BDA Bond Dealers of America

21 Dupont Circle, NW • Suite 750
Washington, DC 20036
202.204.7900
www.bdamerica.org

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Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC

Sent via the Federal eRulemaking Portal at: www.regulations.gov (REG-148659-07)

RE: CC:PA:LPD:PR (REG-148659-07): Arbitrage restrictions on tax-exempt bonds

On behalf of the Bond Dealers of America ("BDA"), I am submitting these comments in response to the IRS' notice of proposed rulemaking (the "Proposed Rules") related to the arbitrage rules under section 148 of the Internal Revenue Code. Although the Proposed Rules would make a number of changes to the regulations, our comments are focused on the rules related to the determination of the "issue price" of a bond. While the BDA appreciates the efforts of the IRS and Treasury to provide clarification in this area, for the reasons described below, we believe that the Proposed Rules are unworkable, will result in higher interest costs for issuers of tax-exempt bonds, and should be substantially revised and reproposed.

We believe that the BDA and its members provide a unique perspective with regard to the Proposed Rules: the members of the BDA are largely focused on "middle market" transactions in the $10-25 million range that make up a large percentage of the issues that come to market each year, both in competitive and negotiated offerings. This experience and the related expertise cannot be found elsewhere in the municipal market. Our comments on the proposed issue price rules will focus on the following aspects of the proposal: First, the rules must take into account the reality that municipal securities are bought and sold within the context of a fluid marketplace with capital at risk; the removal of the reasonable expectations standard ignores this reality. Second, the IRS must identify its policy goals and weigh the costs of any solution to issuers of municipal bonds. Third, the Proposed Rules do not offer

a workable means of determining issue price if the "safe harbor" is not satisfied. Fourth, we believe that the proposed safe harbor rule for determining issue price will lead to unnecessarily higher interest rates as market participants are compelled to use the safe harbor to establish the issue price in each transaction. As a result, we believe that in lieu of the proposed approach that abandons the existing issue price rules, the IRS should make modest changes to those existing rules and couple those changes with appropriately targeted enforcement of those modified rules. The Proposed Rules have been in development for several years. During the course of this process, GFOA, BDA and other industry groups met with IRS and Treasury officials to discuss the rules related to issue price. These discussions culminated with a submission by this joint industry group of proposals related to the issue price rules on August 5, 2010, which is attached hereto. We continue to believe that the August 5, 2010 letter offers the best approach to dealing with the issue price rules. In particular, the August 5, 2010 letter called on the IRS to retain an approach to issue price determinations that is based on reasonable expectations when a bona fide public offering of the bonds is made. We stand by that recommendation.

As set forth below, the Proposed Rules would make dramatic changes to the regulations that would impose substantial costs on nearly every issuer of municipal bonds. Despite IRS personnel having frequently spoken out on the problems with the existing rules, we have yet to see evidence of the type of substantial abuses in numerous transactions that would justify such a dramatic change in the rules.

The rules must take into account the realities of the marketplace. A key shortcoming of the Proposed Rules is the failure to take into account the reality that the municipal bond market, like all public securities markets, is constantly changing. The price of every security is subject to fluctuation from the moment it is offered to the time that it is retired. Further, most municipal issues, unlike other issues in the equity or corporate bond market, are comprised of multiple maturities, often from 20 to 30 different maturities, that take a longer period of time to sell. For this reason, it can take days and even weeks to make an initial sale of all of the maturities of an issue. During this time, however, an underwriter and issuer are subject to market fluctuations. The issue price of a bond should be defined by

the reasonable expectations at a defined point in time for both competitive and negotiated sales. For example, this point would be "at the time of sale" in a competitive issue and "at final pricing" on a negotiated issue, and should not encompass the amounts—whether gains or losses—that the underwriter absorbs because it takes the risk of changes in the market. An approach based on reasonable expectations is the only way to isolate the real underwriters' compensation from changes in bond pricing due to external factors so as to properly reflect the correct issue price for arbitrage purposes. Your proposal would define the issue price based not only on the initial expectations but also on the value of the market fluctuations that take place between the initial pricing and the eventual sale, a period that could last over a month. Clearly, this would not be accurate for anyone's purposes.

