January 23, 2014

Hon. John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Comments Concerning the Definition of Issue Price for Tax-Exempt Bonds and Other Tax-Advantaged Bonds

Dear Commissioner Koskinen:

Enclosed are comments concerning the definition of issue price for tax-exempt bonds and other tax-advantaged bonds. These comments represent the view of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Michael Hirschfeld
Chair, Section of Taxation

Enclosure

cc: Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
    William J. Wilkins, Chief Counsel, Internal Revenue Service
    Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of Treasury
These comments (the "Comments") on certain portions of Proposed Treasury Regulation section 1.148-1 are submitted on behalf of the American Bar Association Section of Taxation (the "Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Arthur Anderson of the Committee on Tax-Exempt Financing (the "Committee"). Substantive contributions were made by Faust Bowerman, Stefano Taverna, Christie Martin, Robert Kaplan and Mark Norell. The Comments were reviewed by Nancy M. Lashnits, Chair of the Committee, and by Frederic L. Ballard, Jr., reviewer for the Committee on Government Submissions, and Bahar Schippel, Council Director for the Committee.

Although the members of the Section who participated in preparing these Comments have clients who might be affected by the Federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact: Arthur E. Anderson II
Phone: (804) 775-4366
Email: aanderson@mcguirewoods.com
Date: January 23, 2014
EXECUTIVE SUMMARY

On September 16, 2013, the Internal Revenue Service (the "Service") and the United States Treasury (the "Treasury") published in the Federal Register proposed regulations\(^1\) on the arbitrage restrictions under section 148\(^2\) applicable to tax-exempt bonds and other tax-advantaged bonds. These Comments relate only to the portions of the proposed regulations related to the changes to the current definition of issue price, which is found in Regulations section 1.148-1 (the "Existing Regulations").\(^3\) Hereinafter such portions of the proposed regulations will be referred to as the "Proposed Regulations." The Section is submitting separate comments on other aspects of the proposed regulations, including provisions relating to working capital expenditures, grants and treatment of qualified hedges.

As used herein, the terms "tax-advantaged bonds" and "bonds" encompass all of the tax-exempt and other tax-advantaged bonds to which the Proposed Regulations will apply, if finalized.\(^4\)

For the following reasons, the Committee respectfully requests that the Proposed Regulations be withdrawn and that any other changes to the Existing Regulations be re-proposed. The Proposed Regulations do not properly assess the significance of the perceived problems with the Existing Regulations nor do they reflect a cost-benefit analysis of replacing the "reasonable expectations" provision of the Existing Regulations with the "actual facts" approach of the Proposed Regulations. The Committee believes that the changes to long-established market practices will harm intergovernmental comity and will increase rather than diminish uncertainty for issuers and other market participants. Therefore, the Existing Regulations should not be replaced by the Proposed Regulations. However, the Existing Regulations could be improved as recommended in comments submitted by the Section in 2010 and attached hereto as Appendix A.

If the Service and Treasury decide to adhere to an actual facts approach, the Committee suggests a number of changes and additions to be made to the Proposed Regulations to retain certain critical benefits of the Existing Regulations.


\(^2\) References to a "section" are to a section of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

\(^3\) Reg. § 1.148-1.

\(^4\) Prop. Reg. § 1.150-1(b), 78 Fed. Reg. 56,842 (2013), defines a "tax-advantaged bond" to mean:

[A] tax-exempt bond, a taxable bond that provides a Federal tax credit to the investor with respect to the issuer's borrowing costs, a taxable bond that provides a refundable Federal tax credit payable directly to the issuer of the bond for its borrowing costs under section 6431, or any future similar bond that provides a Federal subsidy for any portion of the borrowing costs. Examples of tax-advantaged bonds include qualified tax-credit bonds under section 54A(d)(1) and build America bonds under section 54AA.
I. RETAIN THE EXISTING REGULATIONS

A. Introduction.

For all types of tax-advantaged bonds, the issue price is the starting point for determining compliance with all arbitrage-related matters. It is also the starting point for determining compliance with other key requirements applicable to certain types of tax-advantaged bonds, including those relating to volume cap, private business use limitations and the restrictions on bond-financed costs of issuance. For "direct pay" tax-advantaged bonds such as "build America bonds" issued under section 54AA and section 6431, issue price determines whether an issuer has complied with the premium limit and, thus, along with other provisions, whether the issuer is entitled to receive the subsidy from the U.S. Treasury. 5

Section 148(h) provides that the "yield on an issue shall be determined on the basis of the issue price (within the meaning of sections 1273 and 1274)." The Existing Regulations define issue price as follows:

Issue price means, except as otherwise provided, issue price defined in section 1273 and 1274. Generally, issue price of bonds that are publicly offered is the first price at which a substantial amount of bonds is sold to the public. Ten percent is a substantial amount. The public does not include bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers. The issue price does not change if part of the issue is later sold at a different price. The issue price of bonds that are not substantially identical is determined separately. The issue price of bonds for which a bona fide public offering is made is determined as of the sale date based on reasonable expectations regarding the initial public offering price. If a bond is issued for property, the applicable Federal tax-exempt rate is used in lieu of the Federal rate in determining the issue price under section 1274. The issue price of bonds may not exceed the fair market value as of the sale date. 6

The "reasonable expectations" provision of Existing Regulations allows the final determination of the issue price of an issue of tax-advantaged bonds on the sale date. Thus, the issuer will know, on the sale date, whether the tax-advantaged bonds will satisfy the many requirements that depend on the issue price. Having a final issue price on the sale date also enables the issuer to make many calculations required for compliance with tax law (such as the yield on the bonds), which can be critical if yield-restricted investments are being purchased.

The Proposed Regulations would amend the issue price definition in a number of significant respects. Most importantly, the Proposed Regulations would base the determination of issue price on actual sale prices to the public instead of on reasonably expected sale prices. The Proposed Regulations would also remove the definition of "substantial amount" as ten percent. Instead, the Proposed Regulations would provide a safe

6 Reg. § 1.148-1(b).
harbor under which an issuer may treat the first price at which a minimum of 25 percent of the bonds of a maturity is actually sold to the public as the issue price, so long as all orders at this price received from the public during the offering period are filled (to the extent that the public orders at such price do not exceed the amount of bonds sold). The actual facts approach would eliminate, for a standard publicly-offered, tax-advantaged bond issue, the ability to determine with certainty whether the issue complies with tax provisions dependent on the issue price until after the sale date.

