January 20, 2012

Mr. John J. Cross III
Associate Tax Legislative Counsel
Office of Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear John:

We understand that the Treasury Department and the Internal Revenue Service are developing regulations or regulatory guidance examining the definition of "issue price" in Treas. Reg. § 1.148-1(b). Issuers and other marketplace participants continue to struggle with the resulting uncertainty surrounding the question of issue price in the-tax exempt market, much as they did with Build America Bonds ("BABs") as a result of the BABs questionnaire and other statements by IRS personnel.

The question of how bond issuers determine the issue price of a bond is extremely important. The issue arose in 2009 and 2010 in the context of Build America Bonds ("BABs"), but it has been a vexing issue for practitioners with respect to tax-exempt bonds for years. It is an important question because it is key to determining the maximum yield at which tax-exempt bond proceeds can be invested under the Internal Revenue Code's restrictions on arbitrage. The issue has risen in prominence in part because of the availability of trade prices brought about by the implementation of the Municipal Securities Rulemaking Board's ("MSRB") Real-Time Transaction Reporting System ("RTRS") through which secondary market trading prices have become available to regulators and market participants. IRS officials have stated that they are using the RTRS as a tool to determine whether issue prices being used by issuers for arbitrage purposes are valid. While we welcome the IRS's use of these data, we are concerned that a lack of clarity in current issue price rules is causing inconsistencies among practitioners in determining issue prices in real-world transactions.

The Securities Industry and Financial Markets Association ("SIFMA")[1], along with the National Association of Bond Lawyers ("NABL") and the Government Finance Officers Association ("GFOA"), previously submitted information to you concerning the question of issue price for BABs;[2] many of those

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[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.
[2] Letter of Government Finance Officers Association et al., August 5, 2010.

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comments and observations continue to be relevant for the tax-exempt bond market notwithstanding the expiration of the BABs program. Moreover, in 2006 the National Association of Bond Lawyers submitted a set of recommendations; that submission continues to be highly relevant to the discussion of the questions surrounding "issue price."[3] Both of these submissions highlighted that, in general, the "issue price" of bonds under Section 148 should be based upon the initial offering prices set forth by the underwriters pursuant to a bona fide public offering and as set out in the bond purchase agreement between the underwriters and the issuer, as currently set forth in the applicable Treasury Regulations. We maintain the view that this represents the best approach to the determination of issue price, for reasons of both practicality and as matter of following the intent of Congress when it amended the arbitrage yield rules.

However, these prior submissions do not address in depth two areas of the underwriting and marketing process that should be considered by the Treasury and IRS in its deliberative process. These two areas help illustrate why trade prices for new bonds as observed in trade reports compiled by the Municipal Securities Rulemaking Board ("MSRB") may differ from the "issue price" established at the time of the offering. They will also help inform you and your colleagues as you continue to develop additional rulemaking and guidance in the area of issue price. The first consideration is the fact that the broad market and the marketing process for tax-exempt bonds is not so readily divided between the "public" (as the term is used in the current issue price regulations) and "bond houses, brokers or similar persons acting in the capacity of underwriters or wholesalers." In fact, a substantial portion of the demand for tax exempt bonds in a primary market underwriting, as well as in the secondary market, will be from potential purchasers that may or may not meet the definition of the "public" as defined in the regulations. The second consideration is the extent to which various specific securities rules and regulations govern current practices concerning the underwriting and marketing of tax exempt bonds in a primary offering, as well as the rules governing secondary market transactions. Further, as discussed below, the current securities law rules and regulations expressly contemplate the participation of those "nonpublic" potential purchasers in the underwriting process, and the participation of these potential purchasers is in fact in the best interests of the issuer in obtaining market pricing for its bonds.

The Marketing Process: The "Market" vs. the "Public"

We believe that one of the most misunderstood concepts in the marketing of tax exempt bonds is to whom bonds are marketed. Specifically, given that the tax regulations define the "issue price" of bonds as being based (at least to some extent) upon the sales to the "public," there seems to have developed an assumption that bonds are (or should be) offered and sold only to the "public" as defined in the tax regulations. The reality of the marketplace is quite different.