Identification of the IRS' policy goals. When Congress amended the Code to require that the issue price of a bond be determined on the basis of the price paid for the bonds by the public, it had a simple goal in mind: issuers should not be able to compute bond yield in a manner that permitted them to earn back their issuance costs, including underwriters' compensation[1], through the investment of the bond proceeds. Thus, the issue price of a bond must be determined in a manner that captures the compensation earned by the underwriters' in underwriting the bonds. The IRS and Treasury Department performed a wholesale revision of the arbitrage regulations in 1993 with a view towards simplifying those rules and adopting a "rough justice" approach to the rules rather than seeking to capture every dollar that could potentially be viewed as arbitrage without regard to the costs related to compliance and complexity. However, the IRS and Treasury coupled this approach with the adoption of broad anti-abuse rules and the creation of a tax-exempt bond audit program. This approach was intended to reverse two decades of increasing regulatory complexity that resulted from frequent amendments to the regulations in order to capture the latest perceived abuse. The IRS and Treasury have remained true to this approach for the past 20 years, in large part due to the existence of an effective audit program. One result of this approach has been the elimination of the need to make changes to the regulations that affect every issuer of the tax-

[1] For these purposes, we use "underwriters' compensation" to include both the compensation for the actual underwriting of a bond and the other services provided by the firms acting as the underwriters of a bond issue.

exempt bonds in order to address an abuse being perpetrated by a minority of transaction participants. The Proposed Rules abandon this approach and we believe that this is not the way that the IRS should regulate in this area. Instead, we believe that the IRS should identify the conduct that it believes is problematic and enforce the law under its existing authority. For example, if underwriters are executing issue price certificates in an untruthful manner, the IRS has the tools to punish that behavior. Similarly, if the IRS believes that there are broker/dealers who are effectively part of the initial issuance of a bond issue but not being treated as such, the IRS should identify the problematic behavior and either enforce the existing rules or make modest clarifying changes to those rules.

However, as we stated above, the IRS must take these steps in a manner that is consistent with the policy behind the issue price rules: identifying the costs paid by bond issuers in issuing their bonds and including those costs as part of the issue price. By definition, those costs do not include changes in the price of bonds due to interest rate or other changes that occur after the initial sale of a bond issue. Finally, the rules should provide issuers and their advisors with certainty and should not impose unnecessary additional borrowing costs on the entire market place. The Proposed Rules go beyond what is necessary to capture the underwriters' compensation paid by the issuer.

It is also important that the use of issue price under section 148 has a very different policy rationale than do the original issue discount rules. Since 1989, the tax-exempt bond rules for determining issue price have had substantial differences from the "OID" rules for that very reason. In this case, attempting to make those two sets of rules consistent is unnecessary and harmful and changes the approach employed since shortly after the Tax Reform Act of 1986.

The history of the issue price rules being based on reasonable expectations is also noteworthy because it occurred during a period when Congress and the IRS were abandoning the use of reasonable expectations in favor of an actual facts approach in a wide variety of tax-exempt bond compliance contexts. The Tax Reform Act of 1986 gave the IRS statutory authority to take into account intentional acts to earn arbitrage and the IRS availed itself of this authority throughout the 1993 re-write of arbitrage

regulations. Yet as part of that re-write of the arbitrage regulations, the IRS made clear that a bond's issue price was based on the issuer's reasonable expectations. The reason for this, we believe, is that when there is a bona fide offering of a bond at an agreed upon initial offering price, the parties have agreed on the compensation for that underwriting and that is the amount that matters for arbitrage issue price and yield determination purposes. What happens after that offering price is agreed to is a risk that the underwriter has taken on, and not part of the issue price determination. The Proposed Rules reflect a failure to take the policy of the issue price rules into account.

