providing that modification of a qualified hedge does not terminate the hedge if the modification is not reasonably expected to change the yield on the hedged bonds by more than 25 basis points and the payments on the hedge, as modified,

are taken into account as adjustments to the yield on the hedged bonds for arbitrage purposes under section 148. NABL believes the principle of the notice should be extended to apply specifically to assignments, including assignments of contracts that do not have language permitting an assignment under § 1.1001-4. This goal could be accomplished by replacing the last sentence of § 1.148-4(h)(3)(iv)(A) with the following:

> In the case of an assignment by a hedge provider of its remaining rights and obligations under the hedge to a third party or a modification of the hedging contract that is not expected to change the yield on the affected hedged bonds over their remaining term, the assignment or modification is not treated as a termination with respect to the issuer of the hedged bonds for purposes of § § 1.148-4(h) and 1.1001-4. Further, if the assignment or modification is expected to affect the yield on the affected hedged bonds but not by more than 25 basis points (0.25%) per annum, the assignment or modification is not treated as a termination with respect to the issuer of the hedged bonds for purposes of § § 1.148-4(h) and 1.1001-4 if all payments and receipts on the qualified hedge, as modified, including payments and receipts in connection with the assignment itself, are taken into account in determining the yield on the hedged bonds for purposes of section 148.

This amendment would avoid the need for the issuer to deal with the termination rules (including disqualification of the hedge from super integration for terminations within the first five years) in this situation in which from the issuer's standpoint there has been a continuation of substantially the same hedge rather than a termination.

Refundings of Hedged Bonds

The general rule under § 1.148-4(h)(3) is that a redemption of hedged bonds (or a disqualifying amendment to the terms of a hedge) causes a "deemed termination" of the hedge. As clarified by the proposed regulations of September 26, 2007, a deemed termination is treated as giving rise to a deemed termination payment equal to the fair market value of the hedge on the date of the termination. Actual or deemed termination payments are taken into account under the arbitrage rules as if they were payments made or received on the hedged bonds, except that in the case of a refunding, the payments are treated as made with respect to the refunding bonds rather

than the refunded bonds. These rules apply both to "simple integration" hedges under § 1.148-4(h)(3) and "super integration" hedges creating fixed rate bonds under § 1.148-4(h)(4), with the addition of special rules that would permit a super integration swap that has been in place for more than five years to be terminated without upsetting the fixed-rate character of the hedged bonds for purposes of yield restriction on investments.

On occasion, parties will refund a hedged bond issue and keep the hedge in effect rather than terminating it. If the refunding bonds have a similar interest rate structure to the refunded bonds (for example, tender option bonds in the same interest rate mode), the issuer may want to "reidentify" the hedge to the refunding bonds and integrate with them for tax purposes. NABL believes that it is a natural reading of the deemed termination rules to conclude that there is a deemed novation of the hedge if it continues after the deemed termination and that an issuer accordingly may identify the deemed "new" hedge under § 1.148-4(h)(2)(viii) within three days after the deemed termination. If the hedge at the time of the deemed termination has a negative value to the issuer (for example, because the fixed rate payable by the issuer is above the current market rate, so that to accomplish an actual termination, the issuer would have to make a payment to the hedge provider), the regulations provide for that negative value to be treated as if it were an actual payment by the issuer, and the regulations further provide that this deemed payment is taken into account for yield purposes as a payment with respect to the refunding bonds, thus increasing their yield. Similarly, if the deemed hedge termination payment would come from the counterparty to the issuer, the deemed receipt is taken into account for yield purposes with respect to the refunding bonds, thus decreasing their yield.

If the hedge is "reidentified" to the refunding bonds, there are two possible situations. First, if there would be a deemed termination payment with respect to the hedge, there will also be a deemed acquisition payment for the novated hedge—that is, the hedge will be off-market in favor of the counterparty. Under § 1.148-4(h)(2)(i)(C), the issuer and hedge provider will need to identify the amount of the deemed acquisition payment and only take into account the amount of the hedge payments that represent the "on market" portion of the hedge in computing yield on the refunding bonds. While not specifically stated in the regulations, NABL believes that economic consistency requires that the termination value of the "old" hedge upon redemption of the refunded bonds be equal to the acquisition value for "new" hedge upon issuance of the refunding bonds and identification of the hedge to them. Because the yield on the refunding

bonds is also computed by taking into account the deemed termination payment, there are in effect two, offsetting constructive payments: one in connection with the constructive termination of the old hedge and one in connection with the constructive acquisition of the new hedge. Requiring that the deemed termination payment and the deemed acquisition payment be the same will insure that there is no technical difference in the two values because of a difference, e.g., in the bid and ask costs for interest rate swaps (which would otherwise result in unnecessary complication and confusion to issuers and bond counsel).

