NATIONAL ASSOCIATION OF BOND LAWYERS
THE WORKSHOP 2023
October 18-20, 2023

ADVANCED ARBITRAGE

Chair:

Adam R. Baird	Kutak Rock LLP – Spokane, WA

Panelists:

David J. Cholst	Chapman and Cutler LLP – Chicago, IL
David Sutton	Raymond James – Saint Petersburg, FL
Laurie Scott	Integrity Public Finance – Jacksonville, FL

This outline is intended to be a higher-level discussion of arbitrage issues applicable to tax-exempt municipal bonds and the structuring of various transactions. The outline and panel will also focus on investment considerations and investment-related issues and opportunities arising in a higher yield environment, including strategies and approaches to investing without violating yield-restriction rules, as well as for minimizing any rebate or yield reduction payment liability through permitted elections made on the issue date or other permitted structuring tools. The outline will also focus on various issues and items common to rebate compliance and regular problems encountered in the computation of rebate.

I. Classes of Investments

1. Treas. Reg. 1.148-5(b)(2) states the following: "For purposes of the *yield restriction rules* of section 148(a) and § 1.148-2, yield is computed separately for each class of investments. For this purpose, in determining the yield on a separate class of investments, the yield on each individual investment within the class is blended with the yield on other individual investments within the class, *whether or not held concurrently*, by treating those investments as a single investment. The yields on investments that are not within the same class are not blended." What does this mean? It means all investments in the same class must be blended together regardless of when they are held, and despite the five-year computation date for rebate. The single yield is determined over the life of the investments. However, investments (other than escrows) are not treated this way for rebate purposes. For rebate, investments classes do not matter, and yield is computed for each computation period.

2. What are the different classes of investment?

   a. Each category of yield restricted purpose investment and program investment that is subject to a different definition of *materially higher* under § 1.148-2(d)(2)

      - Qualified student loans
      - Tax-exempt loans
      - Qualified mortgage loans
      - Program investments
      - Other purpose investments

      NOTE: The yield on investments in any of the above classes cannot be blended with each other. Only the yield on investments within the same class can be blended, and each purpose investment with a different "materially higher" limitation is considered to be in a separate class.

   b. Yield-restricted nonpurpose investments

      - Project fund money (after the expiration of the temporary period)
      - Sinking fund money (which does not qualify as a bona fide debt service fund or a reasonably required reserve or replacement fund)
      - Advance refunding escrow (to the extent any were/are outstanding)
      - Pledged funds or other replacement proceeds
      - Other amounts for which temporary periods were waived

      NOTE: In general, the yields on yield-restricted non-purpose investments are blended together for yield restriction purposes.

c. All other nonpurpose investments

- Amounts invested during the temporary period for capital projects (typically three years, but extended to five years in certain circumstances)
- Amounts invested during the 13-month temporary period for restricted working capital
- Amounts invested in a reasonably required reserve or replacement fund
- Amounts in a bona fide debt service fund
- Amounts making up the minor portion

NOTE: None of these investments can be blended with those of another class for purposes of yield restriction. If the issuer waives the right to invest in higher yielding investments, those investments are moved into the class of yield restricted nonpurpose investments.

3. Waivers of temporary period and right to invest in higher-yielding investments

a. What is it? Treas. Reg. 1.148-2(h) provides that an issuer may elect to waive the right to invest in higher yielding investments during any temporary period or as part of a reasonably required reserve or replacement fund.

b. Why would you do it? If an issuer expects yields on other non-yield restricted investments will be lower and is concerned that the yield on certain yield restricted investments might be higher, a waiver might be desired in order to bring these investments into collective yield compliance.

c. When do you have to do it? In general, any waiver of a right to invest at a higher yield must occur on or before the issue date. At any time, an issuer may waive the right to invest higher yielding investments that are part of the minor portion.