The general rule of the Proposed Rules is unworkable. The Proposed Rules, as drafted, do not provide an effective way to determine issue price outside of the new, proposed safe harbor. Trying to define issue price based on sales over an extended period of time completely ignores the reality of financial markets and the risks that underwriters take to provide the lowest cost of borrowing to municipal issuers. An issue price needs to be defined at a specific point in time, not over a period of time.

To state the obvious, a regulation that does not have a workable general rule will compel compliance with any safe harbor that is provided. In the case of the Proposed Rules, both the general rule and the safe harbor are defective. Further there is no effective or completely accurate way for an issuer to track the prices of its bonds so that it could ever comply with the rules. For example, the MSRB's EMMA database lacks sufficiently specific details of trades to provide a solution to the problem. The Proposed Rules are also defective in that they fail to distinguish changes in bond prices that result from changes in interest rules and other external factors.

The Proposed Rules are particularly unworkable for competitive bond sales. In competitive sales the bidders will typically not make any sales of the bonds at the time that they bid on the bonds. Accordingly, the only way to comply with the Proposed Rules will be to lower yields so as to ensure that the safe harbor is satisfied. The difficulties with competitive sales will encourage issuers and underwriters to reduce the use of this underwriting method.

The ability of an issuer to comply with the rules by making rebate-like "yield reduction payments" is not an effective way to deal with these other problems. Yield reduction payments will require certainty as to the issue price taking into account the reasonable expectations at the time of the initial offering. Requiring an issuer to make a yield reduction payment as a result of a sale that that may have taken place 30-40 days after the initial pricing completely ignores the impact of market volatility and other factors that would have influenced the price at which the sale was eventually executed. Yield reduction payments also presume that the issuer will have the funds to make those payments. Since the issue price can only be determined after the sale of the bonds (if ever), issuers will be unable to size their borrowings to cover this cost. Moreover, the need to make yield reduction payments could cause an issuer to violate the authorizing resolution for a bond issue (.e.g., where a transaction is approved provided that certain savings targets are met). The requirement to make these yield reduction payments will make issuers responsible for costs that go far beyond what the Tax Reform Act was intended to accomplish.

<u>The safe harbor will increase borrowing costs of state and local governments</u>. For the reasons described above, the Proposed Rules will compel issuers to satisfy the new issue price safe harbor. The safe harbor, by its terms, only applies if at least 25 percent of each maturity of a bond issuer is sold to the "public." Therefore, in order to satisfy the safe harbor and establish a bond's issue price, 25 percent of that bond <u>must</u> be sold to the public. Thus, the issuer and underwriters must set the interest rates high enough (or the prices low enough) that the issuer will essentially be guaranteed that it will meet the 25 percent safe harbor for each separate maturity of an issue. Moreover, the issuer and the underwriters must make these sales to buyers who they are certain will not resell the bonds in a manner that results in them being viewed as dealers. The result is that issuers will have to sell their bonds "cheap" enough that they can be assured that a subset of the municipal bond market will buy at least 25 percent of each maturity. These problems will be magnified in the not unusual situation where an issuer has difficulty selling a particular maturity. Under the current rules, the underwriter would typically purchase that bond rather

than lower its price since that could affect the pricing of a number of other maturities in that bond issue. Under the Proposed Rules, the issuer will be compelled to reduce the price of the "problem" maturity, potentially forcing it to reduce the price of some or all of the earlier and later maturities in the bond issue. Again, this will result in higher borrowing costs for the issuer. These results stem from the fact that the safe harbor makes no provision for situations in which a bond pricing is not successful, necessitating that the underwriter purchased the bonds. This is an unworkable regulatory approach that will result in virtually every issuer having higher borrowing costs.