Second, if the direction of the deemed acquisition payment on the new hedge is from the issuer to the hedge provider (i.e., the deemed termination payment would be from the hedge provider to the issuer), some counsel have been concerned that such a deemed acquisition payment will result in the new hedge having a significant investment element and therefore not qualify for integration treatment (in contrast to a deemed acquisition payment from the hedge provider to the issuer, which under § 1.148-4(h)(2)(i)(C) can be treated as a taxable loan that is separate from the qualified hedge). NABL believes that this result unfairly requires the issuer to actually terminate the swap and enter into a new hedge at market.

In addition, some counsel have been concerned whether the issue date of the refunding issue or the redemption date(s) of the refunded bonds is the date on which the deemed termination and novation of the hedge occurs. Using the issue date of the refunding issue as the deemed termination and novation date would generally produce a cleaner result as the qualified hedge would be transferred in one piece at one market level to the new issue on its issue date as opposed to in tranches as the various redemption dates occurred (which is common in multiple-series auction rate and tender bond issues).

In these situations, NABL believes that it would be clearer and simpler to make a special rule for cases where the hedge is reidentified to the refunding bonds, along the following lines:

> In the event that bonds hedged by a qualified hedge are refunded and the issuer properly identifies the hedge to the refunding bonds, the hedge shall be deemed to terminate from the refunded bonds on the issue date of the refunding bonds at a value equal to its fair market value and to transfer to the refunding bonds at the same value, and there shall be no deemed termination payment and no significant investment element under § 1.148-4(h)(2)(ii) by either

> party. Any amount paid subsequently to terminate the hedge shall be taken into account as a termination payment with regard to a qualified hedge rather than as a repayment of the value at which the hedge was transferred in connection with the refunding and shall qualify for financing with the proceeds of tax-exempt bonds as a capital expenditure under § 1.150-1(b).

This rule, which could be added to the existing special rules for refundings in § 1.148-4(h)(3)(iv)(D) would operate similarly to an existing provision in the termination rules for super integrated hedges, which states that terminations will be disregarded if the terminated hedge is immediately replaced with a new qualified hedge and under all the facts and circumstances there is no change in yield (§ 1.148-4(h)(4)(iii)(C)). The language we suggest assumes that Treasury will accept our suggested method for dealing with bond eligibility of termination payments, set forth below.

Finally, some counsel have questioned the treatment of deemed termination payments in connection with taxable refundings and series of refundings. For example, in the context of a taxable refunding is a deemed termination payment counted toward the yield on the refunded bonds regardless of whether a subsequent tax-exempt refunding is planned or can the novated hedge be hypothetically integrated into the interim taxable refunding such that ultimately it may be integrated into another tax-exempt refunding? To alleviate this concern and capture the economic substance of the ultimate arrangement (*i.e.*, a tax-exempt refunding with a hedge), NABL recommends adding language to § 1.148-4(h)(3)(D) to clarify that a "refunding" under that paragraph includes a taxable refunding to the extent that the issuer reasonably expects to refund the interim taxable refunding with an issue of tax-exempt obligations.

