HAWKINS ADVISORY

FINAL ISSUE PRICE REGULATIONS

The issue price rules included in the Treasury Regulations published June 18, 1993 pertaining to the arbitrage investment restrictions and related provisions for tax-exempt bonds (the "**1993 Regulations**"), have come under serious reconsideration by the Treasury Department and the Internal Revenue Service in recent years as information regarding pricing history has become more readily available. Proposed issue price regulations were published on September 16, 2013. These regulations were subsequently withdrawn; re-proposed issue price regulations were published on June 24, 2015. As a result of the comments received, the issue price regulations proposed in 2015 were revised and published in the Federal Register on December 9, 2016 (the "**Final Regulations**"). The Final Regulations apply to bonds that are sold on or after June 7, 2017.

1. *In General.*

Issue price is a critical component of tax-exempt bond financing, as the arbitrage rules in section 148 (all section references herein shall be to the Internal Revenue Code of 1986, as amended (the "**Code**")) generally limit the allowable yield on the investment of proceeds of tax-exempt bonds to investment yields that are not materially higher than the yield on the bond issue. The yield on a bond issue is to be determined on the basis of the issue price (within the meaning of sections 1273 and 1274). "**Yield**" represents the discount rate of the cash flow of a bond issue to its issue date, using the issue price as the present value target. The determination of the yield on a tax-exempt bond issue will affect many aspects of a bond financing, such as accounting for the proper application of proceeds received from the sale of a bond issue, structuring of a yield restricted advance refunding escrow, and meeting State or local requirements for debt issuance, among others.

Under the 1993 Regulations, the definition of issue price generally provides that the issue price of bonds that are publicly offered is the first price at which a substantial amount of the bonds is sold to the public, where a "substantial amount" means ten percent and the issue price of bonds that are not substantially identical is determined separately. In addition, the 1993 Regulations permit issue price to be determined based on a reasonable expectations standard (rather than actual sales) as of the sale date, in situations in which a bona fide public offering of the bonds is made.

The Final Regulations provide the following:

- A general rule, which requires the *actual sale* of a substantial amount of a bond maturity to establish issue price (the "**general rule**");
- an alternate special rule, which allows the issue price of a bond maturity to be the initial offering price if there has been a public offering, but a substantial amount of the maturity was not sold, *provided* all underwriters of the bonds agree to hold the initial offering price to the public for a maximum of five business days (the "**hold-the-price-rule**"); and
- a special rule which applies to bonds sold in competitive sales if the issuer receives three bids in response to the notice of sale (the "**competitive sale rule**");

In addition, the Final Regulations allow issue price to reflect the price paid by the purchaser where bonds are privately placed.

2. *General Rule: Actual Sale of a Substantial Amount of Bonds.*

Consistent with section 148(h), the Final Regulations retain the rules in the 1993 Regulations that, in respect of bonds issued for money, the issue price generally will be determined under the rules of sections 1273 and 1274, as the first price at which a substantial amount of the bonds (treating bonds with different payment and/or credit terms separately) is sold to the public; a substantial amount is ten percent.

The Final Regulations expressly provide that, for a bond issued for money in a private placement to a single buyer that is not an "underwriter" or a related party (as defined in Treas. Reg. section 1.150-1(b)) to an underwriter, the issue price of the bond is the price paid by that buyer.

The Final Regulations also provide if more than one rule for determining issue price is available (*e.g.*, the general rule and the hold-the-price rule, described below), an issuer may select the rule it will use to determine the issue price for the bonds at any time on or before the issue date of the bonds; provided, however, the issuer identifies its selection in the books and records maintained for the bonds on or before the issue date thereof. The Final Regulations allow an issuer to select different rules for bonds with different maturities or the same maturity, but different payment terms or security.

3. *Definitions.*

"Public" is defined in the Final Regulations for purposes of determining the issue price of tax-exempt bonds to mean any person other than an underwriter or a related party to an underwriter.

"Underwriter" is defined to include: (1) any person that contractually agrees to participate in the initial sale of the bonds to the public by entering into a contract with the issuer or into a contract with a lead underwriter to form an underwriting syndicate and (2) any person that, on or before the sale date, directly or indirectly enters into a contract with any of the foregoing to sell the bonds. Moreover, the Final Regulations clarify that covered agreements must relate to the initial sale of the bonds to the public and that these agreements include retail distribution agreements.

