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## Help! Why Did the Tax Lawyers Change the Issue Price Certificate?

### *New Issue Price Regulations for Municipal Bonds and Newly Released SIFMA and NABL Model Documents*

On Jan. 9, 2017, the U.S. Department of the Treasury (Treasury) published in the Federal Register (81 FR 88999) final regulations under Section 148 of the Internal Revenue Code of 1986, as amended (the Code), amending the “issue price” definition (the New Issue Price Regulations). The issue price definition is used to determine yield on a tax-exempt bond issue, which is needed for determining whether the bond issue satisfies the arbitrage rules of Code Section 148. Notice 2010-35 applies this definition to other tax-advantaged bonds, including build America bonds and other qualified tax credit bonds. While the concept of issue price is used for many other purposes in the tax-advantaged bond rules, the Section 148 definition technically applies only for the arbitrage rules. The Issue Price Regulations apply for bonds sold on or after June 7, 2017.

The promulgation of the New Issue Price Regulations is the culmination of a somewhat contentious process that Treasury began in response to Internal Revenue Service (IRS) beliefs that underwriters were abusing how bonds were priced under the existing issue price definition in Treas. Regs. Section 1.148-1 (Existing Definition). Treasury published its first proposal to change the issue price definition in the Federal Register on Sept. 16, 2013 (78 FR 56842). This proposal faced significant public criticism, and was withdrawn and replaced with another proposed definition (the 2015 Proposed Regulations) that was published on June 24, 2015 (80 FR 36301). While the 2015 Proposed Regulations were more favorably received, they still generated significant comments, resulting in Treasury making substantive changes from the 2015 Proposed Regulations in the New Issue Price Regulations.

The New Issue Price Regulations set forth a procedural framework that allows issuers to determine issue price under a range of circumstances depending on the pricing mechanism the issuer employs for its bonds sale. Given this, the National Association of Bond Lawyers (NABL) and the Securities Industry and Financial Markets Association (SIFMA) drafted model documents for underwriters and issuers to use when the New Issue Price Regulations take effect. On March 30, SIFMA released draft riders for its model agreements, and on March 31, NABL released its model

certifications. These model documents are designed to address the new regulatory requirements for various types of transactions (*i.e.*, negotiated public offerings, competitively bid public offerings, and private placements) under various circumstances. This *GT Alert* discusses the regulatory framework and form documents to answer questions about why tax attorneys changed the issue price certificates.

### **Background on Existing Issue Price Definition**

Under Code section 148(h), issue price is generally determined under Code sections 1273 and 1274; under Section 1273(b), the issue price of publicly-offered bonds issued for money is the initial public offering price at which a substantial amount of bonds is sold. The Existing Definition modified this rule for tax-exempt bonds and provided that “substantial amount” meant 10 percent and, importantly for bona-fide public offerings, permitted issuers to determine issue price as of the sale date based on reasonable expectations regarding the initial public offering price. Separate issue prices were established for bonds with different payment and credit terms and “public” did not include “bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers.” This one-paragraph definition dates back to 1993 (and the concept of using initial offering price, to 1979).

The IRS began expressing concerns about the Existing Definition around the time the Municipal Securities Rulemaking Board (MSRB) opened its electronic pricing system, EMMA (Electronic Municipal Market Access) in 2008-2009, which produced more transparency in bond pricing. Apparently, finding discrepancies in issue prices reported to the IRS and bond prices reported on EMMA, the IRS expressed concern that some underwriters were buying bonds from the issuer at one price and quickly reselling at a higher price with the financial benefit going to the underwriter. The tax problem, the IRS stated, was these actions understated issue price, likely resulting in an issuer incorrectly computing a higher yield on the bond issue and, thus, a higher permitted investment yield. We note that a recent release by the Securities and Exchange Commissioner supports the IRS concerns.