<u>Integration in Failed Remarketings</u>

It is not clear under the current regulations whether or when a change in interest rate mode for multimodal bonds will be treated as an event that disqualifies a hedge that was previously treated as a qualified hedging transaction.[1] Accordingly, questions have arisen as to

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[1] Although Treas. Reg. § 1.148-4(h)(3)(iv)(A) does not say that a change in interest rate mode will cause a deemed termination, concerns have arisen over whether there will be a deemed termination if the issuer takes an "intentional act" that, if expected at the time

whether the integration of a qualified hedge can survive a failed remarketing and subsequent transfer (or pledge) of the bonds to a letter-of-credit bank, with a conversion of the bond interest to a "bank rate." As soon as markets stabilize, the bonds are expected to be remarketed in an authorized mode. In the alternative, a failed remarketing could result in an issuer converting the bonds to another interest rate period until the markets return to normal or the bonds can be remarketed. NABL believes that, at the least, these changes should not result in loss of integration when rate changes on the bonds are due to events beyond an issuer's control such as failed remarketings. To deal with this problem, the following language could be added as a new paragraph after the existing Treas. Reg. § 1.148-4(h)(3)(iv)(E):

> (F) A hedge will not terminate or cease to be a qualified hedge merely because, following a good faith effort to remarket hedged bonds, (i) the interest rate on the bonds is converted to an alternate rate in accordance with the terms of the bonds, or (ii) the interest rate period on the bonds is converted from a period that does not exceed one year to some other period that also does not exceed one year.

This change clarifies that a conversion to a bank bond rate or to a different short-term mode, if made in response to a failed remarketing, will not disqualify the hedge, notwithstanding that the hedge may no longer meet the "substantial similarity" criteria of Treas. Reg. § 1.148-4(h)(2)(v)(B) as a result of the rate or interest rate period conversion.

Financing Termination Payments

The accounting regulations currently provide that payments for a qualified hedge for the issue are not treated as working capital expenditures for purposes of the "proceeds spent last" rule (§ 1.148-6(d)(3)(ii)(2)). This language readily applies to a termination payment as well as an acquisition payment, but it is not as clear that it establishes generally that a termination payment can be treated as a capital cost, and if so, of what, for general purposes of bond eligibility. Further, the limitation to a hedge "for the issue" reduces the utility of the rule in the common case of a termination that occurs substantially after the issuance of the bonds and the expenditure of proceeds, or in the case of termination of an anticipatory hedge substantially before the

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the hedge was originally entered into would have resulted in the hedge not meeting the requirements of 1.148-4(h)(2)(v)(B). The Treasury Department may want to address this specific issue as well.

issuance of the hedged bonds. This problem could be relieved by eliminating the cited reference to qualified hedges in the accounting regulations and adding language along the following lines to the definition of capital expenditure in § 1.150-1(b):

> Payments for a qualifying hedge (other than periodic payments within the meaning of § 1.446-3), whether made from proceeds of the hedged issue or another issue and including termination payments, shall be treated as made for a capital expenditure with respect to the facilities or purposes financed by the hedged issue.

This language would allow a termination payment to be paid with the proceeds of a tax-exempt bond issue, with the proceeds of a taxable borrowing that is subsequently refunded with a tax-exempt issue, or with "equity" that could be subsequently reimbursed from the proceeds of a tax-exempt issue (assuming compliance with the requirements of a prior official intent and the timing requirements of the regulations for reimbursement bonds). It would also provide similar treatment for both governmental purpose bonds and qualified private activity bonds.

Financing a Reserve Fund to Replace a Surety Bond

Bond indentures commonly allow issuers to purchase a surety bond in lieu of using cash to fund a debt service reserve fund for a bond issue. Such indenture provisions typically provide that if the credit rating of the provider of the surety bond goes below a specified level, the issuer is required to either replace the surety bond with a new surety bond from a provider having the required credit rating or fund the debt service reserve fund with cash. In light of the recent downgrades of many insurers, many issuers are being required to replace reserve fund surety bonds with cash, and would like to issue tax-exempt bonds to finance such amounts. Unfortunately, the prohibition in section 148(d)(2) on using more than 10 percent of the proceeds of an issue to fund a debt service reserve fund seems to prevent issuers from doing a stand-alone bond issue to fund the debt service reserve fund. Since an issuer could have funded a debt service reserve fund upon initial issuance of the bonds, NABL believes that the issuer should not be penalized for instead having used a surety. In this situation, NABL recommends that the 10% limit on using proceeds of an issue to fund a debt service reserve fund be applied by looking at both the amount of bonds originally issued and the amount of bonds subsequently issued to fund the debt service reserve fund upon downgrade of the surety bond provider. A similar rule should

apply for purposes of determining whether 95% of net proceeds of an issue of exempt facility private activity bonds are considered used for qualifying project costs.