The "reasonable expectations" standard of the Existing Regulations does not require an issuer to delve into the intent of any particular purchaser of its tax-advantaged bonds. Issuers can form and rely on reasonable expectations about both the price at which the bonds will be sold and the identity and intent of the potential bond purchasers. In apparent recognition of this problem, in the Proposed Regulations the Service and Treasury attempt to clarify and simplify the distinction between a purchaser who is a member of the public and a purchaser who is not. The Proposed Regulations define the term "public" to mean any person other than an "underwriter." "Underwriter" is defined to mean any person that purchases bonds from the issuer for the purpose of effecting the original distribution of the bonds, or otherwise participates directly or indirectly in the original distribution. An issuer will find it fairly easy to identify as underwriters the financial firms with which it has a contractual relationship, such as, for example, through a bond purchase agreement. Under the Proposed Regulations, however, issuers would be required to determine intent in assessing purchases by security dealers and others who are not part of the underwriting syndicate, who may be acting "for the purpose of effecting the original distribution of the bonds."

B. Identifying the Problems and Assessing Their Significance.

The legislative history of Section 148(h) is clear. In enacting the provision as part of the Tax Reform Act of 1986, Congress intentionally overturned *State of Washington v. Commissioner*, 692 F.2d 128 (D.C. Cir. 1982), which held that an issuer's calculation of arbitrage yield should reflect the "all-in" costs of its borrowing, including the underwriter's compensation and the other costs of issuance. The underwriter's discount or commission is a major component of the costs of issuance for the issuer of any publicly-offered, tax-advantaged bond issue. Including costs of issuance in the issue price raises the issue price, and a higher issue price for a given principal amount of tax-advantaged bonds lowers the arbitrage yield thereon. Section 148(h) in effect prohibits an issuer from increasing the arbitrage yield on its bonds to recover the costs of issuance through the investment of bond proceeds at the higher yield.

The preamble to the Proposed Regulations identifies the problems the Service and Treasury see with the Existing Regulations. First, the preamble asserts that the ten percent standard does not always produce a representative price for tax-advantaged bonds due to the execution by underwriters of the first ten percent of the sale of a maturity of the bonds at the lowest price (and thus the highest yield) of the range of prices being offered. In other words, there is not a "bona fide public offering" of all of the bonds of the maturity at the stated issue price. Second, the public availability of certain actual pricing information on the Internet—most importantly through the Electronic Municipal Market Access ("EMMA") platform
developed by the Municipal Securities Rulemaking Board (the "MSRB")—has led the Service and Treasury to question the ability of the reasonable expectations standard of the Existing Regulations to produce a representative issue price. The reported trade data has shown, in certain instances, actual sales to the public that differ significantly from the reasonably expected issue price. Third, the reported trade data has also shown sales to underwriters and security dealers being counted as sales to the public. Essentially, the Service and Treasury believe that the Existing Regulations are facilitating the understatement of the issue price of tax-advantaged bonds and the underwriter's compensation, producing an arbitrage yield higher than Section 148(h) permits.

Although the problems are adequately identified, the preamble fails to assess the significance of the problems. For example, it does not assess the loss to the Federal government resulting from lower rebate payments or higher subsidy levels. An underwriter who is holding back a portion of a maturity of tax-advantaged bonds may be faced with selling at a loss if the market moves away from it. An intermediary purchasing bonds on the sale date with the intent to "flip" them before the issue date may be in the same position. The reality is that markets go down as well as up.

Compounding the failure to assess the significance of the problems is the mislaying of the burden of fixing the problems. All three of the problems identified in the preamble—not making a bona fide public offering of all of the bonds of a maturity at their stated issue price, significantly different actual sale prices, and sales to "flippers" being counted as sales to the public—stem from the actions of underwriters and securities dealers. Issuers have little incentive or ability to control or alter the actions of these other market participants. The Existing Regulations should not be abandoned without a complete consideration of whether there are other tools available (such as MSRB or SEC rules) to address the problems without placing the burden on issuers.

C. Cost/Benefit Analysis.

The Service and Treasury should ascertain whether the benefits of the Proposed Regulations would be greater than the costs. If an issuer decides to eliminate the possibility of unsold maturities on the sale date, it will be forced to accept lower prices and higher yields

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7 The Committee will make several references to Exec. Order No. 12,866, 58 Fed. Reg. 51,735 (October 4, 1993) ("EO 12866"). In EO 12866 President Clinton set forth the principles to which Federal agencies are to adhere in promulgating regulations. One of these principles requires Federal agencies not only to identify the problem intended to be addressed by a regulation, but also to assess the significance of that problem. On January 18, 2011, President Obama issued Exec. Order No. 13,563, 76 Fed. Reg. 3821 (January 21, 2011), to reaffirm and supplement EO 12866. President Obama made no substantive changes to any of the regulatory principles of EO 12866.

8 In developing a regulation, EO 12866 requires a Federal agency to: [continued on next page]

[A]ssess both the costs and the benefits of the intended regulation and, recognizing that some costs and benefits are difficult to quantify, propose or adopt a regulation only upon a reasoned determination that the benefits of the intended regulation justify its costs….
in negotiated underwritings. In order to ensure that no unsold maturities exist, underwriters will have less incentive to market bonds aggressively. They will instead accept lower prices and higher yields just so bonds can be "put away" on the sale date. Due to the nature of competitive sales, it is virtually impossible to eliminate the possibility of unsold maturities. Underwriters in competitive sales cannot know whether they will have the opportunity to purchase bonds until the sale date, which discourages pre-sale marketing of those bonds. Alternatively, if the issuer determines to continue to sell its bonds as such sales occur in the current market, where the possibility of unsold maturities exists, the issuer will be forced to incur additional legal and financial advisory costs in attempting to determine issue price based on actual sales to the public. Additional bonds are likely to be issued to cover the higher costs. The Service and Treasury should determine whether the benefits of ascertaining what they believe to be a more accurate representative price of bonds may be offset by (i) the higher bond interest rates produced by discouragement of market pricing through competitive sales and the other ways in which the Proposed Regulations may narrow the market, and (ii) the higher fees paid to financial advisors and legal counsel because of the additional analyses that will need to be performed under the Proposed Regulations.

D. Effects on State and Local Governments.

Recent years have been difficult for State and local governments. Their finance staffs are currently thin and suffer from high rates of turnover. The Service and Treasury should consider the administrative burden that would be imposed on State and local finance officials if they are required to obtain, evaluate and apply the information about the identity of bond purchasers and pricing necessary to satisfy the actual sales standard in the Proposed Regulations.9

The burden could be particularly acute, and compliance may be impossible in the short-term, if issuers are required to determine the intent of a market participant (including participants with whom there is no privity of contract) in purchasing bonds—in other words, whether the purchaser is purchasing bonds for the purpose of effecting the original distribution of the issue. Although EMMA has clearly made pricing in the tax-advantaged bond market more transparent, it is not possible to ascertain a purchaser's intent through EMMA. The Committee's understanding is that EMMA was designed to provide general market transparency and that it was not designed to serve as a tool to establish issue price. The use of EMMA to gauge issue price can lead to erroneous conclusions. Therefore, State and local governments will likely be forced to add personnel or spend more money on lawyers and financial advisors to perform the due diligence needed to make the determinations of intent. These issues must be viewed in light of the fact that for governmental bond issues,

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9 EO 12866 requires Federal agencies to be sensitive to the views of State, local and tribal governmental entities. In developing a regulation, an agency must:

[A]ssess the effects of Federal regulations on State, local, and tribal governments, including specifically the availability of resources to carry out those mandates, and seek to minimize those burdens that uniquely or significantly affect such governmental entities, consistent with achieving regulatory objectives. In addition, as appropriate, agencies shall seek to harmonize Federal regulatory actions with related State, local, and tribal regulatory and other governmental functions....
only the yield would change as a result of the application of the Proposed Regulations. Neither the amount nor the timing of the debt service to be paid by the issuer nor the net proceeds to be received by the issuer at issuance would be affected by assigning bonds a higher issue price and thus a lower arbitrage yield for events occurring after the sale date.