4. Example 1 – Unspent project fund proceeds

a. Facts: In October 2020, City issued $100mm for a revenue bond project. The City funded costs of issuance and a reasonably required debt service reserve fund from its own cash. The City deposited all $100mm of the proceeds into the project fund. Now it is October 2023, and the City has not competed the project and approximately $14mm remain in the project fund and the project is expected to take 2 more years to complete (due to cost overruns and supply chain problems). Prior to this time, investments in the project fund and the debt service reserve fund earned significant amounts of negative arbitrage. The City anticipates that it may not have enough funds to complete the project and is contemplating issuing more

bonds. In addition to this, the City's financial advisor says the City should consider investing monies in the project fund at a higher level, and above the bond yield, in order to fund these additional cost overruns. The financial advisor states that positive arbitrage now should be offset by prior years' negative arbitrage, and should not result in violation of the arbitrage rules. What advice do you have for the City?

b. Potential Advice: Amounts in the project fund after the third anniversary are in a class of investments different from the class containing amounts in the debt service reserve fund and project fund that previously earned negative arbitrage. Consequently, positive arbitrage from the project fund now cannot be blended with prior negative arbitrage for yield restriction purposes. The City can earn above the bond yield, but unless there are proceeds which are in the same class of investment as the project fund, no other reduction of the proposed positive arbitrage or blending can occur to bring the yield into compliance. If the City earns above the bond yield now, it is able to make a yield reduction payment for amounts in the project fund. One thing the City could have considered at the outset is receiving the architectural or engineering certifications necessary to get the benefit of the five-year temporary period, if it expected that the project would take longer than 3 years. Finally, if the City was able to anticipate this potential issue at the closing date, the City could have considered waiving the temporary period for the project fund.

5. Example 2 – Defeasance escrow

a. Facts: In 2015 a County issued bonds in order to advance refund bonds originally issued in 2007 which were subject to optional redemption in 2017. The proceeds of the 2015 bonds generated a significant amount of negative arbitrage. In October 2023, the County desires to defease the 2015 bonds with its own cash and call the 2015 bonds in 2025, as is allowed under their underlying documents. The County's financial advisor suggests that any investment above the bond yield now can be blended with the negative arbitrage previously. As their legal counsel, you are nervous because amounts in the 2023 escrow would be treated as replacement proceeds of the 2015 bonds and you are being pressured to intentionally invest amounts pledged to the 2015 bonds above the bond yield. What do you do?

b. Potential Advice: In general, amounts in the 2015 escrow account and the 2023 defeasance account are the same category of investment, but bear in mind those amounts earned within the first 30 days of the advance refunding escrow were subject to a 30-day temporary period of no yield restriction (unless waived) and need to be taken into account. In any event, great

caution should be taken in structuring these investments and financial advisors and rebate analysts should be consulted. A current rebate calculation should be performed to identify all related amounts subject to yield restriction.

c. Important consideration. For yield restriction purposes, all categories need to be blended together.

6. Blending of investments in the context of rebate

a. For rebate, as distinguished from yield restriction, investments are generally blended without regard to classification. For example, consider an issuer with a reasonably required reserve or replacement fund and some other fund which is subject to yield restriction (e.g., additional required reserves or otherwise pledged funds which are subject to yield restriction). For rebate purposes, any positive arbitrage in the reasonably required reserve or replacement fund can be blended with negative arbitrage in the yield restricted fund.

7. Application of Anti-abuse rules. A potential sanction is a requirement that an issuer treat each investment as a separate class, and the issuer would lose the ability to blend low-yield investments with high-yield investments. See Treas. Reg. 1.148-10(b)(1)(i).

II. Investment Options and Considerations

1. Investment Options

a. Tax-exempt bonds – IRC 148(b), Generally, tax-exempt investments are not treated as investment property and are therefore not subject to arbitrage restrictions. For non-AMT bonds, specified private activity bonds are carved out of the investment exception.

b. Mutual funds (if 95% or more of the income is tax-exempt, considered to be a "tax-exempt bond" under IRC 148(b); but tax-exempt mutual funds present special problems because income could include capital gain distributions)

c. Money market funds (if 95% or more of the income is tax-exempt, considered to be a "tax-exempt bond" under IRC 148(b))

d. Local government investment pools (really external comingled funds)

e. United States Treasuries – directly purchased vs. open market purchases

f. Certificates of deposit, subject to special rules to determine fair market value.

g. Guaranteed investment contracts (GICs) – subject to special rules to determine fair market value

h. State and Local Government Series securities (SLGS) – See discussion below
i. Other – any investment of a type that is traded on an established market