"Reasonable expectations" under the Final Regulations reflect the same standard as the 1993 Regulations; *i.e.* an issuer's expectations or actions as treated as "reasonable" only if a prudent person in the same circumstances as the issuer would have those same expectations or take those same actions, based on all the objective facts and circumstances.

4. *Hold-the-Price-Rule for Use of the Initial Offering Price to the Public.*

The Final Regulations abandon the reasonable expectations standard of the 1993 Regulations and adopt a special hold-the-price rule that allows an issuer to treat as the issue price the initial offering price to the public as of the sale date of each bond bearing the same interest rate and/or security, notwithstanding the failure to sell ten percent of such bond as of the sale date, provided the following requirements are met:

- The underwriters offered the bonds to the public at a specified initial offering price on or before the sale date (presumably this is the bona fide public offering of the 1993 Regulations);
- The lead underwriter in the underwriting syndicate or selling group (or, if applicable, the sole underwriter) provides, on or before the issue date, a certification of the initial offering price to the issuer, together with reasonable supporting documentation for that certification, such as a copy of the pricing wire or equivalent communication;
- Each underwriter agrees in writing that it will neither offer nor sell the bonds to any person at a price that is higher than the initial offering price during the period starting on the sale date and ending on the earlier of (1) the close of the fifth business day after the sale date, or (2) the date on which the underwriters have sold a substantial amount of the bonds to the public at a price that is no higher than the initial offering price to the public; and
- The underwriters hold the price for offering and selling unsold bonds at a price that is **no greater** than the initial offering price to the public for a shorter time period that ends on the earlier of (1) the close of the date that is the fifth business day after the sale date or (2) the date on which the underwriters have sold a substantial amount of the bonds to the public.

Importantly, under the Final Regulations, a failure to meet a specific eligibility requirement of a rule for determining issue price will result in a failure to establish the issue price under that rule. In such a circumstance, an issuer will be required to redetermine the issue price for the bonds under a different rule. A failure to establish the issue price will affect the issuer's ability to ensure compliance with the arbitrage restrictions and may give rise to legal penalties against underwriters for false statements. A false statement by an underwriter in a certification or in the agreement among underwriters under one of these special rules may result in a penalty against the underwriter under section 6700, depending on the facts and circumstances.

5. *Special Rule for Competitive Sales.*

The Final Regulations set forth a special competitive sales rule under which the issuer of bonds issued for money pursuant to an eligible competitive sale may treat the reasonably expected initial offering price to the public of the bonds as the issue price of the bonds as of the sale date, provided the issuer obtains a certification from the winning bidder regarding the reasonably expected initial offering price to the public of the bonds upon which the price of the winning bid is based.

For purposes of this special rule, the Final Regulations define "competitive sale" to mean a sale of bonds by an issuer to an underwriter that is the winning bidder in a bidding process in which the issuer offers the bonds for sale to underwriters upon specified written terms and that meets the following requirements:

- The issuer disseminates the notice of sale to potential underwriters in a manner reasonably designed to reach potential underwriters;
- all bidders have an equal opportunity to bid;
- the issuer receives bids from at least three underwriters of municipal bonds who have established industry reputations for underwriting new issuances of municipal bonds; and
- the issuer awards the sale to the bidder who offers the highest price (or lowest interest cost).

Here again, it should be noted that, under the Final Regulations, a failure to meet a specific eligibility requirement of a rule for determining issue price will result in a failure to establish issue price under that rule and necessitate a redetermination of issue price under a different rule.

6. *Recordkeeping Requirements.*

In accordance with section 6001, the issuer must maintain reasonable documentation in its books and records to support its issue price determinations. In addition, the Final Regulations require that the issuer obtain from the underwriter certain certifications and other reasonable supporting documentation such as a pricing wire to establish its issue price determination under a specific rule in the Final Regulations. A certification from the underwriter of the first price at which ten percent of the bonds of each maturity were sold to the public is an example of reasonable supporting documentation to establish the issue price of the bonds under the general rule in the Final Regulations.

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