Financing a reserve fund for one issue with the proceeds of another is, in substance, a special application of the proposed regulations on allocation and accounting rules. In the framework of these rules, the cost of the reserve fund is a "common cost" that is part of the same "project" as the underlying capital or working capital costs. See Prop. Treas. Reg. § 1.141-6(a)(3) and 1.141-6(i). The overall project, including the reserve fund, is being financed with two issues instead of one, but if all costs are prorated between the two issues, the reserve fund qualifies readily within the 10% limit on use of proceeds of the combined issues.

Termination of Escrow Float Contracts

An issuer that enters an escrow float contract will calculate its investment yield by including the initial receipt from the contract, the disbursements to purchase the scheduled investments, and the receipts from the scheduled investments at their maturity. If the contract is terminated, the issuer will generally have to take some further action to deal with the increase in yield that would result from losing the effective 0% investment represented by the remaining scheduled investments. A simplified form of relief could be provided in the form of rule to the effect that if a float contract is terminated on account of a bankruptcy or credit rating reduction of the provider, the issuer does not have to recalculate the yield on the contract if the funds that would have been used to purchase scheduled investments are instead invested in eligible investment securities, and an amount equal to the income from the securities is paid to the Internal Revenue Service in one or more installments of yield reduction payments on the payment schedule in § 1.148-5(c). This relief would be similar to the relief offered by Rev. Proc. 95-47 for cases in which scheduled reinvestments in 0% State and Local Government Series Securities cannot be made because the securities are not at the time offered by the Treasury.

Purchase of Qualified Tender Bonds and Tax-Exempt Commercial Paper by Issuer or Conduit Borrower

NABL applauds the decision in Notice 2008-88 to extend the 90-day and 180-day periods for issuer purchases of their own bonds. The extension both as to the type of bonds covered and the time periods permitted will be of immense practical benefit to issuers.

Treatment of the bonds as remaining outstanding will require a decision as to how the issuer's purchase, holding, and eventual remarketing should be taken into account in calculating the yield on the bonds for arbitrage purposes in the situation where the issuer purchases all of the bonds or enough of the bonds to affect the determination of the interest rate paid on the bonds.[2] In such a case, NABL believes a reasonable result can be achieved by treating the payment to purchase the bonds as a disbursement with respect to the bonds and the eventual proceeds of any remarketing as a receipt. The calculation would not take into account any payments of debt service on the bonds made by the issuer to itself or to a related party.

Similarly, if the purchase is made by a conduit borrower and that purchase affects the determinate of the interest rate paid on the bonds, the purchase price could be treated as a disbursement, the remarketing proceeds as a receipt, and any interim payments of debt service to the conduit borrower or a related party would be ignored. In addition, the conduit borrower may[3] need technical relief from the borrower-purchase rule for "program investments" rule in § 1.148-1(b). Notice 2008-41, section 5.2, grants relief from this rule for conduit borrowers that purchase auction rate bonds. This rule should be extended to tender option bonds and tax-exempt commercial paper as well as auction rate bonds. Notwithstanding the theoretical liquidity of tender bonds and tax-exempt commercial paper, the fact remains that just as with auction rate bonds, present market conditions can force the borrower into a situation where a purchase of the obligations is the best, or only, financial course. As such, it should not be jeopardized by the borrower-purchase rule which was not intended to deal with post-issuance situations like the present.

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[2] Where the purchase by the issuer or conduit borrower does not affect the interest rate mechanism (for example, where the interest rate is based upon an independent index), NABL believes that it is appropriate to ignore the purchase and ultimate resale by the issuer or conduit borrower.

[3] NABL notes that it is not clear that the prohibition against purchase of bonds "in an amount related to amount of the purpose investment" is implicated by a subsequent purchase of the bonds on the market by the conduit issuer. Treasury may want to clarify the scope of the program investment rules in the future.

Use of Equity to Fund or Collateralize a Bond Retirement

Again, NABL is grateful for the extension in Notice 2008-88 of the periods for which issuers may hold their own bonds. The discussion and suggestions in this section are not meant in any way to limit, or criticize, the relief granted in Notice 2008-88, but instead to augment the relief through potential amendments to the temporary period rules of Notice 2008-41 to accommodate equity purchases of various types of obligations.