2. SLGS and the use of demand deposit SLGS

a. SLGS securities are offered for sale to issuers of state and local government tax-exempt debt to assist with compliance of yield restriction or arbitrage rebate provisions of the Internal Revenue Code. Subscribers may invest in time deposit or demand deposit types of securities. All SLGS securities are issued in book-entry form and are non-marketable.

b. Closure of SLGS window and consequences (yield reduction payments)

When the federal government hits or nears the debt ceiling, the ability to acquire SLGS is suspended. When this happens, issuers are limited to other kinds of investments which may result in potential noncompliance with the arbitrage rules. It is key to remember that investments when acquired have to be acquired at their fair market value. If the fair market value of an investment is greater than the associated bond yield, this can be problematic. In scenarios where the sale of SLGS is suspended, an issuer is allowed to make yield reduction payments. See Treas. Reg. 1.148-5(c)(3)(viii). But note, importantly, that the ability to make a yield reduction payment appears to only apply to "nonpurpose investments allocable to the *proceeds* of an issue" which, on its face, appears to exclude replacement proceeds.

c. The Uses and Benefit of Demand Deposit SLGS

Two different regulation provisions add Demand Deposit SLGS to excluded tax-exempt investments. Neither regulatory provision mentions AMT treatment, but since the carveout separately excludes specified private activity bonds and SLGS are not specified private activity bonds, it is safe to apply the Demand Deposit SLGS treatment as tax-exempt investments to restrictions on non-AMT bonds.

The arbitrage regulations reference demand deposit SLGS (in both places) as "a certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series program described in 31 CFR part 344."

When the United States Treasury takes extraordinary measures including the suspension of sale of new SLGS, they also convert outstanding Demand Deposit

SLGS into special 90-day Certificates of Indebtedness of the State and Local Government Series (*"Special 90-day Certificates"* see Attachment 1, Notice of Conversion to 90-day Certificates). A question has arisen as to whether a Special 90-day Certificate is itself a demand deposit SLGS certificate or more formally, whether a Special 90-day Certificate is a certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series program described in 31 CFR part 344 (see Attachment 2, Chief Counsel Memorandum No. 202326019).

The answer seems to be clearly "yes" as further described below. Evidently, however, this is not clear to the IRS Chief Counsel, although they got the right answer pursuant to the broad powers of the IRS to deviate from the technical words of the arbitrage regulations under Treas. Reg. §1.148-10(g), which states:

> (g) Authority of the Commissioner to waive regulatory limitations. Notwithstanding any specific provision in §§1.148-1 through 1.148-11, the Commissioner may prescribe extensions of temporary periods, larger reasonably required reserve or replacement funds, or consequences of failures or remedial action under section 148 in lieu of or in addition to other consequences of those failures, or take other action, if the Commissioner finds that good faith or other similar circumstances so warrant, consistent with the purposes of section 148.

Chief Counsel clearly reached the correct result, but employed a provision that probably should be reserved for situations where the technical regulations reach the wrong result.

First, Special 90-day Certificates are certificates of indebtedness issued pursuant to 31 CFR 344.7(b), which is part of 31 CFR part 344, Subpart (C) dealing with the Demand Deposit SLGS program. Second, special 90-day Certificates may be redeemed under the same provisions as other demand deposit SLGS (one-day notice). That certainly makes them demand deposit investments in any ordinary meaning of "demand deposit." Third, although it has only happened once, if the suspension of SLGS sales continues for more than 90 days, special 90-day Certificates are in fact reinvested in new Special 90-day Certificates. This must happen pursuant to 31 CFR 344.7(b), which only allows Special 90-day Certificates to be reinvested into Demand Deposit SLGS. Fourth, the Bureau of Fiscal Service treats Special 90-day Certificates as part of the Demand Deposit program in the statements they issue to investors.

3. Mixing of investments

a. Under regulations applicable to advance refunding bonds (which are no longer permitted), Treas. Reg. 1.149(d)(b)(3) provides that a transaction which has a mixed escrow, where a portion of the proceeds is invested in tax-exempt bonds and a portion is invested in other nonpurpose investments could be construed as an abusive transaction under prior Section 149(d)(4) of the Code. While this rule applies to advance refundings, the absence of a similar rule under the arbitrage rules suggests that the mixing of various types of investments (both taxable and tax-exempt) is permitted.