### **The 2015 Proposed Regulations**

The 2015 Proposed Regulations were designed to reduce the potential for abuses by basing issue price not on reasonable expectations but on the actual price of the first 10 percent of each maturity of bonds sold. Using actual sales created problems, however, when the issuer needed certainty about issue price on the sale date. The underwriter may not have been able to sell 10 percent of each maturity in the bond issue by the sale date. The 2015 Proposed Regulations addressed this problem by allowing an issuer to use the initial offering price for undersold maturities if the underwriter made certain certifications and covenants about not filling orders at prices higher than the initial offering price. The 2015 Proposed Regulations:

- > Generally removed the ability to base issue price on reasonable expectations; issue price was the price at which the first 10 percent of each maturity of the bonds was actually sold;
- > Provided an alternative method for determining issue price when the issuer did not receive orders for 10 percent of each maturity by the sale date. The issuer could treat the initial offering price to the public as the issue price, provided that:
  - > The underwriters filled all public orders at the initial offering price on or before the sale date and no underwriter filled an order at a price higher than the initial public offering price on or before the sale date;
  - > The lead underwriter certified to the issuer the initial offering price, that the above requirements were met, and that no underwriter would fill an order from the public received after the sale date and before the issue date at a price higher than the initial offering price unless such higher price was the result of a market change, such as a change in interest rates (the hold-the-price-period);
  - > The underwriter provided the issuer with supporting documentation for matters covered in the certifications; and
  - > The issuer did not know or have reason to know, after exercising due diligence, that the underwriter’s certificate was false.
- > Defined public as any person other than an “underwriter” (and related entities) and defining “underwriter” as: (i) any person that enters into a contract with the issuer (or lead underwriter) to participate in the initial sale of the bonds to the public, and (ii) any person that, on or before the sale date, directly or indirectly enters into arrangement to sell the bonds with any of the foregoing.

## Concerns with the 2015 Proposed Regulations

While the industry was more receptive to the 2015 Proposed Regulations than they had been to the withdrawn proposed regulations, there were still concerns and comments, including:

- > Requests for special simple rules for private placements (for example, bank loans) and competitive sales (the commentators pointed out that competitive sales have their own check on issue price through the bidding process and thus, should not create the same concerns as negotiated sales);
- > While agreeing a special rule was needed to allow the initial offering price to be used, commentators noted several problems with the proposed alternative rule, including the lead underwriter would have to certify for other underwriter's actions, and problems with the hold-the-price period including the length of the period, the lack of clear industry benchmarks supporting when the price could not be held firm, and the increased cost to the issuer of the hold-the-price rule because underwriters would want to be compensated for their risk in holding the price;
- > The desire for issuers to have the flexibility to choose the method used to determine issue price when more than one method applies;
- > Requests for a special rule based on a percentage of sales of the aggregate issue (rather than separate percentages for bonds with different payment and credit terms);
- > Concerns about the underwriter definition, including concerns about what "arrangement" created an underwriter relationship with the issuer;
- > Concerns that the diligence standard required of an issuer relying on an underwriter certification appeared to be higher than the general standard for reasonable expectations under Code section 148;
- > The lack of conclusiveness about issue price on the sale date (for example, when the underwriter fails to hold the price firm, as required);
- > Problems applying the rules to competitive sales;
- > The desire to use the issue price definition for other tax-exempt bond rules.

The New Issue Price Regulations incorporate many of these comments and provide a somewhat simpler approach to determining issue price.

## The New Issue Price Regulations

### 1. Alternatives for Determining Issue Price:

Under the New Issue Price Regulations, an issuer may determine the issue price of a maturity of bonds with the same payment and credit terms under one of the following methods:

- > The first price at which a substantial amount (10 percent) of a maturity of the bonds is sold to the public (Actual Sales Price Rule);
- > For private placements to a single buyer other than an underwriter (or related party), the price actually paid (the Private Placement Rule), which is an application of the Actual Sales Price Rule;
- > For competitive sales, the reasonably expected initial offering prices to the public as of the sale date that was used in formulating the bid, provided the issuer obtains the required certification from the winning bidder and the competitive sale meets the specified definition, which include rules for a three-bid competitive process (the Competitive Sales Rule); or
- > For all sales in which clearly defined conditions are agreed to and met, the initial offering price to the public on the sale date (the Initial Offering Price Rule, which replaced the alternative rule in the Proposed Regulations).

If more than one method applies, the issuer may elect on or before the issue date which method it wants to apply.

## 2. The Initial Offering Price Rule

The Initial Offering Price Rule may be used in a public offering when:

- > The underwriters offer the bonds to the public at a specified initial offering price on or before the sale date and the lead underwriter certifies to that effect to the issuer and provides supporting documentation (such as pricing wire), on or before the issue date; and
- > Each underwriter agrees in writing that it will neither offer nor sell the bonds to any person at a price in excess of the initial offering price during a period (the new “hold-the-price” period) starting on the sale date and ending on the earlier of 1) the fifth business day after the sale date, or 2) the date on which the underwriter sells a substantial amount (*i.e.*, 10 percent) of the bonds to the public at a price no higher than the initial offering price.