Underwriters and flippers. We understand the IRS' desire to ensure that the issue price of a bond is determined in a manner the takes into accounts sales of bonds by underwriters and by so-called "flippers". The BDA believes that it is a difficult distinction but clarity is needed if the IRS believes that this is an important distinction for tax purposes. At a minimum, we believe that it is critical that the regulations distinguish between two types of purchasers of bonds and that the breadth and vagueness of the Proposed Rules be eliminated in order for our members (and bond issuers) to be confident in their compliance efforts. Further, as with defining the price based on sales, defining customer in a restrictive way will also increase issuance and borrowing costs as a result of the subsequent administrative burdens and the limits on permitted bond purchasers. The Proposed Rules include as an underwriter "any person that purchases the bonds for the purpose of effecting the original distribution of the bonds or that otherwise participates directly or indirectly in such original distribution." This definition is simply unreasonable: it uses extremely broad terms and requires that issuers determine the intent of bond purchasers. Even with the ability to cure bond yield-related problems through yield reduction payments, it will be impossible for an issuer and its bond counsel to determine the parties that the IRS might view as an underwriter with the sort of certainty necessary to conclude that a bond issue is tax-exempt.

We understand the IRS concern with purchasers who intend to immediately resell the bonds that they purchased as part of the initial offering regardless of other market factors (for example, regardless of whether interest rates increase or decrease). However, a separate category of purchaser are those who

maintain substantial portfolios of municipal bonds and who do not purchase with the intent to resell those bonds but who may, depending on a variety of facts and circumstances, determine to resell the bonds over a period of time that may begin within a very few days after the initial public offering of the bonds but which typically take several days or weeks to complete. These purchasers may analyze the state of the market to determine whether there is an opportunity to resell those bonds at a profit, taking into account a variety of factors including movements in interest rates after the initial offering of the bonds, the supply of tax-exempt bonds in the market, how the pricing of other tax-exempt bonds compares to the prices of the newly purchased bonds, whether they need to sell bonds as a result of their investors wanting to reduce their positions in the funds maintained by these bond purchasers, etc. This latter type of investor should not be viewed as a "flipper" and their resales of tax-exempt bonds should not be viewed as affecting the issue price of a bond.

The Proposed Rules use the term "dealer" as defined under section 475 of the Code as a part of the identification of sales that are counted in determining a bond's issue price. The precedent under that definition of dealer indicates that a dealer expects to profit based purely on the mark-up that they can earn as a middle-man or wholesaler. An investor with a portfolio of municipal bonds that buys more bonds and subsequently determines to resell some or all of those bonds is looking to profit based on the municipal bond market and changes in that market. While the concept of using this definition of under section 475 may be good, the law regarding "dealer" status is not sufficiently developed to provide the type of certainty that is needed for purposes the tax-exempt bond rules that use "issue price" as part of the analysis. For this reason, we believe that the rules must clarify that mutual funds, insurance companies, and other investors that do not purchase bonds in the initial offering with an expectation that they will immediately begin reselling those bonds are not "dealers" for this purpose.

Suggested approach. We believe that the IRS should issue new proposed rules that retain the basic framework of the existing final regulations with the following modifications:

(a) Improve the general rule. The general rule should be that issue price is determined based on the issuer's reasonable expectations at a specific time provided that a bona fide public offering of all of the bonds is made. The regulations should provide greater detail on the requirements for the making of a "bona fide public offering." And, this time should be defined as a specific time, not a period of time. The August 5, 2010 letter contained a number of suggestions for providing greater detail for establishing that a bona fide public offering has been made. The IRS should use its available enforcement tools to ensure that abuses are not occurring and should work with the SEC, FINRA, and MSRB to enforce the municipal securities regulations.

(b) Consider maintaining the 10 percent threshold. The BDA believes that the reasonable expectations general rule must be in place and should be coupled with a workable safe harbor. The existing 10 percent rule has served that function for the last 20 years, but can not work in the absence of the reasonable expectations rule that is essential to recognizing that the rules interact with a fluid marketplace in which capital is at risk. Should the IRS consider an increase in this threshold, it should be coupled with a clear rationale for the anticipated benefit any such increase would produce.