We start with the fundamental premise that, as a matter of economic and marketing principles, an underwriter will get the best pricing (and therefore the issuer will get the best pricing reflecting that) if the underwriter exposes the offering of a security to as wide a range of potential purchasers as

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[3] "Recommendations by the National Association of Bond Lawyers Issue Price Study Group," August 25, 2006.

possible: mutual funds, property and casualty insurance companies, "mom and pop" retail, and separately managed accounts ("institutional retail")—all of which are almost always considered members of the "public"—as well as traders, hedge funds, arbitrage accounts, tender option bond program managers, broker dealers and other parties, many of whom are or are affiliated with broker dealer firms and are not so obviously the "public" under the tax regulations. Put another way, it is in the best interest of the issuer if the marketing of a bond issue is not limited exclusively to potential investors that the tax rules define as being members of the "public." And in fact, the current construct of the marketing process for tax-exempt bonds explicitly incorporates this broad marketing reach as part of the marketing process.

The fact that purchasers of tax-exempt bonds in the primary offering may not come within the definition of "public" should not affect the determination of "issue price" for yield computation and other relevant purposes, since these purchasers should be viewed as investors in their own right and their actions *vis-à-vis* the bonds are not subject to the terms of any underwriting arrangement with the issuer of such bonds. As described in the August 5, 2010 report, those purchasers of tax-exempt bonds are engaged in business activities independent of the underwriter or underwriting syndicate that is bound by the terms of the bond purchase agreement and responsible for the dissemination of the entire bond issue and not isolated portions thereof. The actions of such purchasers, notwithstanding the fact that they are not technically members of the "public", should not affect the ability of the issuer, bond counsel and any other interested person, to rely on the bona fide public issuance process described in the current Treasury Regulations.

We would also reiterate the extent to which the marketing of bonds begins well before the actual order period. The process typically may include: (a) distribution by the issuer of a preliminary official statement; (b) a contemporaneous notice of the upcoming issue in a publicly available medium (such as through the calendar of upcoming issues in *The Bond Buyer*, a Bloomberg wire, or the MMD calendar); distribution of the notice may, in smaller offerings, be limited to customers of the underwriter or underwriters; (c) notice of the upcoming issue and possible pricing levels to the sales force(s) of the underwriters (such as through internal sales force meetings or distribution of one or more wires or emails internally to the sales force indicating the coming availability or current availability of the bonds); (d) solicitations of "indications of interest" from potential investors, even if limited to clients of the underwriting group; (e) a "retail order period", in which retail investors are offered an opportunity to submit orders ahead of institutional investors; (f) distribution of a preliminary pricing wire, together with an active solicitation of orders at those interest rate levels; and (g) publication of final pricing (for example, through a final pricing wire, a Bloomberg communication, or similar means), even if limited to clients of the underwriting group. The prices and yields in the final pricing wire thus will typically represent the culmination of a lengthy process involving the underwriters, the issuer and its financial advisor, and investors.

Notwithstanding this process, it is important to note that even the most extensive process does not always produce initial offering prices that will reflect the "best" price for a bond in the market. First, no marketing process will reach 100 percent of the investors in the marketplace at a given moment:

investors may not be customers of the underwriters, or ,for example, may not have funds available to invest at the time of the offering, but otherwise would be willing to purchase the bonds at a later time. Second, market custom and expectations obligate the underwriter to reoffer all identical bonds at the same prices (with possible adjustment for concessions); there may well be investors that will pay a higher price than the single initial offering price. However, unless those investors are willing to purchase the entire amount of the bonds, the higher price of that investor does not determine where the market may "clear" for bonds offered under the single price approach.