In addition, the Committee believes that competitive sales will be difficult under the Proposed Regulations. Competitive sales generally ensure the lowest cost of capital for issuers (and hence minimize the arbitrage yield). Competitive sales are also required by the law of a significant number of States.10

The actual facts regime of the Proposed Regulations requires a protracted and continual tracking of actual sales of bonds and the determination of which purchasers are or are not underwriters. The possibility that the arbitrage yield on an issue could change after the sale date will require issuers to put additional cushion in the savings and other parameters in their authorizing resolutions if they are so permitted by State law. Furthermore, while the Proposed Regulations permit issuers to make a yield reduction payment in connection with advance refunding escrows the yield of which would exceed the yield on the bonds, issuers will certainly face additional costs in computing the yield reduction payments and many issuers may not have the funds to make any such payments. Overburdening State and local governments with the actual facts regime of the Proposed Regulations would be harmful to intergovernmental comity.

E. Reducing Uncertainty.

The greatest virtue of the Existing Regulations is certainty. Issuers are able to calculate the issue price and arbitrage yield on the sale date. Advance refunding issues can be verified, and refunding escrow securities can be locked in well before the closing date. Practitioners have also relied on the Existing Regulations to test compliance with many other tax and structuring requirements, such as whether the issuer has sufficient volume cap or has properly sized a debt service reserve fund. Official statements can be finalized in a timely manner. Furthermore, the certainty provided by the Existing Regulations allows issuers to proceed to closing with the knowledge that the sale date number runs would conclusively show compliance with the bond authorization parameters. For example, under the Existing Regulations an issuer can award bonds and purchase a refunding escrow on the sale date with the certainty of compliance with an authorizing resolution that requires a showing of a three percent present value debt service savings. The Proposed Regulations do not provide such level of certainty, and the Committee does not believe that the Service and Treasury have made the case that the savings either to the Federal government or to issuers will be sufficient to justify the loss of certainty.

F. Section II Conclusion: Retain the Existing Regulations.

The Committee believes that the Proposed Regulations should not be adopted.

The Committee acknowledges that the Existing Regulations would benefit from additional guidance to make them work more effectively. In this regard, the Committee references the comments on the definition of issue price submitted by the Section in 2010, a copy of which is attached as Appendix A. The Committee would welcome the inclusion in a re-proposed issue price definition of any or all of the suggestions set forth in the 2010 comments.

II. COMMENTS ON THE PROPOSED REGULATIONS

A. Introduction.

If the Service and Treasury decide to abandon the Existing Regulations, the Committee proposes the changes to the Proposed Regulations set forth below. The Committee respectfully requests that the market be given an opportunity to comment on any of these changes the Service and Treasury may determine to make and that such changes, along with the Proposed Regulations modified thereby, be re-proposed.

B. Twenty-Five Percent versus Ten Percent.

The 25 percent "substantial amount" safe harbor threshold is too high. Issuers will strive to achieve as much finality on the sale dates of their bonds as they can. The actual facts regime of the Proposed Regulations will result in issuers insisting on a demonstration by the underwriters that 25 percent of each maturity of an issue is actually sold to the public on the sale date. At times in the current market, the underwriter will not have actual sales of ten percent of each maturity on the sale date, much less 25 percent. The Committee believes that the narrowing of the market will result from the higher threshold, particularly when combined with the requirement to fill all orders for bonds at the safe harbor threshold price, and will drive up yields. The ten percent figure has been used for more than two decades by practitioners and market participants in the taxable market as well as by the tax-exempt market to establish how much of a particular maturity is a "substantial amount." The removal of the substantial amount definition, therefore, affects not just the tax-exempt bond market, but also the taxable market. The Committee urges that the threshold remain at ten percent.

When a large number of substantially similar products, commodities or financial instruments (for example, multiple bonds of the same maturity) are offered for sale, there are likely to be multiple prices for such products, commodities or financial instruments. An increase in the substantial amount threshold from ten percent to 25 percent exacerbates this problem. If the Service and Treasury settle on the higher threshold, then it will be critically necessary to provide guidance on how issue price for a maturity is to be determined when multiple prices occur and less than 25 percent is actually sold at one price.

C. Competitive Sale Safe Harbor.

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The Proposed Regulations surprisingly lack accommodation for competitive sales. Many issuers are required by the laws of their states to sell bonds competitively, and many others prefer competitive sales because they are believed to result in better bond pricing and streamlined procurement. Moreover, in competitive sales the issuer and the purchasers of the bonds do not have the same privity and contractual relationship that issuers enjoy in negotiated underwritings. This lack of accommodation is particularly surprising in light of past indications from the Service that the abuses observed in the determination of issue price, which were perceived occurring in negotiated transactions, were not apparent with competitive sales.

Given the compressed time periods and lower underwriting spreads in the competitive sale arena, the Committee believes that few competitive sales as currently configured will be able to satisfy the 25 percent safe harbor on the sale date. This may encourage issuers to choose the negotiated sale or private placement routes, if possible. This may have the unfortunate effect of raising tax-advantaged bond yields, harming both the Federal government and issuers.

The Committee urges the Service and Treasury to retain the basic reasonable expectations rules under the Existing Regulations for bond issues sold in competitive sales that meet requirements analogous to those for the establishment of fair market value prices for yield-restricted escrows and guaranteed investment contracts.

The Committee also urges the Service and Treasury to set the "substantial amount" threshold in competitive sales at the current market expectation — that is, ten percent — and to eliminate the requirement that all orders be filled at the stated offering price during the offering period. The nature of competitive sales simply does not permit the kind of pre-sale market testing that would encourage a bidder to take risks with the initial offering prices. Again, the Committee fears that yields will go up and harm both the Federal government and issuers.

D. Authorize Reliance on Certain Certificates.

The goal of an issuer in selling tax-advantaged bonds is to obtain the best possible pricing of debt instruments to finance a school, a municipal building or a road system. The issuer sells its bonds through underwriters and securities dealers because these intermediaries are in the business of finding bond purchasers and dealing with them. The Committee urges the Service and Treasury to add a provision to the Proposed Regulations, if finalized in their current form, authorizing an issuer to rely in good faith on a certificate from the managing underwriter or successful bidder regarding (i) the first price at which 25 percent of a maturity of tax-advantaged bonds is sold, (ii) the filling of all orders from the public at the first price during the offering period, and (iii) the identity of each underwriter of the bonds (including each "related party" underwriter). "Good faith" would mean the absence of abuse (for example, bid rigging, pay-to-play, or price-fixing) or actual contrary knowledge by the issuer.

