KING & SPALDING

Client Alert

Finance Practice Group

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Treasury Revises Issue Price Regulations

The Treasury Department published in the June 24, 2015 Federal Register new proposed regulations for determining the "issue price" of bonds. The same announcement also withdrew the proposed regulations published in 2013 (the "2013 proposed regulations") relating to the determination of the issue price of bonds. The "issue price" is important because it is used in calculating the yield on bonds, which is relevant for determining compliance with a number of rules in the tax exempt bond area, including but not limited to, the yield restriction rules and arbitrage rebate rules. Generally, under existing regulations, 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. Under the existing regulations, a "substantial amount" is defined as 10%. The existing regulations also provide that for bonds for which a bona fide public offering is made, the issue price is determined as of the sale date based on reasonable expectations regarding the initial issue price. These existing rules have led to significant confusion about the proper determination of the issue price especially in those situations in which less than 10% of bonds of a maturity are sold as of the sale date.

The Treasury issued the 2013 proposed regulations to clarify the method of determining the issue price. The 2013 proposed regulations would have imposed a 25% requirement on the amount of bonds sold before the amount sold was treated as a "substantial amount," and were also criticized as not providing sufficient certainty as to the determination of the issue price as of the sale date. Following receipt of many comments about the 2013 proposed regulations, the Treasury withdrew the 2013 proposed regulations and proposed new regulations.

The new proposed regulations provide that the "issue price" of bonds will first be determined in the case of bonds which are publicly offered on the basis of the first price at which a "substantial amount" of bonds is actually sold to the public on or before the pricing date. The issue price of bonds with different terms is determined separately as under the existing regulations. For a variety of reasons discussed in the announcement of the new proposed regulations, the Treasury abandoned the proposed 25% standard in the 2013 proposed regulations for determining a "substantial amount" in favor of retaining the 10% rule which is in the existing regulations. Under the new proposed regulations, if 10% of each maturity of the bonds of an issue are sold to the public as of the sale date, then the new regulations differ very little from practices currently in effect other than the proposed regulations suggest that the issuer should maintain records to evidence meeting the 10% test, including a copy of the pricing wire or similar communication.

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On the other hand, if less than 10% of the bonds or individual maturities of the bonds are sold to the public in a bona fide public offering, then the new proposed regulations abandon the "reasonable expectations test" which is in the existing regulations and adopt an "alternative method" for determining the issue price. Under this new alternative method,

1. the underwriter must fill all orders at the initial offering price placed by the public and received by the underwriters on or before the sale date, and not fill any order received by the underwriters on or before the sale date at a price higher than the initial offering price;
2. the lead or sole underwriter must agree that no underwriter will fill an order received after the sale date and before the issue date at a price higher than the initial offering price unless the higher price "is the result of a market change … after the sale date (for example, due to a change in interest rates);"
3. the underwriter must provide the issuer as of the date of issue of the bonds with information about the price at which the bonds are sold after the sale date and prior to the issue date, and if bonds are sold at a price higher than the initial offering price, information regarding the corresponding market change, such as proof of "the value of a broad-based index of municipal bond interest rates on bonds similar to the type and credit rating of the bonds being sold;"
4. the issuer of the bonds must not know, or have reason to know, after exercising due diligence, that the certifications of the underwriter are false.

The notice of proposed rulemaking states that the Treasury believes that the number of instances where bonds are sold after the sale date and before the issue date at a price higher than the initial offering price is limited, and that the burden of complying with the requirements above for the "alternative method" should be limited.

The proposed regulations will be the subject of a public hearing in late October, and compliance with the proposed regulations would not be required until 90 days after the final regulations are published in the Federal Register (likely sometime in early 2016). **The proposed regulations however provide that issuers may rely on the proposed regulations with respect to bonds sold on or after June 24, 2015.** Our expectation is that issuers will want to comply with the proposed regulations immediately in order to avoid uncertainty about the appropriate issue price.

On transactions in which all of the bonds meet the "10% sold by the sale date" requirement, the practical implications of complying with the new proposed regulations as compared to the existing regulations are limited other than that the issuer will want to retain records such as a certificate from the underwriter and possibly a copy of the pricing wire with the issuer's permanent records.

On transactions where some portion of the bonds do not meet the "10% sold by the sale date" requirement, the underwriting or purchase agreement will likely need to be modified to include the agreement and additional underwriter certifications described above in order to comply with the new proposed regulations.

If you would like to discuss the implications of these new rules in more detail, please give us a call.