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RE: Comments on Establishing Fair Market Value for Open Market Escrow Investments

Dear Ms. Schakel and Gentlemen,

At a meeting held on May 10, 1995, among representatives of the Internal Revenue Service, Treasury and the National Association of Bond Lawyers ("NABL"), the issue of establishing fair market value for investments of bond proceeds was discussed. At this meeting, as well as in various public forums, IRS personnel have expressed concern that, on occasion, the prices of investments purchased with bond proceeds (including replacement proceeds) may have been in excess of their fair market values. This concern appears to be particularly acute with respect to purchases of open market securities (i.e., securities other than U.S. Treasury Obligations, State and Local Government Series "SLGS") for advance refunding escrows ("Escrow Securities"). For instance, the Tax-Exempt Bond Action Plan released by the IRS on January 10, 1994, indicates that, among other things, "open market purchases of Treasury

obligations for advance refunding escrows and purchases of long-term guaranteed investment contracts" will be the focus of the examination program. The Arbitrage and Rebate Committee of NABL (the "Committee") has considered the issue of fair market valuation of Escrow Securities and would like to present its views to you. The members of the Arbitrage and Rebate Committee who participated in preparing these comments are Neil P. Arkuss, William H. Conner, John J. Cross III, Amy K. Dunbar, Perry E. Israel, Arthur M. Miller, Mitchell H. Rapaport, David A. Walton and Patti T. Wu. NABL was incorporated as an Illinois nonprofit corporation on February 5, 1979, for the purposes of educating its members and others in the law relating to state and municipal bonds and other obligations and participating in national and local forums in order to advise and comment on legislative, regulatory and judicial issues affecting said bonds and obligations. NABL currently has 3,000 members.

Current Bond Counsel Practice in Assuring Fair Market Value Purchases and Due Diligence

The Committee believes that the vast majority of issuers of tax-exempt obligations diligently comply with fair market value investment requirements and do not knowingly pay in excess of the fair market price for investments purchased with bond proceeds. Most issuers covenant in the relevant bond documents not to purchase investments with bond proceeds at other than their fair market value. In the case of Escrow Securities, most bond counsel usually require a certification from a qualified investment professional (usually an underwriter or financial advisor) to the effect that the investment was purchased at its fair market value. Such fair market value certifications are not customarily required by bond counsel for other investments of bond proceeds. The due diligence exercised by bond counsel with respect to the fair market value certification regarding Escrow Securities is, and must necessarily be, limited to assuring that the person making the certification is qualified to do so. Bond counsel do not customarily review the methodologies employed by the person making the fair market value certification nor do bond counsel seek to independently verify the certifier's conclusions. Such a review or independent verification by bond counsel is not appropriate because bond counsel does not

possess the necessary financial and market expertise to perform these reviews and verifications.

All Investment Problems Are Related to Lack of Economic Incentive

In the case of proceeds of tax-exempt obligations subject to arbitrage yield restriction or to rebate, the economic motivation to maximize aggregate investment yield generally ceases once bond yield, in the aggregate, is attained since, in the former case, the issuer is prohibited from earning a higher yield and, in the latter case, the issuer is not allowed to keep any earnings in excess of bond yield. We believe that the simplest, fairest and most effective solution to this problem is for Congress to amend the Internal Revenue Code to permit issuers to retain a meaningful portion (e.g., at least 25%) of earnings in excess of bond yield and to treat such retained earnings as proceeds for sizing and expenditure purposes. Such an amendment would (i) delete all yield restriction requirements and (ii) reduce the required rebate percentage from 100% to something significantly less (e.g., 75%). Yield restriction requirements would be unnecessary because the rebate requirement would discourage arbitrage motivated transactions (in the case of refundings, the retained earnings could be required to be used to reduce the size of the refunding issue). These two simple changes would provide a sufficient economic incentive to issuers to insure that all investments of bond proceeds are at fair market value.

We believe that the adoption of the amendments discussed in the preceding paragraph would not result in any significant revenue loss to the Federal government because current law encourages issuers not to maximize their investment yields which, in turn, results in less or no rebate paid to the Federal government. For example, assume that an issuer issues 6 percent bonds and needs to invest the bond proceeds for a three-year temporary period. The issuer has the option of investing in Fund A that earns 6 percent per annum, is rated AAA, is strongly collateralized, and has very liberal withdrawal provisions. The issuer also has the option of investing in Fund B that earns 7 percent per annum, is rated A, is not as well collateralized as Fund A, and has limited withdrawal provisions. The issuer chooses to invest in Fund A because the extra benefits of Fund A do not really cost the issuer anything since Fund A earns bond yield and all the excess earnings above bond yield on Fund B would be required

to be rebated to the Federal government. In making the decision to invest in Fund A, the issuer has chosen the safest investment alternative, and has complied in all respects with all fair market value investment requirements. A statutory change allowing the issuer to retain a portion of the arbitrage earned may provide the incentive for the issuer in this example to assume additional credit risk and reduced liquidity and invest in Fund B which would provide the issuer with more earnings and the Federal government with more rebate. We encourage the IRS and Treasury to support such a legislative change.