Some Securities Law Rules Affecting Underwriting

In order to fully understand the underwriting process, it is important to distinguish between what may (or must) transpire: (i) during the "order period"[4] of an underwriting; (ii) the period between the end of the order period and end of the underwriting period (usually, immediately after the bond purchase agreement is signed by both the issuer and the underwriter and any orders to customers are confirmed in writing);[5] and (iii) sales and marketing that occur after the end of the underwriting period. MSRB Rule G-11 generally governs syndicate practices in connection with a primary offering; other MSRB rules (notably Rule G-12, concerning uniform practices, and Rule G-17, concerning general conduct of business) govern transactions not covered by the syndicate practices rules of Rule G-11.[6]

Rule G-11 Provisions

Some of the specific provisions of Rule G-11 bear upon the question of to whom (and how) bonds are offered and sold pursuant to a primary offering, and thus have a bearing on the establishment of the "issue price" of bonds.

First, under MSRB Rule G-11(b), any broker dealer that submits an order during an order period to a member of a syndicate must disclose at the time of such order if the order is for its own account ("for stock" in the parlance of the syndicate process) or for a related account. Several things are worthy of note with respect to this provision. First, and most importantly, the rule quite clearly contemplates that broker dealers that are not members of the syndicate can submit orders both on behalf of their customers and for their own account. Second, the rule does not apply to orders from parties that are

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[4] Defined in MSRB Rule G-11(a)(v) as "the period of time, if any, announced by the syndicate or, where no syndicate has been formed, a sole underwriter during which orders will be solicited for the purchase of securities in a primary offering."

[5] At the end of any underwriting period, if there are any unsold bonds, the syndicate owns those bonds except to the extent that syndicate members have agreed to purchase them for their own account. Further, the marketing and sales of any unsold bonds after the end of the underwriting period generally are not subject to the syndicate provisions of Rule G-11, but are subject to the other MSRB rules, including but not limited to Rule G-12 and Rule G-17.

[6] The MSRB has proposed an Interpretive Notice concerning Rule G-17 that would impose specific disclosure obligations on the underwriters of negotiated transactions as part of the underwriters' duty of "fair dealing" with an issuer, most notably (in the context of the definition of "issue price" the existence of any third-party arrangements for the marketing of the issuer's bonds. See MSRB Notice 2011-61 (November 3, 2011).

not broker dealers. Thus, potential purchasers that are not broker dealers are under no obligation to disclose whether they are purchasing bonds with a view to resale.

Further, under Rule G-11(f), prior to the first offer of any bonds, if the issuer has established a "priority" by which orders are to be filled, those priority rules must be conveyed to all members of the syndicate; if the priority provisions are prepared by the senior manager, those provisions must be provided in writing to the issuer. These priority rules may, for example, require that all "in-state retail" orders received during the order period up to a specified size be filled; further, it may also require that such orders be filled even if placed by broker dealers that are not members of the syndicate, and depending upon how it is worded may even mandate the priority of such orders for stock. This provision is of note in that it clearly requires issuer involvement and/or notice in establishing the priority of allotments of bonds. Thus, it will often be the case that bonds are allotted pursuant to these priority rules established or approved by the issuer to purchasers that are "brokers, dealers or other parties acting in the capacity of wholesalers."[7]

Third, Rule G-11(e) provides a specific obligation with respect to allocations of bonds to related accounts of members of the syndicate:

> (i). . . . Unless otherwise agreed to with the issuer, such priority provisions shall give priority to customer orders over orders by members of the syndicate for their own accounts or orders for their respective related accounts, to the extent feasible and consistent with the orderly distribution of securities in the offering. Notwithstanding the preceding sentence, a syndicate may include a provision permitting the syndicate manager or managers on a case-by-case basis to allocate securities in a manner other than in accordance with the priority provisions, if the syndicate manager or managers determine in its or their discretion that it is in the best interests of the syndicate. <u>In the event any such allocation is made, the syndicate manager or managers shall have the burden of justifying that such allocation was in the best interests of the syndicate</u> [emphasis added].
>
> (ii) In the case of a primary offering for which a syndicate has not been formed, unless otherwise agreed to with the issuer, the sole underwriter shall give priority to customer orders over orders for its own account or orders for its related accounts, to the extent feasible and consistent with the orderly distribution of securities in the offering.