There may still be situations outside Notice 2008-88 in which issuers may find themselves unable to issue needed refunding bonds under current market conditions or even to arrange temporary taxable debt for that purpose. This problem could arise, for example, with bond anticipation notes not covered by Notice 2008-88. If the issuer has access to endowment funds or cash reserves ("equity"), it may be desirable to use these funds to retire the outstanding obligations in the hope of reimbursing the equity as soon as a tax-exempt bond issue can be marketed with appropriate terms. However, this procedure appears to be prevented by a brief statement in the reimbursement bond regulations to the effect that these regulations do not apply to an allocation of proceeds to pay principal or interest on an obligation (§ 1.150-2(g)(1)). The regulations say that a purported reimbursement of an expenditure to pay principal or interest must be "analyzed" under the rules for refunding issues. Notice 2008-41, section 2, paraphrases this rule by stating that a debt retirement that is not "linked to another borrowing" may be nonrefundable. Notice 2008-88 may temporarily ameliorate this problem; however, in recent years there have been several market disruptions that possibly suggest the need for a more permanent solution.

The effect of the rule in § 1.150-2(g)(1) is unclear, and it could be interpreted to mean that in no situation could an interim use of equity followed by replacing that equity with tax-exempt debt be treated as a refunding.[4] NABL believes that general rules prohibiting interim equity purchase would be needlessly harsh and that an issuer ought to be able to qualify bonds as refunding bonds on the basis of a use of proceeds to reimburse equity that was spent in retiring a prior issue, provided the transaction complies with the requirements of the reimbursement

[4] NABL notes that there are a couple of private letter rulings that hold that in extreme circumstances the interim use of equity will not cause the subsequent issue to fail to be treated as a refunding. *See* PLR 9417027 (January 28, 1994) and PLR 9507010 (November 14, 1994).

regulations. Thus the issuer would have to adopt a declaration of official intent not later than 60 days after the debt retirement (*e.g.*, not later than 60 days after the expiration of the 90 day period in the case of purchased qualified tender bonds) and would have to issue the refunding bonds generally within 18 months after the retirement of the prior bonds. Imposing a requirement of an intermediate debt financing in this situation seems to attach a needless significance to the formalism of tracing the use of proceeds back through the interim debt.

With or without this suggested change, an issuer holding substantial equity and desiring to retire outstanding bonds might conclude that the optimal financial solution would be to use the equity to collateralize a bank loan or other temporary debt that would be used to retire the bonds. However, if the effort is made to qualify the bank loan as a tax-exempt obligation, the presence of the collateral will create difficulties under the arbitrage rules if it is invested above the yield on the loan. A use of SLGS might be complex or inefficient if the bank loan is at a floating rate, and the use of yield reduction payments in this situation does not seem authorized under Treas. Reg. § 1.148-5(c) either existing or as proposed. The simplest solution, which we would recommend, would be to eliminate the 15% limit for reserve funds that will be adjusted through yield reduction payments under Treas. Reg. § 1.148-5(c)(3)(i)(E). This expansion would not change the statutory 10% limit on reserves funded with sale proceeds in section 148(d)(2); thus it would apply only to reserve funds containing equity (or proceeds of a taxable borrowing).

Federal Guarantee Issue on Investments of Proceeds in Money Market Funds

In Notice 2008-81, the Treasury Department and the IRS provided guidance with respect to a program being provided by the Treasury Department (the "Program") in response to the credit market instability to make available certain funds from its Exchange Stabilization Fund on a temporary basis upon prescribed terms and conditions to certain money market funds. Notice 2008-81 generally provided that the Treasury Department and the IRS would not assert that the Program causes any violation of the restrictions against Federal guarantees under section 149(b) of the Code with respect to any tax-exempt bond assets held by tax-exempt money market funds participating in the Program. Counsel have raised additional concerns that an issuer's investment of tax-exempt bond proceeds in money market funds participating in the Program could be considered an investment of bond proceeds in "federally insured deposits or accounts" within the meaning of section 149(b)(2)(B)(ii), potentially causing the bonds to be considered federally

guaranteed under section 149(b). This concern has caused some issuers (and in particular those whose investments are not otherwise excluded from the federal guaranty prohibition due to the fact that the invested funds are entitled to one of the listed temporary periods in section 149(b)) to consider liquidating their money market investments and reinvesting the amounts after the September 19, 2008 deadline for invested moneys to be covered by the Program. Such actions would only further exacerbate the troubles of money market funds if issuers withdraw substantial amounts from funds to reinvest in a different fund without the Program coverage (since the investment would be after the September 19, 2008 cut off date).