## 3. Competitive Sale Rule

The Competitive Sale Rule may be used when an issuer sells its bonds under a defined competitive bidding process. That definition requires:

- > The issuer disseminates the notice of sale in a manner reasonably designed to reach potential underwriters;
- > All bidders have an equal opportunity to bid (the regulations refer to the three-bid requirements for guaranteed investment contracts at Treas. Reg. Section 1.148-5(d)(6)(iii)(A)(6));
- > The issuer receives at least three bids from underwriters of municipal bonds with established industry reputations for underwriting new issuances of municipal bonds; and
- > The issuer awards the bid to the bidder that submits a firm offer to purchase the bonds at the highest price (or lowest interest cost).

NOTE - When an issuer can use more than one method, it may elect which method it wants to apply up until the issue date. Thus, if an issuer is engaging in a competitive sale and cannot meet the competitive sale definition (*e.g.*, the three-bid requirement), it can still elect to use the Initial Offering Price Rule if the requirements for that rule are met. Of course, the issuer could face problems making this election if the agreements with the underwriter do not contemplate this possibility. As discussed below, SIFMA’s and NABL’s model certificates and agreements have been designed to address these possibilities as well as to provide issuers with all underwriter certifications required by the regulations.

## 4. Other Changes that Narrow Underwriter Definition and Change Issuers Due Diligence

The New Issue Price Regulations narrow the definition of underwriter to remove the reference to an “arrangement,” and include only those persons in a contractual relationship with the issuer (or the lead underwriter) to participate in the initial sale of the bonds to the public, and any person that agrees pursuant to a written contract directly or indirectly with one of those persons in contractual relationship with the issuer to participate in the initial sale of the bonds to the public (*e.g.*, under a retail distribution agreement). The New Issue Price Regulations also remove the issuer’s special due diligence requirement, relying instead on a general reasonable expectations requirement.

### **Model Documents to Help Issuers Effectuate the Issue Price Regulations**

The New Issue Price Regulations necessitate changes to various documents between the issuer and the underwriter and among underwriters. To help issuers and underwriters comply with the new regulations, on March 30, SIFMA released draft riders to various model documents, and on March 31, NABL released model issue price certifications.

## 1. NABL's Model Issue Price Certifications

NABL has produced five model certificates, each very concise and self-contained. These model certifications support determining issue price using:

- > The Actual Price Rule for all maturities;
- > The Initial Offering Price Rule for all maturities;
- > A combination of the Actual Price Rule for some maturities and the Initial Offering Price Rule for other maturities;
- > The Competitive Sale Rule (this certification includes a municipal advisor certificate about the bidding process); and
- > The Private Placement Rule.

NABL also provided a consolidated form for negotiated sales that applies whether the issue price of one or more maturities is determined under actual sale prices and/or initial offering prices. This certification is similar to the combination certification except it provides options for when the issue price is determined solely under initial offering prices or actual sale prices.

## 2. SIFMA Draft Model Riders

SIFMA provided draft riders for the master Agreements Among Underwriters, the master Selling Group Agreement, the Retail Distribution Agreement, the Bond Purchase Agreement, and the Notice of Sale. Of particular note are the draft riders for competitive sales. These riders provide rights and obligations when, despite the issuer's reasonable efforts, the competitive bidding process is not met (*e.g.*, the issuer does not receive three bids). One alternative under these riders is the underwriter may revoke its bid if the issuer determines to apply the hold-the-price-firm requirement for any maturity, in which case the issuer may award the securities to another bidder under the notice of sale. If the underwriter does not revoke its bid, it will have agreed to meet those requirements (and through riders to agreements with other underwriters in the group or syndicate, for those underwriters to also meet the requirements). The draft riders also include an option that does not permit the underwriter to revoke its bid, and requires the underwriter(s) to meet the hold-the-price requirements.

The riders also help the lead underwriter to make certifications about actions of other underwriters in the syndicate, such as the prices at which the maturities were sold and, if necessary, that the underwriters in the syndicate followed the special-rule requirements.

In the end, the New Issue Price Regulations seem much less controversial than Treasury's interim proposals. Nevertheless, they represent a significant change in the law and will necessitate changes in contractual arrangements between issuers and underwriters. It will be interesting to see how their implementation affects larger practice over time.

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