BRACEWELL

INSIGHTS

# The New Issue Price Regulations: The Good, the Bad and the Ugly

February 3, 2017

*By: **Victoria N. Ozimek** and **Brian P. Teaff***

Late last year, the Treasury Department released final Treasury Regulations (the "New Regulations") relating to the "issue price" of tax-exempt bonds, effective for bonds sold after June 7, 2017. Because the changes imposed by the New Regulations generally are more palatable than versions proposed in 2013 and 2015, the initial reaction of many in the municipal bond industry - including us - was a collective sigh of relief. Although this initial reaction has not fully faded, a deeper dive into the New Regulations has resulted in a list of questions that need to be considered. Promising a free lunch (and proving that there is, in fact, no such thing), we have spent the last few weeks meeting with various players in the municipal bond market, including issuers, underwriters, and financial advisors, to discuss the New Regulations and to get reactions based on their respective viewpoints. While a detailed summary of the entirety of the discussions is beyond the scope of this article, we boiled down the salient points into the observations that follow.

**The Good: A More Inclusive "Public"**

Under both the current issue price Treasury Regulations (the "Current Regulations") and the New Regulations, the general rule is that the issue price of bonds issued for money is the first price at which a substantial amount (i.e. 10 percent) of the bonds is sold to the public (the "General Rule"). Under the Current Regulations, many bond counsel have been reticent to consider a sale to, for example, an unrelated broker-dealer as a sale to the "public." The New Regulations set forth a new definition of "public," which excludes only an underwriter or a related party thereto. An "underwriter," in turn, is defined under the New Regulations as any person who agrees pursuant to a written contract with the issuer or with the lead underwriter to participate in the initial sale of bonds to the public or has a written contract with any such person directly or indirectly to participate in the initial sale of bonds to the public (e.g., a retail distribution agreement).

Bankers have immediately zeroed in on the definitions of "public" and "underwriter" under the New Regulations. While future experience may color the interpretation of these definitions, the plain language appears to permit the sale of at least 10 percent of the bonds to non-underwriter broker-dealers to be sufficient to set the issue price, even if it is expected that such broker-dealers may immediately resell the bond to retail buyers at higher prices. The consensus of the bankers we spoke with is that this plain reading of these definitions in the New Regulations makes the General Rule easier to meet and "The Bad" discussed below a bit easier to swallow.

### The Bad: Change May Come at an (Issue) Price

Under the Current Regulations, if the General Rule is not met on the sale date of the bonds, issue price may be established on the sale date solely on the basis of the underwriter's reasonable expectations regarding the initial offering price of the bonds. The New Regulations, however, only allow reliance on reasonable expectations under two "special rules" – the "Hold-the-Offering-Price Rule" and the "Competitive Sale Rule."

Under the Hold-the-Offering-Price Rule, an issuer may rely on reasonable expectations as long as certain requirements are met, chief among which is that each underwriter must agree in writing not to sell bonds at a price that is higher than the initial offering price for five business days after the sale date or until 10 percent of the bonds are sold, if earlier. The Competitive Sale Rule allows reliance on reasonable expectations to establish issue price for competitively-bid deals as long as the offering meets the definition of a "competitive sale," which requires, among other things, that at least three bids have been received. Thus, if fewer than three bids are received, issue price must be established using the General Rule or the Hold-the-Offering-Price Rule.

Pointing to market risk and the potential sequestration of capital, the underwriters we spoke with expressed a strong preference to avoid the Hold-the-Offering-Price Rule and "wait it out" until the General Rule is met, even if that means the issue price will not be established until after the sale date (or even the issue date). However, there are certain types of deals – advance refundings and private activity bonds come to mind – in which the need for issue price certainty as of the sale date (and certainly by the issue date) will override the preference to "wait it out." In these cases, one must wonder whether the desire to avoid the Hold-the-Offering-Price Rule will result in a pricing of the bonds at lower initial offer prices so as to ensure that the General Rule will be met quickly, which in turn begs the question of whether the stated policy objective of ensuring that an issuer is getting the full benefit of its debt offering will be realized.

### The Ugly (Details): Decisions, Documentation and Diligence

Turning to where the devil resides, market participants must also deal with the details. As the June 7 effective date approaches, an issuer must decide whether it is comfortable "waiting it out" or whether it will require an underwriter to agree to the Hold-the-Offering-Price Rule. In addition, from a documentation perspective, the New Regulations will impact more than just issue price certificates. For example, documents prepared in anticipation of a competitively bid deal must now address the possibility that it may not qualify as a "competitive sale" because three bids are not received. Additionally, the potential for the issue price to be established after the sale date could cause awkward results, such as the "issue price" not matching the "sale proceeds" received by the issuer. Another item to be sorted out is the type and availability of documentation that should be requested and/or retained by issuers and underwriters to demonstrate diligence and compliance in the establishment of issue price so as to be prepared for an audit of the issue that, if sufficient documentation is not provided, has the potential to lead to a redetermination of the issue price and the imposition of penalties against an underwriter. Details such as these will beg for attention as the industry further considers the New Regulations.

### Concluding Thoughts

To the Internal Revenue Service's credit, the New Regulations take into account the comments of market participants and respond with significant adjustments to the regulations proposed in

2013 and 2015. After all, market participants no longer face the threat of the “25% of actual sales” or a “hold-the-offering-price-until-closing” rules previously proposed. Nevertheless, now is the time for market participants to put our heads together to address the changes in the New Regulations and consider their impact on transactions, as June 7 will be here sooner than we know it.

For more information, please contact ***Brian Teaff***.