In fact, underwriters, who are best positioned to know the facts surrounding any particular pricing, are already bound by MSRB standards dealing with factual representations.
The standards provide that "all representations made by underwriters to issuers of municipal securities in connection with municipal securities underwritings (e.g., issue price certificates and responses to requests for proposals), whether written or oral, must be truthful and accurate and may not misrepresent or omit material facts." Obtaining issue price representations, mostly written, is part of a well-established practice of bond tax counsel. In addition, the Committee supports specific identification rules, similar to those of section 1236(b) relating to dealer's identification of securities held for investment, so long as the responsibility for making the specific identification resides with the underwriters and securities dealers. Those identification requirements should remain with the market participants and can be used as evidence of truthfulness about the underwriter's representations.

The underwriters of a tax-advantaged bond issue have, or can cost-effectively obtain, the background needed to make the certifications necessary to satisfy the safe harbor issue price rule. Policing mechanisms exist to assure the veracity of the certifications. The Committee urges the Service and Treasury to make it clear that an issuer can satisfy the safe harbor issue price rules through good faith reliance on an underwriter's certificate.

E. Need for Actual Sales Price Data.

Although technological improvements (such as EMMA) are mentioned in the preamble to the Proposed Regulations, the text of the Proposed Regulations does not specify where an issuer is to obtain the information about the actual sales of its bonds. EMMA in its current form does not provide a viable solution, because of its various timing and misidentification problems, which have been mentioned above and discussed with the Service and Treasury in other contexts. EMMA can only serve as a tool to verify in some, but not all, cases, the certifications provided by paid professionals that are supposed to comply with securities laws. If the Service and Treasury require that the issue price of sales be based on actual facts, they should first make sure that issuers have access to the necessary data to comply or to verify the certifications of the underwriters. Prior to requiring that prices be based on actual sales prices, the Committee recommends that significant lead time be provided so as to ensure that databases (whether from EMMA, from underwriters or by other means) exist to ensure transparent and accurate information for compliance with the tax law. Additionally, the Committee recommends that prior to effectiveness of the Proposed Regulations, the Service review those databases to ensure that it is satisfied with the quality and sufficiency of the data.

F. Defined Safe-Harbor Offering Period.

The Proposed Regulations have the potential to create enormous uncertainty by the requirement to track — possibly long after the closing date of a bond issue — the actual sale prices of the bonds. This tracking may be necessitated by (i) the need to assure that even if

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13 Reg. § 1.1236-1 clearly imposes the responsibility for identification of a security as "held for investment" on the securities dealer.
the required portion of a maturity of bonds is actually sold at the initial offering price, all orders for bonds of the maturity at the initial offering price during the "offering period" are filled, and (ii) situations in which less than the required threshold of the maturity is sold at the initial offering price. The Proposed Regulations do not define "offering period," but most market participants assume that it has the same meaning as under the securities laws. This means, for a particular maturity of bonds, a period ending on the date the underwriters no longer retain an unsold balance of the bonds for sale to the public. The end date need not correspond to the closing date of the issue.

In order to provide issuers some finality and certainty in the process of determining issue price, the Committee urges the Service and Treasury to include the concept of a defined safe-harbor offering period. This is, admittedly, a rough-justice approach, but it reflects the undeniable fact that markets go down as well as up in the two-week to four-week period between the sale date and the closing date of a typical governmental bond issue and certainly fluctuate after the closing date. The Service and Treasury should consider whether any net loss in terms of overstated yields will be negated by the cost of the bonds that will have to be issued to cover the additional issuance costs.

The Committee recommends that the offering period end six business days after the sale date. The six-day period is chosen for two reasons. First, six business days would always require the holding of the initial offering price or a position in the to-be-issued bonds over a weekend. Second, six business days would allow the final determination of issue price in time for the issuer to meet its obligation under SEC Rule 15c2-12 to deliver the final official statement within seven business days after the sale date. Such a rule would not only promote certainty but would also reflect that tax laws related to issue price do not operate in a vacuum. It would promote intergovernmental comity by dovetailing with the other regulatory guidelines with which issuers and underwriters must comply.

The Service and Treasury could alternatively consider defining the offering period by reference to the 13-day or 15-day periods established under Regulations Section 1.1275-1(f) or 1.150-1, even though this approach would not work as well with existing market requirements and practices as the six business day offering period. If two bond issues that are sold 15 days apart from each other are deemed to be separate issues, the Service and Treasury should view the sale of the second bond of a maturity 15 days after the sale of the first bond of the same maturity as not affecting each other.

The concept of a definite safe harbor offering period would also facilitate addressing the situation in which less than 25 percent (or ten percent) of a maturity can be sold at the initial offering price (or at the "first price," if different). If by the end of the safe-harbor period less than 25 percent (or ten percent) of a maturity is actually sold to the public, the issue price of that maturity should be the initial offering price at which that maturity was marketed to the public on the sale date in a bona fide public offering.
G. Bifurcated Rule.

If the concern of the Service and Treasury is that the yield on new money financings is too high based on the Existing Regulations, then they should consider finalizing the Proposed Regulations with a bifurcated rule under which refunding escrows would be subject to one rule and new money transactions, which include longer term investments in construction and acquisition funds, as well as reserve funds, would be subject to a different rule.

H. Non-Yield-Related Consequences of the Actual Facts Regime.

The Committee does not believe that issuers can adequately assess the potential consequences of the Proposed Regulations without knowing how the Service and Treasury intend to address the many other provisions of the Code the compliance with which is determined based on the issue price of the bonds. For example, the actual facts regime may not allow an issuer to secure adequate volume cap. In addition, the limits on costs of issuance may also be violated if the issue price becomes less than originally anticipated. This is the most important reason for the Committee's request that any change in the issue price definition be re-proposed.
APPENDIX A

(See Attached)
November 9, 2010

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Issue Price

Dear Commissioner Shulman:

Enclosed are comments on the determination of issue price applicable to tax-exempt bonds and tax credit and Build America bonds. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Charles H. Egerton
Chair, Section of Taxation

Enclosure

cc: Michael F. Mundaca, Assistant Secretary (Tax Policy), Department of the Treasury
    William J. Wilkins, Chief Counsel, Internal Revenue Service
    Jeffrey Van Hove, Acting Tax Legislative Counsel, Department of the Treasury
    Bryon Christensen, Deputy Tax Legislative Counsel, Department of the Treasury
    John J. Cross III, Associate Tax Legislative Counsel, Department of the Treasury
    Clifford J. Gannett, Director, Office of Tax Exempt Bonds, Internal Revenue Service
    Stephen R. Larson, Associate Chief Counsel, Financial Institutions & Products, Internal Revenue Service
    James A. Polfer, Branch Chief, Branch 5, Financial Institutions & Products, Internal Revenue Service
ABA SECTION OF TAXATION
COMMENTS ON ISSUE PRICE