Under this provision, then, orders from trading desks, retail sales desks, or similar related accounts of members of the syndicate generally may be filled only after other orders are filled, or if the trading desk is taking a significant amount of a maturity or of the deal structure generally such that that it helps the overall marketing of the bond issue. Note, however, that Rule G-11(e) does not apply to

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[7] The MSRB's Proposed Interpretive Notice concerning Rule G-17 contains an explicit reminder that if an issuer establishes a retail order period or other priority provisions, the underwriter is under an obligation to follow those provisions. See MSRB Notice 2011-61 (November 3, 2011).

orders of broker dealers that are not members of the syndicate: there is no requirement that such orders be filled only after all other orders.

Rule G-17: "Fair Dealing"

In addition to the specific provisions of Rule G-11, underwriters are also subject to the general "fair dealing" rule of MSRB Rule G-17. This rule states:

> In the conduct of its municipal securities or municipal advisory activities, each broker, dealer, municipal securities dealer, and municipal advisor shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice.

This rule of "fair dealing" applies to both the conduct of an underwriter during the primary offering (the underwriting period) and to any transactions after that ("secondary market" transactions). Under this rule, all parties with whom an underwriter deals – issuers, investors and other broker dealers – must be dealt with "fairly." Although the concept of fair dealing is a broad and flexible one (and, by virtue of similar provisions in FINRA rules is not limited to municipal transactions), it does incorporate several core concepts of market making and fair dealing, including specifically:

- If an underwriter offers bonds at a price, it must be prepared to execute at that price or better (i.e., lower price); and
- If the offering is limited (e.g., retail only, qualified institutional buyers ("QIBs") only), the underwriter should tell the market of such at the outset.

The inexorable logic of these specific rules (as well as the general concept of fair dealing), then, would require that, for example, if the underwriter offers bonds pursuant to a bona fide public offering (as distinguished from an offering "to the public") without reservation or qualification, and another broker dealer or other potential purchaser that is not a member of "public" (as defined in the tax regulations) submits the only order at the price offered during the order period, <u>the underwriter cannot refuse to fill the order</u>. Similarly, if there are unsold balances after an order period and are held by the syndicate, or that have been taken down[8] by an underwriting firm from a syndicate that are offered after the date of sale of the bonds, if another broker dealer accepts the offer, the underwriter is obligated to fill the order. Under these circumstances, it is possible that the first sales of 10% or more of the bonds of a maturity to the "public" might well be at prices higher than the initial offering price established by the underwriter. We do not believe that these types of sales (which often occur on maturities for which insufficient demand was present during the primary offering, or are a relatively small percentage of a larger maturity) should invalidate what would otherwise constitute a bona fide offering process.

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[8] "Taken down" means that, after the syndicate has ceased its attempts to sell bonds because there are no more buyers indicating willingness to purchase bonds at the initial offering prices, a syndicate member accepts a share of unsold bonds; the syndicate is then said to have "broken."

One additional outcome of the underwriting process should be noted. It is often the case that, even with a bona fide offering process in which in the aggregate a large percentage of the issue is in fact sold to the public, bonds in certain maturity ranges may have little or no demand on the day of pricing, with the result that for those maturities less than 10 percent (or even none) will have been sold to customers. In that case, the underwriting syndicate will put up its own capital to purchase the bonds. In effect, at that moment in time, the underwriters are the best price in the market given the yield and underwriting spreads dictated by the underwriting process.[9] The fact that the bonds are subsequently sold to other parties (including other broker dealers) should not affect the issue price if there has been a bona fide public offering.