4. Current market trends and structuring investments options

a. Laddered Portfolio of U.S. Treasury Securities

- What is it? A portfolio of U.S. Treasury Securities which mature on different dates.
- Why do it? For issuers that may achieve IRS spending exception benchmarks, this is a vehicle with perceived least credit risk. For issuers that will likely fail or know they will fail IRS spend-downs, this is a vehicle that can enable them to invest a significant portion of proceeds at a fixed rate at least equal to or in excess of the arbitrage yield (expecting to rebate the difference). If an issuer failing spend-downs can exceed the arbitrage yield on investments, there is no need to take any credit risk in other instruments.

b. Laddered Portfolios of U.S. Treasury and Agency Securities

- What is it? A portfolio of U.S. Treasury Securities and Agency Securities (i.e., specific maturities issued by either Fannie Mae, Freddie Mac, Farm Credit System, or the Federal Home Loan Banks) which mature on different dates.
- Why do it? For issuers that have failed spend-downs and accrued negative arbitrage, this is a means to now potentially re-capture some or all of the previously accrued negative arbitrage, at least prior to the end of the temporary period. For issuers that anticipate achieving spend-downs, investing a significant portion of the bond proceeds in these instruments is a means to maximize potential retainable positive arbitrage.

c. Demand Deposit SLGS

- What is it? See discussion above.
- Why do it? For issuers that anticipate failing the IRS spend-downs and have a low arbitrage yield, these can be a means to earn exempt arbitrage.

d. Combination Taxable Investments and Demand Deposit SLGS

- Why do it? If a client has a lengthy draw schedule (i.e., 2.5 years or longer), may be viability in a combined taxable/demand deposit SLGS approach to hedge against a decline in market rates below the arbitrage yield over the anticipated lengthy expenditure period

e. Unsecured GIC's

- What is it? A GIC is a guaranteed investment contract and type of investment where the provider of the GIC (usually a highly rated bank or insurance company) receives bond proceeds (or other moneys) from a bond issuer and agrees to repay the principal at par, on a fixed date or upon request, with a fixed or floating rate of interest until repayment.
- Why do it? A GIC allows a bond issuer to invest bond proceeds without risk of adverse market rate liquidation loss (at least in the case of a project fund GIC) when the investment proceeds are needed to finance the issuer's project or program. These are utilized primarily in not for profit and structured transactions such as health care and state HFA financings, and are best utilized in transactions where the goal is to minimize negative arbitrage.
- Other Considerations? A principal challenge is the ability to meet the IRS 3 bid safe harbor, which is impacted by: the modest number of GIC market participants, and minimum rating requirements or other restrictions imposed by bond indentures (often "AA" category which can constrain the number of participants). It is easiest if developing a new bond indenture and can control the definition of "permitted investments" to maximize market participation. It is also typically easier to achieve the fair market value safe harbors for investment of reserve funds than project funds due to propensities of GIC market participants.

III. Rebate Considerations

1. The presence of IRC 148(f)(5) – "Gross income shall not include the [rebate amount]. Notwithstanding any other provision of this title, no deduction shall be allowed for any amount paid to the United States [for rebate]". How does this provision actually apply in practice and who would it apply to?

2. Allocations of Proceeds to Expenditures

   Three factors directly impact the amount of arbitrage rebate: 1) the amount of proceeds invested, 2) the size of the spread between the earnings rate and the

arbitrage yield, and 3) the length of time that the proceeds are invested. As a result, the allocation of proceeds to expenditures directly impacts the rebate liability.

Section 1.148-6(d)(2) states that "reasonable accounting methods for allocating funds from different sources to expenditures for the same governmental purpose include any of the following methods if consistently applied: a gross proceeds spent first method, a first-in, first-out method or a ratable allocation method." Further, it states that "an allocation of gross proceeds of an issue to an expenditure must involve a current outlay of cash for a governmental purpose of the issue" (defined as no later than 5 banking days as of the date of which the allocation is made), and that the "issuer must account for the allocation of proceeds to expenditures not later than 18 months after the later of the date the expenditure is paid or the date the project, if any, that is financed by the issue is placed in service".

Example 1 – School District A plans to fund capital expenses for a new school with proceeds of a new bond issue as well as grants received from the State Department of Education. How should School District account for the grant monies once received? Should they be deposited into the Project Fund with the sale proceeds? Are they subject to rebate? What about yield restriction?