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Winnie Tsien of the Committee on Tax Exempt Financing of the Section of Taxation. Substantive contributions were made by Frederic L. Ballard, Jr.; David J. Cholst; Maxwell D. Solet; Jeremy A. Spector; Stefano Taverna; and Lorraine Tyson. The Comments were reviewed by John Swendseid, Vice-Chair of the Committee. The Comments were further reviewed by Clifford M. Gerber and David C. Garlock of the Section’s Committee on Government Submissions and by Andrew J. Dubroff, Council Director for the Tax Exempt Financing Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact:    Winnie Tsien
Phone:     (213) 612-2336
Email:     wtsien@orrick.com

Date: November 9, 2010
Executive Summary

These Comments recommend that the determination of issue price under Regulation section 1.148-1(b) (the “Regulation”) be made permanently applicable to tax-exempt bonds and all tax credit and Build America Bonds. Making the Regulation permanent, and clarifying several of its aspects, would facilitate the determination of issue price for all such bonds, which would enhance compliance with the various Code requirements that depend in whole or in part on the issue price of bonds. Two important themes discussed in these comments are that (i) the Regulation allows for issue price to be determined on the sale date, and (ii) the Regulation provides that issue price can be determined under a reasonable expectations standard or by the first price at which ten percent of each maturity is sold.

These Comments recommend that issue price be established using the reasonable expectations of the managing underwriter in a negotiated sale (or of the successful bidder in a competitive sale) as of the time the prices of the bonds are agreed to by the issuer and the managing underwriter (or successful bidder). Those prices are appropriate because they best reflect the underwriter’s (or the successful bidder’s) expectations for the initial prices at which the bonds will be offered to the public and at which a substantial amount of each maturity of the bonds will be sold to the public. For this purpose, the expectations should relate to the sale price of the first ten percent of each maturity of the bonds.

The underwriting team is the most appropriate entity to determine the first price at which ten percent of each maturity of the bonds is actually sold to the public. The issuer has no contact with the buying public, and data that is available on public websites cannot be easily interpreted to identify the status of the buyers. Thus, these Comments recommend that the Regulation be interpreted to permit good-faith reliance on the certificate of the underwriting team as to first price at which ten percent of each maturity of the bonds was sold, or reasonably expected to be sold, to the public.

The process involved in a negotiated underwriting (or a competitive sale) supports a presumption that it reflects a bona fide public offering, absent actual knowledge by the issuer that a bona fide public offering was not made, or that clear abuse such as bid-rigging, pay-to-play, or price-fixing, occurred. Efforts by the issuer or underwriter to alter a bona fide process, by limiting its offering to only particular types of buyers, or by otherwise controlling the subsequent sales of bonds by the initial buyers, will increase inefficiencies and interest rates and likely harm taxpayers as much as the government. Thus, these Comments recommend that the Regulation support the presumption.

Financial institutions frequently buy bonds in a primary offering, and it is very difficult for the issuer to know whether those institutions (other than the members of the underwriting team with whom the issuer has a contract) are purchasing “in the capacity of underwriters or

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1 References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

2 References to a “maturity” of bonds means the portion of a bond issue that consists of “substantially identical” bonds within the meaning of the Regulation.
wholesalers” within the meaning of the Regulation, or as investors on their own behalf. Thus, these Comments recommend that the Regulation permit financial institutions to be treated as public buyers (i.e., not as underwriters or wholesalers) unless the underwriting team that has contracted with the issuer knows, based on a written contract or other agreement with the purchaser, that the purchaser is acting in the role as underwriter or wholesaler, and not as investor.
Issue Price

I. Introduction.

The issue price for tax-exempt bonds is determined pursuant to the Regulation. In 2009, Congress enacted legislation authorizing the issuance of Build America Bonds (“BABs”), of which certain BABs (“Direct Pay BABs”) are eligible to receive a subsidy payment from the U.S. Government pursuant to section 6431. In 2010, Congress extended the same type of subsidy to “specified tax credit bonds” (collectively, with Direct Pay BABs, the “Direct Pay Bonds”). In response to questions regarding the rules applicable to determine the issue price of the Direct Pay Bonds, the Internal Revenue Service (the “Service”) issued Notice 2010-35 (the “Notice”), stating, in part, that the Regulation will be used to determine the issue price of all Direct Pay Bonds until further notice.

These Comments urge that the Regulation be permanently applied to determine the issue price of all Direct Pay Bonds as well as tax-exempt bonds. These Comments also recommend that the interpretation of certain components of the Regulation be confirmed.

II. Establishing Issue Price under Regulation section 1.148-1.

A. Permanent Application of the Regulation to Establish Issue Price for All Bonds.

Section 148(h) provides that “yield on an issue shall be determined on the basis of the issue price (within the meaning of sections 1273 and 1274).” The Regulation further defines issue price as follows:

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

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4 Pub. L. No. 111-147, 124 Stat. 1029 (Hiring Incentives to Restore Employment Act of 2010). Such bonds include new clean renewable energy bonds defined in section 54C, qualified energy conservation bonds defined in section 54D, qualified zone academy bonds defined in section 54E and qualified school construction bonds defined in section 54F.
the issue price under section 1274. The issue price of bonds may not exceed the fair market value as of the sale date.\(^6\)

The Notice states that the Regulation will apply to Direct Pay Bonds for purposes of determining issue price. The Notice, however, also states that the Department of Treasury (the “Treasury”) and the Service continue to review the definition and may issue prospective guidance or changes to the definition. These Comments urge that the Regulation be permanently applied to determine the issue price of tax-exempt bonds and Direct Pay Bonds. In addition, if there are to be changes to the Regulation, tax-exempt bonds and Direct Pay Bonds should be subject to the same rules and the same changes.

Because issuers of Direct Pay Bonds and tax-exempt bonds are generally the same entities, providing the same issue price rule for them would enhance certainty and administrability. They are often issued at or about the same time to finance different portions of the same overall project and uniform rules will enhance compliance.

For tax-exempt bonds and Direct Pay Bonds, the issue price is the starting point for determining compliance with all arbitrage-related matters. It is also the starting point for certain other key requirements applicable to tax-exempt bonds, including those relating to volume cap, limitations on “private business use” and the limitation on costs of issuance with respect to private activity bonds (including qualified section 501(c)(3) bonds). For Direct Pay Bonds, the issue price determines whether an issuer is entitled to receive the subsidy from the U.S. Treasury by virtue of several additional requirements. Similar to tax-exempt private activity bonds, section 54A incorporates a limit on costs of issuance that may be financed with proceeds from the sale of an issue of Direct Pay Bonds.\(^7\) While issue price is not specifically mentioned, most practitioners apply the section 54A limit by reference to issue price. The Act further imposes a premium limit on BABs\(^8\) (and, under the Notice, to all Direct Pay Bonds), and this limit also applies by reference to issue price. Further, most practitioners use the issue price for measuring compliance with the volume cap limits applicable to Direct Pay Bonds other than BABs.