Rule G-30: Prices and Commissions

Another area where the issue price rules intersect with MSRB regulations is in the use of the term "fair market value." Treas. Reg. § 1.148-1(b) provides that the "issue price of bonds may not exceed their fair market value." By comparison (for example), MSRB Rule G-30(a) requires that a broker dealer charge a price for bonds to customers in a principal transaction that is:

> fair and reasonable taking into consideration all relevant factors, including the best judgment of the broker, dealer or municipal securities dealer as to the fair market value of the securities at the time of the transaction and of any securities exchanged or traded in connection with the transaction, the expense involved in effecting the transaction, the fact that the broker, dealer, or municipal securities dealer is entitled to a profit, and the total dollar amount of the transaction.

This MSRB rule clearly contemplates that broker-dealer profits and commissions are factors separate from the "fair market value" of a municipal bond, a concept made explicit in MSRB Notice 2004-03, "Review of Dealer Pricing Responsibilities" (Jan. 26, 2004). The Notice states that "Dealer compensation on a principal transaction is considered to be a mark-up or mark-down that is computed from the inter-dealer market price prevailing at the time of the customer transaction. As part of the aggregate price to the customer, mark-up or markdown also must be a fair and reasonable amount, taking into account all relevant factors.". See also Financial Industry Regulatory Authority Notice 10-41, which states that "Firms must use this [EMMA] information to determine the prevailing market price of a [municipal] security as the basis for establishing a fair price in a transaction with a customer."

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9 An example of this phenomenon that often occurs may help to illustrate the concern. Assume that the issuer is selling $20 million of bonds on a level principal basis over 20 years, $1 million per year. The underwriting syndicate has orders for $1 million all of the bonds maturing in 2023 at a 2.90% yield and for the 2025 maturity at 3.00% yield. The syndicate offers the 2024 maturity at a 2.95% yield but finds no buyers. The underwriters could raise the offering yield on the 2024 maturity to 3.00% to entice investors, but in doing so it would also have to raise the yield on the 2025 maturity above 3.00% (and perhaps other, later maturities as well), so as to retain investor interest in those maturities, to the overall detriment of the issuer (and, it should be noted, at an increase in the arbitrage yield). Rather than doing this, underwriters will often underwrite the "orphan" 2024 maturity, with the result that less than 10% of the bonds of that maturity are sold.

This regulatory framework—that a dealer's markup or commission is added to the "fair market value" of a bond—is difficult to square with what the tax rules intend, namely, that the issue price of bonds include the underwriters' "markup." We believe that these rules would be better harmonized by the adaptation of the recommendation that the "issue price" of bonds be based upon the initial offering prices set forth by the underwriters pursuant to a bona fide public offering and as set forth in the bond purchase agreement between the underwriter and the issuer.

Consequences and Implications of Rules

We believe that part of the reason for the uncertainty surrounding the "issue price" of bonds is the fact that, by and large, underwriters and tax counsel, all are largely focused on the "process" of pricing, whereas the IRS, with its apparent emphasis on data derived from the MSRB's Real-Time Trade Reporting System ("EMMA data"), seems to be focused on the "results" of pricing. We assume that the concern of the IRS generally is that the issue price of bonds (based upon EMMA data) are understated, not overstated. Yet, because of the syndicate practices and rules currently embodied in the MSRB rules, as described above, there are many occasions in which EMMA trade data will show prices higher than the initial offering prices. The most obvious of these reasons is, of course, changes in interest rates. After the end of the order period, it is often the case than an underwriter will hedge its unsold balances, for example, in the Treasury market in the case of taxable BABs. The pricing of the unsold bonds in inventory then will be subsequently adjusted to reflect the changes in the benchmark interest rates; declines in interest rates would thus result in an increase in the offering and sale prices, even with the same (or wider) yield spreads to the benchmark rates.