Example 2 – City A issues bonds to fund capital expenditures in connection with the improvement of a variety of city parks. Proceeds are invested at a rate in excess of the arbitrage yield. They are expended quickly, but not quickly enough for the issue to qualify for a Spending Exception to Rebate. Can City take any action whereby it would meet all of the Spending Exception benchmarks, allowing City to retain the positive arbitrage?

Example 3 – City B allocates proceeds to expenditures as they occur. In the process of preparing for the annual audit, B realizes that it paid for expenditures from bond proceeds that were not eligible for that purpose. A correcting entry is made to return the proceeds to the Project Fund. Does B need to take any additional actions?

3. Debt Service Funds

Section 1.148-1(b) defines a "bona fide debt service fund" as a "fund, which may include proceeds of an issue, that – (1) is used primarily to achieve a proper matching of revenues with principal and interest payments within each bond year; and (2) is depleted at least once each bond year, except for a reasonable carryover amount not to exceed the greater of: (i) the earnings on the fund for the immediately preceding bond year or (ii) one-twelfth of the principal and interest payments for the immediately preceding bond year.

Example 1 – Hospital A deposits revenues into the Principal and Interest accounts each month. The lowest aggregate balance of these accounts is greater than the

reasonable carryover amount. Are the P&I Accounts in total subject to rebate, or is a portion of the account a bona fide debt service fund, and only the excess is subject to rebate? If only the "excess", how is such amount identified?

Example 2 – City A issues bonds for capitalized interest equal to the first two interest payments on the bonds, which are paid 5 and 11 months after the issue date. These amounts are invested in a Cap I Fund, and the balance depletes to $0.00 after the 2nd interest payment. Is the Cap I Fund a bona fide debt service fund and exempt from rebate? Does your answer change if the Cap I Fund is a subaccount of the Project Fund?

Example 3 – City A issues bonds for capitalized interest sale proceeds sufficient to pay 3 interest payments and a portion of the 4th. The proceeds are deposited to a Debt Service Fund. City A starts depositing revenues into the Debt Service Fund during the 2nd bond year resulting in commingled proceeds and revenues. The Debt Service Fund does not deplete below the reasonable carryover during the 1st bond year due to unspent Cap I proceeds that remain, but the Debt Service Fund does deplete below the required limit during the 2nd bond year. Is the whole Fund exempt from rebate as a bona fide debt service fund?

Example 4 – Hospital B issues non-governmental bonds. To fund its debt service, B deposits 1/6th of the upcoming interest payment plus 1/12th of the upcoming principal payment each month and invests the funds in taxable instruments. After the P&I payment, the remaining balance in the account is $0.00. Earnings in the Debt Service Fund for the bond year are $101,000.00. Are amounts in the Debt Service Fund exempt from rebate? Are they subject to yield restriction? If B invested the amounts in the account in taxable securities to generate earnings of $99,999.99 and then invested only in demand deposit SLGS for the remainder of the bond year, are the funds subject to rebate?

4. Reducing Arbitrage

Arbitrage earnings are calculated for invested gross proceeds. Section 148(b)(3) states that the term "investment property" does not include tax-exempt bonds (with the exception that "with respect to an issue other than an issue a part of which is a specified private activity bond (as defined in section 57(a)(5)(C)), the term "investment property" includes a specified private activity bond (as so defined)". Section 1.150-1(c)(1) defines "tax-exempt bond" as any bond the interest on which is excludable from gross income under section 103(a). For purposes of section 148, tax-exempt bond includes:

(1) An interest in a regulated investment company to the extent that at least 95 percent of the income to the holder of the interest is interest that is excludable from gross income under section 103; and
(2) A certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series program described in 31 CFR part 344.

Example 1 – City invests 50% of its Project Fund in U.S. Treasury securities and 50% in Demand Deposit SLGS. The Treasuries yield a return of 150 basis points above the arbitrage yield. The Demand Deposit SLGS are floating, but their average return is 100 basis points above the arbitrage yield. What, if any, excess must be rebated back? Can City A deposit funds into a non-interest-bearing checking account to offset positive arbitrage? Can City A invest proceeds in a money market equal to the arbitrage yield to avoid rebate?