The Regulation provides a method of determining the issue price as of the sale date of bonds. This methodology is very important for issuers of tax-exempt bonds and Direct Pay Bonds as well as their advisors. It enables the parties to know, on the sale date, whether the sale of bonds will satisfy the many requirements for Direct Pay Bonds that depend on the issue price. Finality regarding issue price on the sale date also enables the issuer to make many calculations required for compliance with tax law (e.g., the yield on the bonds), which can be critical if yield-restricted investments are being purchased.

Allowing the long-established issue price rule under the Regulation to be used for all bonds would be consistent with the stated Congressional intent of assisting municipal issuers in their financial planning and operations. It would also avoid the market uncertainty that would

\(^{6}\) Reg. § 1.148-1(b).
\(^{8}\) I.R.C. § 54AA(d)(2)(C).
result from a different rule for Direct Pay Bonds that would perhaps threaten the continued viability of such bonds in some situations, even if based on an existing rule under another Code provision.

B. Reasonable Expectations Regarding the Initial Public Offering Price.

In addition to providing a general framework for establishing issue price, the Regulation provides a narrow, specific safe harbor through a series of declaratory rules. One such safe harbor in the Regulation, but not in section 1273, is that “the issue price of bonds for which a bona fide public offering is made is determined as of the sale date based on reasonable expectations regarding the initial public offering price.”

“Reasonable expectation” is provided as an alternative to the actual sales price rule set out in the second sentence of the Regulation. The use of reasonable expectations in establishing the issue price of tax-exempt bonds has been vital in many instances. Reasonable expectations are especially important where the actual sale price of the bonds cannot be obtained or accurately determined on the sale date (e.g., if ten percent of a maturity of the bonds was not sold on the sale date).

1. Reasonable Expectations Are Established at the Time of Offering.

While the Regulation permits the use of reasonable expectations to establish the issue price of publicly offered bonds, it does not provide further guidance or limits on which expectations are the most reasonable. Underwriting or selling the bonds is a fluid process. An underwriter or a bidder in a competitive sale—which is the entity on whose expectations an issuer will be relying—may change its expectations as to the offering prices of bonds throughout the process, and all of the different expectations may be reasonable. These Comments recommend that the proper time to measure one’s reasonable expectations as to the initial offering price for purposes of establishing the issue price of bonds is when the issuer’s representative and the managing underwriter agree to a price in a negotiated sale (or when the issuer’s representative in a competitive offering has agreed to the prices in the successful bid), rather than any other time (e.g., the time of execution of a bond purchase agreement, the formal award of bonds at a competitive sale, or the end of the day of sale).

As part of the typical underwriting process in a negotiated sale, an underwriter conducts its due diligence on the market in which the bonds will be offered, in large part through conversations with potential buyers. This “pre-sale” period can vary in time and scope, depending on the bonds to be sold, the timing and any factors unique to the issuer or the underwriter. Practitioners generally understand that the following events occur on the sale date (albeit, not always in this order): (i) the bond offering prices are established, sometimes as adjusted from the prices previously considered during the pre-sale period, and at other times by confirming expected trades between the underwriter and buyers; (ii) the issuer and the underwriter execute a bond purchase agreement (“BPA”), agreeing to the prices at which the underwriter will acquire the bonds from the issuer; and (iii) sales are “ticketed” (i.e., bonds are promised to be delivered to the buyers). In the typical series of events, the public offering could be viewed as occurring as early as the beginning of the sale date, and any subsequent period prior to the execution of the BPA.
Potential purchasers in a typical competitive sale will bid individually or as part of a syndicate. There are often no pre-sale orders because there is no assurance any one bidder will win the bid. Bidders put forth their best bid, usually in the form of the lowest interest cost, and the issuer selects the winner based on the lowest cost, taking into account premium credited to, or discount charged to, the issuer. There is no requirement that compensation be disclosed before the winning bid is awarded. A purchaser will normally bid the lowest cost possible to win the bid and still resell the bonds to the public at a reasonable profit.

Potential bidders undergo a process similar to a negotiated sale, although it may involve less effort because no bidder knows whether it will be the actual underwriter until the bids are opened and the bonds are awarded. Each bidder formulates a bid based on its own reasonable expectations regarding the initial public offering price at which it expects to sell the bonds. The bidder hopes to make a profit by buying from the issuer and selling at a higher price in the market. The bid, if accepted, establishes the prices at which the bidder will buy the bonds from the issuer. Once the bids are opened, the successful bidder is notified that the formal award has been made to that bidder, and that bidder can formally offer the bonds in the market (i.e., sales can be “ticketed”).

Both underwriters in negotiated sales and purchasers in competitive sales typically re-offer bonds to investors pursuant to procedures that are transparent and intended to comply with securities laws. They establish the reoffering prices of the bonds based on their reasonable expectations as to the sale prices. Purchasing through a competitive process ensures that bonds are sold at the lowest cost to the issuer, hence reducing yield to the most competitive level.

The foregoing underwriting and competitive sale processes imply that reasonable expectations as to the issue price are the prices incorporated into the BPA or accepted in a competitive sale. The time to measure whether those prices reflect reasonable expectations should not be the end of the sale date, as that can be many hours after the underwriter or the bidder has established the initial offering prices. The time of actual execution of a BPA is also an inappropriate measure of reasonable expectations because execution is usually driven by the availability of someone authorized to sign the contract, and this timing has no connection to expectations regarding how the bonds will be sold to the public.

These Comments recommend that the Regulation be interpreted to provide that the issue price is established using the reasonable expectations of the managing underwriter in a negotiated sale, or of the successful bidder in a competitive sale, as of the time the prices of the bonds are agreed to by the issuer’s representative and the managing underwriter or successful bidder.

2. Reasonable Expectations to Sell First Ten Percent of Each Maturity.

The Regulation, which permits the use of reasonable expectations of an underwriter (or a bidder) for purposes of establishing issue price of a publicly offered debt instrument, does not provide guidance on the scope of applicability of the expectations. Based on the entire context of the Regulation, the issue price should be established using the price at which an underwriter (or a successful bidder) reasonably expects to sell a substantial amount (i.e., at least ten percent) of each substantially identical group (or each maturity) of bonds to the public.
C. The First Ten Percent Sale Price to Establish Issue Price.

The Regulation also provides that issue price may be established using the first price at which a substantial amount of each maturity of the bonds is sold to the public. While not addressed in section 1273, the Regulation affirmatively states that a “substantial amount” is ten percent. Therefore the bright line of ten percent is available to unequivocally establish the issue price of bonds that are eligible for this rule. Indeed, the Regulation states that, once the issue price is established, a subsequent sale at a different price does not affect the issue price.