It is also noted that the Treasury only announced further details of the Program on September 29, 2008 and that funds have until October 8, 2008 to apply for the coverage. Some issuers held off taking any action pending the receipt of information about the Program. As this application process continues, there is greater uncertainty for these issuers as to whether their fund will be covered by the Program, but, as the process unfolds, the time period of a potential Federal guaranty issue is becoming extended, through no fault or involvement of the issuers.

Accordingly, NABL recommends that guidance be provided to the effect that the Treasury Department and the IRS will not assert that an investment of tax-exempt bond proceeds in money market funds participating in the Program causes any violation of the restrictions against Federal guarantees under section 149(b) of the Code. There is little or no opportunity for issuers to take improper advantage of such relief, as only investments made prior to September 19, 2008 would be affected.

National Association *of* Bond Lawyers

NABL TAX LAW COMMITTEE
MEMBERS OF THE NABL TASK FORCE ON CURRENT MARKET CONDITIONS

Frederic L. Ballard, Jr. (Chair)
Ballard Spahr Andrews & Ingersoll, LLP
Washington, DC
202-661-2210
flb@ballardspahr.com

Arthur E. Anderson, II
McGuireWoods LLP
Richmond, VA
804-775-4366
aanderson@mcguirewoods.com

Kimberly C. Betterton
McKennon Shelton & Henn LLP
Baltimore, MD
410-843-3516
Kimberly.betterton@mshllp.com

R. Preston Bolt, Jr.
Hand Arendall, L.L.C.
Mobile, AL
251-694-6292
pbolt@handarendall.com

Mitchell J. Bragin
Kutak Rock LLP
Washington, DC
202-828-2450
mitch.bragin@kutakrock.com

Michela Daliana
Hawkins Delafield & Wood LLP
New York, NY
212-820-9631
mdaliana@hawkins.com

Kristin H. R. Franceschi
DLA Piper US LLP
Baltimore, MD
410-580-4151
kristin.franceschi@dlapiper.com

Scott R. Lilienthal
Hogan & Hartson L.L.P.
Washington, DC
202-637-5849
srlilienthal@hhlaw.com

G. Mark Mamantov
Bass, Berry & Sims PLC
Knoxville, TN
865-521-0365
mmamantov@bassberry.com

Samuel Norber
Law Offices of Samuel Norber
Beverly Hills, CA
310-201-9870
snorber@earthlink.net

Mark O. Norell
Sidley Austin LLP
New York, NY
212-839-8644
mnorell@sidley.com

Ed G. Oswald
Orrick, Herrington & Sutcliffe LLP
Washington, DC
202-339-8438
eoswald@orrick.com

Lisa P. Soeder
Soeder & Associates LLC
Hartford, CT
860-246-1800
lsoeder@soeder-associates.com

Maxwell D. Solet
Mintz Levin Cohn Ferris Glovsky and Popeo, P.C.
Boston, MA
617-348-1739
msolet@mintz.com

J. Thomas Francis, Jr.
Balch & Bingham LLP
Birmingham, AL
205-226-3430
tfrancis@balch.com

Perry E. Israel
Law Office of Perry Israel
Sacramento, CA
916-485-6645
perry@103law.com

Gregg H. Jones
Andrews Kurth, LLP
Houston, TX
713-220-4479
greggjones@andrewskurth.com

Michael L. Larsen
Parker Poe Adams & Bernstein LLP
Charlotte, NC
(704) 372-9000
michaellarsen@parkerpoe.com

Jeremy A. Spector
Mintz Levin Cohn Ferris Glovsky and Popeo, P.C.
New York, NY
212-692-6283
jspector@mintz.com

John O. Swendseid
Swendseid & Stern
Reno, NV
775-323-1980
jswendse@sah.com

Patti T. Wu
Sidley Austin LLP
New York, NY
212-839-5341
pwu@sidley.com