Recommended Improvements to the SLGS Program

The Committee believes that SLGS are underutilized as Escrow Securities and as other investments because of the current inflexibility of, and low rates of return offered by, this program. Investments in SLGS do not present the same fair market value concerns as do investments in other securities and the Committee believes that if the problems with the SLGS program are remedied, investments of bond proceeds in SLGS will increase. In October, 1989, the Anthony Commission on Public Finance (the "Anthony Commission") issued its report entitled "Preserving the Federal-State-Local Partnership: The Role of Tax-Exempt Financing" (the "Anthony Commission Report"). On page 38 of the Anthony Commission Report (a copy of this page is attached hereto), the major problems with the SLGS program are described and the following suggestions for improvements are made:

(1) Provide an adequate return to state and local governments,

(2) Permit the Treasury Department to enter into a contract with private businesses to run the program, and

(3) Permit investments by the issuer to be divided between time-deposit and demand-deposit obligations and between zero interest SLGS and open market obligations to lower yield to meet arbitrage restrictions.

The Committee concurs in these recommendations. We urge the Treasury Department to promptly make these suggested changes to the SLGS program.

Recommended Safe Harbors for Determining Fair Market Value For Escrow Securities and Enforcement of Existing Regulations

The Committee believes that the methods for determining fair market value as set forth in Treas. Reg. §1.148-5(d) are adequate and do not need to be expanded. To the extent investments of bond proceeds, in fact, are made at prices in excess of fair market value, such actions are not due to an inadequate definition of fair market value, but instead are due to misrepresentations by those certifying the fair market value of said securities. Regulatory expansion of the definition of fair market value will . We believe that only effective enforcement of the current fair market value requirement will prevent willful misrepresentation of fair market value. We encourage enforcement efforts aimed at discouraging deceptive pricing practices; however, as stated above, the Committee believes that the vast majority of issuers investing bond proceeds and, in the case of Escrow Securities, those certifying the fair market value thereof, are honest in their dealings. To the extent there are problems in this area, the Committee believes that they exist with a small minority of market participants.

Should the IRS or Treasury decide that additional action in this area is necessary, the Committee suggests that such action be limited to Escrow Securities. We suggest that a safe harbor be established providing that investments are presumed purchased for fair market value if (1) a qualified professional certifies that the purchase price, taking into account the facts and circumstances, is fair market value, (2) three bids from non-interested parties are obtained and the investments are purchased at the lowest price or the highest yield offered, or (3) the yield on the investments is significantly below the relevant bond yield. The Committee does not believe that the safe harbors for three bids or a fair market value certification will be workable in all circumstances for investments of bond proceeds other than Escrow Securities and, therefore, we recommend that the safe harbors only explicitly apply to Escrow Securities. If the foregoing safe harbors are adopted, the Committee recommends that when the aggregate investment yield of all the Escrow Securities produces significant

negative arbitrage, determined without taking into account non-escrowed securities (e.g., the lower of 25 basis points below the refunding bond yield or $200,000), the purchase price of the Escrow Securities should be deemed to be their fair market value. We believe that in these circumstances, the loss realized by the issuer is significant enough to warrant the presumption that the securities were purchased at fair market value. The Committee suggests that the safe harbor be promulgated in the form of a proposed Revenue Procedure, and that it be drafted, with modifications, in a manner similar to Treas. Reg. §1.148-5(d)(6)(iii) relating to guaranteed investment contracts. We suggest the following language for the Revenue Procedure:

> Safe harbor for establishing fair market value for securities to be deposited in advance refunding escrows. Except as otherwise provided in this Revenue Procedure, in the case of securities purchased with proceeds of an advance refunding issue or with other moneys that are deposited in an advance refunding escrow, the purchase price of such securities is treated as the fair market value on the purchase date if either --
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> (1) A person or entity knowledgeable about similar securities and investments certifies to the Issuer that the purchase price of the securities is the fair market value thereof (as defined in §1.148-5(d)(6)) and such person or entity agrees to maintain objective evidence of the methodology and data used in arriving at such conclusion and to provide it to the Internal Revenue Service in the event such information is requested in writing by an authorized representative of the Internal Revenue Service in connection with its audit or examination of the bonds or to a participant in the financing provided such participant is subject to an Internal Revenue Service investigation in connection with the bonds and enters into a non-disclosure agreement satisfactory to the person or entity providing such certification; or
>
> (2) The issuer, or any person or entity acting on behalf of the issuer complies with each of the following:

(i) Makes a bona fide solicitation for specified securities and, of the bids received, at least three are bona fide bids from sellers that have no material involvement in the pricing of the issue; and

(ii) The issuer purchases securities from the bidder which made the highest yielding bid and such securities have a yield at least as high as such bid.

Safe harbor for below bond yield investments. In the case of securities purchased with proceeds of an advance refunding issue that are deposited in an advance refunding escrow, the purchase price of such securities is treated as the fair market value on the purchase date if either the aggregate yield to maturity of such securities is less than the yield of the advance refunding issue by at least .25 percent or the aggregate expected cash flow from such securities which would have resulted had the securities been invested at an aggregate yield equal to the yield of the advance refunding issue is at least $200,000 more than the actual aggregate expected cash flow from such securities, and no other investments are treated as the same class of investments as such securities within the meaning of §1.148-5(b)(2). In the case of securities purchased with moneys other than proceeds of the refunding issue that are deposited in an advance refunding escrow, the purchase price of such securities is treated as the fair market value on the purchase date if either the aggregate yield to maturity of such securities is less than the yield of the refunded issue by at least .25 percent or the aggregate expected cash flow from such securities which would have resulted had the securities been invested at an aggregate yield equal to the yield of the refunded issue is at least $200,000 more than the actual aggregate cash flow from such securities, and no other investments are treated as the same class of investments as such securities within the meaning of §1.148-5(b)(2).

We appreciate your consideration of these comments. We would be pleased to make ourselves available to discuss them with you and other representatives of the IRS or Treasury at your convenience should you believe that to be helpful. Questions should be directed to David A. Walton, chair of the Arbitrage and Rebate Committee, at (415) 391-5780.

Sincerely,

David A. Walton
Chair, Arbitrage and Rebate Committee

Enclosures
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frequent need for local governments to alter existing financing documents or to take advantage of lower interest rates often require the use of advance refundings. Prudent use of advance refundings should continue to be permitted.

The 1986 Act generally allows governmental bonds issued after December 31, 1985, to be advance refunded once, permits two advance refundings of pre-1986 governmental bonds and prohibits advance refundings for all private-activity bonds (other than qualified 501(c)(3) bonds) and of all governmental bonds that do not satisfy the related-use requirement. **The Commission recommends that all public-purpose bonds be eligible for an unlimited number of advance refundings, subject to the current restrictions on structuring such refundings.**

State and Local Government Series (SLGS) Program

The 1986 Act mandated certain modifications to the State and Local Government Series ("SLGS") program to provide a viable alternative to arbitrage rebate. [49] Congress instructed the Treasury to create a new demand-deposit SLGS program to complement the existing time-deposit program; however, the current program is ineffective and unused by issuers because the regulations require that the time-deposit and demand-deposit programs cannot be utilized simultaneously. This inflexible requirement effectively precludes issuers from using the program because expenditures cannot be planned with sufficient accuracy. In addition, in spite of changes effective August 1, 1989, the demand-deposit program still provides a rate of return on the investment too low to make the program attractive to issuers, even for short-term investments for which the program should be workable.

The rate of return on the demand-deposit SLGS results in a rate of return below the bond yield, resulting in an actual monetary loss to issuers. The Congressional purpose of providing a workable alternative to rebate is simply not being served when issuers are forced to lose money on the investment in demand-deposit SLGs and then additionally cannot mix time-deposit investments with part of their proceeds to minimize the resulting loss.

New "zero interest" SLGS available September 1, 1989, may be used only for investment of proceeds originally entitled to unrestricted yield. Outside of the limited case of investment of unexpended proceeds when a temporary period expires, this new class of SLGS cannot be used to lower yield when other proceeds simultaneously are invested in market obligations. Thus, the new class will not be very useful in complying with arbitrage restrictions.

The improvements recommended by the Commission to make the program workable are to (1) provide an adequate return to state and local governments, (2) permit the Treasury Department to enter into a contract with a private business to run the program, and (3) permit investments by the issuer to be divided between time-deposit and demand-deposit obligations and between zero interest SLGS and open market obligations to lower yield to meet arbitrage restrictions.