Publicly available trade data is imperfect. In addition to the Municipal Securities Rulemaking Board’s Electronic Municipal Market Access System (“EMMA”) website, which is specifically referenced in IRS Form 14127, the “investinginbonds” website is a source of trading data and financial professionals also often subscribe to the Bloomberg wire services for trade information on bonds. Each website has its own independent reporting and posting rules, but each depends on financial institutions to timely supply complete and accurate trade information. In addition, different websites provide different and limited information. For example, EMMA only identifies whether a sale is one made to a “customer” or is an “inter-dealer trade.” Inter-dealer trades on EMMA do not distinguish between trades with the intention to hold for investment purposes and trades for immediate resale. In some cases, trades recorded as “inter-dealer” trades are, in fact, trades to the “public” because the dealer-purchaser is purchasing on behalf of a true investor that is not a bond house. Sales to the public are complicated because they may have varying, embedded commissions, and the failure of the fixed income bond market to require separate reporting of commissions adds to the complexity and lack of transparency. Therefore, interpretational leaps are required for a user to draw conclusions from the publicly available data.

Only the underwriting team knows if at least ten percent of a maturity has been first sold at a specific price, because some informational websites do not track sales of specific bonds within each maturity, and some sites (including EMMA) only report trades of bonds by date, amount and type of transaction. Therefore, only the underwriter, as the initial seller of the bonds to the marketplace, knows the identities of the purchasers and the first price at which at least ten percent of a maturity is sold. Given the underwriter’s access to information and control over the process, a certification by the underwriter regarding the first ten percent sale price should establish the issue price of bonds that are publicly offered, absent abuse, such as bid-rigging. While a review of public trade data may lead to further conversations with an underwriter, that data alone should not overcome the presumption of the underwriter’s certification. These Comments recommend that the Regulation be interpreted to allow the issuer to rely on a certificate of the underwriter as to its reasonable expectation to sell at least ten percent of each maturity of the bonds to the public at its initial offering price, absent abuse such as bid rigging or lack of a bona-fide, public offering (discussed below).

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9 This site can be found at http://www.emma.msrb.org.
10 This site can be found at http://www.investinginbonds.com.
11 Trades posted at the same time on EMMA are sometimes re-ordered when reviewed at a later time or date.
D. Definition of “Public” in Public Offering and Sale

The recommendations regarding reliance on the issue price rules in the Regulation and section 1273 are premised on the bonds being “publicly offered.” The sale process, as previously described, encourages a public offering, and a public offering is commonly required in the BPA between the issuer and an underwriter, or as a term in the notice of sale for a competitive sale. An issuer may be unable to do anything further to ensure a public offering.

1. Presumed Public Offering Absent Abuse or Knowledge.

An underwriter (or the winning bidder in a competitive sale) commonly is subject to an obligation or covenant to publicly offer the bonds it purchases from the issuer. Given the transparency of the process, a sale of bonds by an issuer through a negotiated underwriting (or a competitive bid) should be presumed to be a bona-fide public offering, absent clear abuse or actual contrary knowledge by the issuer. For example, practices such as bid-rigging, pay-to-play, or price-fixing would overcome the presumption, as would the issuer’s actual knowledge that a public offering did not occur (e.g., where the cover page of the Official Statement lists one or more maturities as “not re-offered” (or “NRO”)), but the mere sale of a bond at a price different from the offering price should not be viewed as evidencing the absence of a bona-fide public offering.

One indicator of a public offering is whether the public\(^\text{12}\) was actually able to purchase the bonds at the offering prices. Actual sales of bonds to the public would confirm that bonds were indeed offered to the public. It is customary for underwriters to send out an “offering wire” to the market, offering bonds at stated prices for anyone to buy at those prices. But offering the bonds for sale is not the same as actually selling the bonds. A public offering can occur without regard to the actual results. Public buyers can acquire and resell bonds on the sale date or other dates; financial institutions can acquire bonds for their own investment purposes for a short, intermediate or long timeframe; and, financial institutions can also buy for resale. It is important to re-emphasize that trades at different prices, alone, do not evidence lack of a public offering.

Absent a contractual agreement or understanding with the buyer, the underwriter cannot control the resale prices. The issuer has no control over the prices at which anyone other than the underwriter sells the bonds, because it only has a contract with the underwriter. The underwriter may be able to control the prices at which others in the underwriting syndicate or distribution group sell the bonds for a relatively short period of time. But, after the bonds leave the underwriter (and any syndicate or distribution group), even the underwriter loses control over prices, and market conditions thereafter dictate price increases or decreases. Bond prices can also be influenced by a particular seller’s need to sell quickly, a particular buyer’s need to purchase at a particular price or on a particular date, and a variety of other factors.

The Treasury and the Service might be concerned that an underwriter will intentionally withhold bonds from the initial sale, or sell them to select wholesaler buyers that will resell them (perhaps immediately) at higher prices. An issuer’s only recourse is based on its BPA with the

\(^{12}\) The meaning of the term “public” is discussed further in the “Definition of the Public” discussion, below.
underwriter (or agreement with a bidder in a competitive sale–through contract or through the notice of sale) in which the underwriter (or the winning bidder) commits to publicly offer the bonds. The issuer’s lack of control necessitates its reliance on the underwriter’s certification and the prices shown on the official statement or other publically disseminated offering documents for the bonds. We understand that organizations such as the Municipal Securities Rulemaking Board (the “MSRB”) and the Financial Industry Regulatory Authority have jurisdiction to monitor fairness of pricing of underwriters.\textsuperscript{13}

Indeed, the MSRB has recently promulgated new amendments to MSRB Rules G-8 and G-11 to assist in assuring public access to bonds in initial offerings and fairness in the public offering process.\textsuperscript{14} According to the release (the “Release”) by the Securities and Exchange Commission (the “SEC”) approving the amendments, the “proposed amendments to Rule G-11 would: (1) apply the rule to all primary offerings, not just those for which a syndicate is formed; (2) require that all dealers (not just syndicate members) disclose whether their orders are for their own account or a related account; and (3) require that priority be given to orders from customers over orders from syndicate members for their own accounts or orders from their respective related accounts, to the extent feasible and consistent with the orderly distribution of securities in the offering, unless the issuer otherwise agrees or it is in the best interests of the syndicate not to follow that order of priority.”\textsuperscript{15} Moreover, “[t]he Commission believes the proposal will help achieve a broader distribution of municipal securities while still providing sufficient flexibility to syndicate managers and sole underwriters, and further believes that investors would benefit from a broader distribution of securities that is fair and reasonable and consistent with principles of fair dealing.”\textsuperscript{16}

In addition, a competitive sale that meets all of the state law and securities law requirements for competitive bidding should by itself establish a “public offering” of all of the bonds, at least in the absence of a clear abuse (\textit{e.g.}, bid-rigging, pay-to-play, or price-fixing) or actual contrary knowledge by the issuer. A competitive sale should eliminate a possible Service concern that, in a negotiated sale, bonds may be held back by the underwriter for later resale or for sale to preferred customers who might be brokers.\textsuperscript{17} The bidder in a competitive sale has no assurance that it will be able to buy the bonds from the issuer. This uncertainty reduces the likelihood that a bidder will have side arrangements that are contingent upon winning the bid when any other broker or wholesaler can also bid on the issuer’s sale. Accordingly, these

\textsuperscript{13} Also, section 6700 provides that penalties may be imposed on any person who participates in, among other things, an investment plan or arrangement and makes a “statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. . . .”