Also, there are other, less obvious, situations in which EMMA trade data will show prices higher than the initial offering prices, wholly aside from changes in interest rates generally. For example:

- Sales to other broker dealers (not members of the syndicate or "related" to them) during the underwriting period or immediately thereafter, or to brokers' brokers, at or below the initial offering price, followed by "matching" sales to the purchasing broker dealers' customers at higher prices. The follow-on trades are not executed by the members of the syndicate, and, if between unrelated parties, as a formal matter are outside the legislative intent of the issue price rules, being a secondary market trade.
- Sales to bona fide customers, which then resell at a higher price (so-called "flippers"). Given the lack of any requirement that customers that are not broker dealers identify their trading intentions, there is no way beforehand to "know" (however much one might suspect) whether a customer is or will be a "flipper". Moreover, attempts to require an underwriter to monitor such after-market trading would be contrary to policies in other markets that generally discourage underwriters from "tracking" purchaser behavior in the secondary markets.[10] Since EMMA trade

[10] Such "tracking" purchaser behavior is generally regarded negatively with respect to securities covered by SEC Reg. M. See SEC Rule 101; SEC Release Nos. 33-8565 & 34-51500 (April 7, 2005), p. 19: "However, tracking customers' aftermarket purchases in the first few days of trading following an IPO could be evidence supporting a claim that the customers' expressions of desire to purchase in the aftermarket were induced."

> reports do not identify parties by name, a coincidence—for example, a broker sells a $50,000 par amount of bonds to another broker; five minutes later, a different, third broker sells the same amount to its customer at a higher price—could lead to incorrect conclusions. Further, as a technical matter under MSRB rules, the resale by the customer is a secondary market trade, which should not be affected by the issue price rules.

Notwithstanding the above, there is a process by which underwriters can in fact limit (a) the audience to whom bonds are sold; and (b) prevent any prices showing up on EMMA at prices higher than the initial offering price: it is called a private placement. However, in general, the private placement market, with its more limited (or sometimes nonexistent) liquidity in many cases results in higher interest rates for issuers. In a real sense, focusing on uninterpreted pricing information rather than on assuring an open and broad distribution process (consistent with the credit and structure of the transaction) elevates the “purity” of the pricing result over the process that should be to aimed at providing market based interest rates.

We do believe that some additional comfort could be derived by the IRS that a bona fide public offering has been conducted in an underwriting if there were to be a minimum time frame during which orders are solicited at a specific prices. The typical order period in negotiated transactions is in the range of an hour or so. We do not believe that an explicit rule requiring such a minimum order period would impose any burden on the market, and could provide the IRS (and others) additional comfort that a bona fide offering of the bonds has in fact taken place. However, any such rule should be coordinated with the appropriate securities regulators, especially the MSRB.

We are encouraged that Treasury and the IRS are developing additional rules or guidance to help clarify issue price rules. In that context, we ask that you be very clear about what you think is wrong with the existing process (or perhaps, more accurately, what you consider to be the “don’ts” practitioners should adhere to). Further, we ask that you be cognizant of the MSRB rules that currently govern syndicate practices; if you want to change or limit those practices so as to address concerns about “issue price”, we ask that you be clear as to what you are seeking to limit and coordinate those changes with the MSRB rules. Lastly, should Treasury and the IRS seek to limit the range of investors to whom bonds can be offered (e.g., to purchasers that may or may not be members of the “public”), please recognize that such limits on marketing bonds to as wide a range of investors as possible will impose additional costs on issuers.

Thank you for the opportunity to comment on the question of issue price and for your consideration of this submission. We would be pleased to discuss any of these comments in greater detail, or to provide any other assistance that would help facilitate your review and analysis. If you have any questions, please do not hesitate to contact me.

Sincerely,

Michael Decker
Managing Director and Co-head of Municipal Securities

C: Emily McMahon, Acting Assistant Secretary for Tax Policy, Department of the Treasury
The Honorable William Wilkins, Chief Counsel, Internal Revenue Service
Lisa Zarlenga, Acting Tax Legislative Counsel, Department of the Treasury
Erik Corwin, Deputy Chief Counsel (Technical), Internal Revenue Service
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