(c) Require acceptance of all orders. We believe that the requirement in the Proposed Rules that all orders received from the public during the offering period are filled (to the extent of the amount of bonds sold) is a good proposal that should be retained. We would suggest, however, that the IRS further make clear that the order period during the underwriting process is synonymous with the term used under the proposed regulations, "offering period" so that there is general understanding that any trade after the bond purchase agreement is signed shall not be considered part of the initial public offering. This proposal combined with the suggested minor clarification should address some of the concerns with the existing rules that the IRS has noted.

(d) Clarify who is a "dealer." As indicated above, while the "dealer" concept is a good one, clarification of its application is needed. The Proposed Rules state that a person that buys and holds bonds for investment is not an underwriter but additional guidance is needed.

(e) Clarify the length of the underwriting period. The Proposed Rules state that sales by a dealer during an order period (as understood to coincide with the term "offering period" as suggested above in (c)) are taken into account if it purchases bonds for the purpose of effecting the original distribution of the bonds. This is another example of an aspect of the Proposed Rules that is good in concept but that does not provide enough certainty in the context of the tax-exempt bond rules.

(f) Safe harbor for competitive sales. We believe that the rules should be drafted reflecting the fact that competitive underwritings reduce the concerns that the IRS should have regarding the determination of issue price. A safe harbor for competitive sales should be provided and should state that the issue price for a competitive sale is determined by reasonable expectations at the time of sale.

(g) De minimis rules are needed. In drafting its rules the IRS should recognize that special consideration is appropriate for both small issues of bonds and smaller maturities within a longer issue. In both of these situations, it will often be difficult to establish actual sales of a substantial percentage of the bonds. Given that these transactions are smaller in size, the risk for abuse of the arbitrage rules is greatly reduced. We suggest that greater flexibility be provided in the case of smaller bond issues and smaller bond maturities and would offer our assistance in working with the IRS to establish the appropriate thresholds.

(h) Other uses of "issue price." The Code and regulations use "issue price" for a number of other aspects of the tax-exempt bond requirements. The concerns that seem to be the rationale for the Proposed Rules do not apply in these other contexts. For those other purposes, than "issue price" should be exclusively based on reasonably expectations.

We believe that the municipal bond industry works best when the industry and regulators work together to develop practical solutions that address issues in a manner that does not create unnecessary costs or burdens for the industry. The industry provided substantial input regarding the issue price rules in meetings with the IRS and Treasury and in the August 5, 2010 letter. This input does not seem to have impacted the development of the Proposed Rules. Further, we believe that a cost/benefit analysis of the Proposed Rules would demonstrate that the costs that would be imposed on issuers of tax-exempt bonds far outweigh the compliance benefits that the IRS is seeking to obtain.

Although our comments are focused on the aspects of the Proposed Rules related to issue price, we are generally supportive of the other clarifications that the IRS has proposed. We recognize, however, that these rules raise complex technical issues that should be resolved before the rules are finalized. In addition, the changes proposed should be made available more broadly on a retroactive basis. We are, however, concerned with the proposed change to the anti-abuse authority of the Commissioner. Throughout the history of the arbitrage regulations, the anti-abuse rules have been appropriately targeted so as not to provide the Commissioner with unlimited discretion. Thus, for example, the regulations prohibit transactions that involve a material financial advantage related to arbitrage but only if there is a related burden on the market for tax-exempt bonds. The regulations permitted wider discretion to the Commissioner related to arbitrage-driven transactions but limited that discretion to making modifications to properly reflect the economic substance of the transaction. In contrast, while Congress provided the IRS with broader authority in the context of advance refundings, no such broad authority was provided under the arbitrage rules. For this reason, we believe that the IRS should reconsider the proposed changes to the anti-abuse rules under the arbitrage regulations.

The BDA greatly appreciates the effort undertaken by the IRS and Treasury to clarify the issue price rules. We believe that the opportunity to comment on the Proposed Rules and an ongoing dialogue between the federal government and industry participants is necessary to ensure that a workable set of rules if promulgated. The BDA offers its assistance in this process.

Sincerely,

Michael Nicholas, CEO

Enclosure: *August 5, 2010 Letter to Department of Treasury and Internal Revenue Service*