\textsuperscript{14} See File No. SR-MSRB-2009-17 (November 8, 2009), as amended by Amendment 1 to File No. SR-MSRB-2009-17 (August 4, 2010). Both documents were approved by the Securities and Exchange Commission August 16, 2010, and are effective October 12, 2010.


\textsuperscript{16} \textit{Id.}

\textsuperscript{17} \textit{See} Proposed Internal Revenue Service Form 14127, Question 4.
Comments recommend that, absent clear abuse or actual contrary knowledge by the issuer, a competitive sale be treated as a bona-fide public offering, with the reasonable expectations of the winner of the competitive bid to sell at least ten percent of each maturity of the bonds it was awarded establishing the issue price.

2. Public Offering Should Not Exclude Anyone.

Neither the Regulation, nor the issue price rule in section 1273 and its underlying Regulations, requires that a public offering exclude bonds houses, brokers or others that are not considered part of the public. While the only sales that establish issue price are sales to the public, the offering should be open to all buyers. The issue price can still be properly established under the Regulation in such a public offering.

An issuer has limited options to control the underwriting and selling process, and any controls might disrupt the market and result in unintended consequences. If an issuer narrowed its pool of purchasers to those covenanting not to resell their bonds for a specified time period, the issuer’s cost (and the corresponding subsidy paid by the Treasury with respect to the Direct Pay Bonds) would increase. Alternatively, if an issuer limited the prices at which the underwriter or the initial purchaser may sell or resell their bonds, again, the issuer’s cost (and the corresponding subsidy paid by the Treasury) would increase. These limitations would create further inefficiencies by being less “public,” due to participation being restricted to only select or pre-screened parties. Moreover, state law often requires the issuer in a competitive sale to accept the lowest interest-rate bid, thereby depriving the issuer of legal authority to impose conditions on the bond purchasers.

3. Definition of Public.

There has historically been some uncertainty about what constitutes the public in the context of a public offering. The term “public” is explained in the Regulation by reference to what is not the public. The Regulation excludes “bond houses, brokers, or similar persons or organizations acting in the capacity as underwriters, or wholesalers.”

The “acting in the capacity” requirement in the Regulation can be interpreted either (i) to apply to bond houses, brokers and all other persons or organizations similar to bond houses or brokers that have the capacity to act as underwriters or wholesalers, or (ii) to apply only to entities (bond houses, brokers or “other persons or organizations”) actually acting in the capacity of underwriters or wholesalers in a particular bond sale (and, presumably, other bond houses and brokers are not excluded from the “public” in that transaction). These Comments recommend that the phrase “acting in the capacity of an underwriter, or wholesaler” be interpreted as modifying “bond houses”, “brokers,” and “other persons or organizations” so that a sale to a bond house or broker is disregarded only if the bond house or broker is actually acting in such capacity or it is acting as a member of the underwriting syndicate or distribution group. A

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18 (Emphasis added.)

19 For example, a bond house can be both an investor and an intermediary, and its role, from the time of bond sale, may not be clear and also may change quickly thereafter.
contrary reading would exclude all financial institutions that have trading capacity, even if the buyer intends to hold the bonds for investment rather than resale. But as described above regarding publicly available information on actual trades, an issuer generally cannot distinguish between bond houses that are holding bonds for investment or for resale, because services such as EMMA only identify sales to a bond house as an “inter-dealer” trade.

Even the underwriter’s opportunity to assess the identity of the buyer and the buyer’s intent is limited to the initial offering. Without a written agreement or direct knowledge, the underwriter cannot be certain about whether a trade executed, likely by computer, with another dealer is for the dealer’s investment or resale. In our experience, investment banking firms often purchase debt instruments for their own account; in such cases, disregarding these original sales in calculating issue price could lead to an inconclusive result.

The Service has publicly asked about trades to affiliates of the underwriter or their “affiliated accounts,” with no guidance provided for how the scope of “affiliate” is to be determined. Members of an underwriting syndicate or distribution group are clearly acting in concert during the term of the syndicate or group, but the extent of any remaining rights or obligations between the members following dissolution of the syndicate or group is unclear. A similar question arises for entities that submit a joint bid in a competitive sale, although the rights or obligations between these entities may be even more informal.

The concept of the “public” is even more fluid when subjective considerations are taken into account. For example, an initial buyer may view itself differently from time to time, or disagree with how its role is being characterized by others. Moreover, a buyer’s intent might shift over time, perhaps having an initial intention to sell the bonds but subsequently deciding to retain the bonds for a period of time.

In light of the interpretative difficulties with respect to website information, the multiple roles a financial institution could assume, and the fluid intention of participants, these Comments recommend that the scope of the “public” should be presumed to include financial institutions unless the underwriter knows, from a written contract or other agreement, that the financial institution is acting in the capacity of underwriter or wholesaler.

III. Conclusions.

The concerns of the government, bond issuers, underwriters and bond lawyers over the issue price of tax-exempt bonds and Direct Pay Bonds can be best addressed by making the Regulation permanently applicable to tax-exempt bonds and Direct Pay Bonds, with certain clarifications.

Specifically these Comments recommend that:

1. The Regulation be permanently applicable to tax-exempt bonds and Direct Pay Bonds.

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20 See Proposed Internal Revenue Service Form 14127, Question 1, part 3.
2. The Regulation be interpreted in formal guidance (e.g., a Notice) as follows:

a. Establish issue price using the reasonable expectations of the managing underwriter in a negotiated sale (or of the successful bidder in a competitive sale) as of the time the prices of the bonds are agreed to by the issuer’s representative and the managing underwriter (or successful bidder) and using expectations as to the price at which the first ten percent of each maturity is to be sold.

b. Permit good-faith reliance on the certificate of the underwriting team as to first price at which ten percent of each maturity of the bonds was sold, or reasonably expected to be sold, to the public.

c. Presume that a public negotiated offering or competitive bid that contractually requires a public offering of all of the bonds is a bona fide public offering, absent clear abuse (e.g., bid-rigging, pay-to-play, or price-fixing) or actual contrary knowledge by the issuer.

d. Permit the “public” to include financial institutions, unless the underwriting team that has contracted with the issuer knows, based on a written contract or other agreement with the bond purchaser, that the bond purchaser is acting in the role as underwriter or wholesaler, and not as investor.