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Client Alert

February 2014

2014: What's New in Public Finance

Over the past several months, the Internal Revenue Service (the "IRS"), the Securities and Exchange Commission (the "SEC") and the Municipal Securities Rulemaking Board (the "MSRB") have either taken or proposed significant actions affecting municipal bond financings and public finance generally. What follows are summaries of these actions as well as other public finance news.

SEC and MSRB Actions

New MSRB Restrictions on Using Consents from Underwriters for Amendments to Bond Documents

Bond issuers and conduit borrowers from time to time seek to amend pre-existing bond documents, primarily to provide greater flexibility. Common reasons include altering coverage tests for additional bonds, permitting the use of new types of financial structures in additional bonds and altering other financial and operating covenants. Collecting consents from individual bondholders is difficult, costly and indeed sometimes impossible. As a result, issuers and underwriters had developed a practice of having the underwriters, as temporary owners of new bonds or bonds being remarketed, consent to requested amendments, thereby either permitting the immediate amendment of the documents or permitting the amendments to become effective in the future when old bonds are paid off and/or future additional bonds are issued. The MSRB has recently imposed restrictions on this practice because it believes that it adversely affects existing bondholders. The SEC has approved the restrictions, which are expected to reduce, but not eliminate, this practice.

With careful planning, issuers still can maximize their ability to use underwriter consents for bondholders to make desirable amendments to bond documents.

The MSRB amended MSRB Rule G-11, on Primary Offering Practices, effective February 3, 2014, to provide that brokers or dealers cannot give consent to amendments to issuance documents requiring holder consent unless one of five exceptions is met:

- The documents to be amended and the offering documents for both the new bonds and the bonds previously issued clearly state brokers and dealers may so act; or
- The bonds so held are owned by the broker or dealer other than in its capacity as an underwriter; or
- All bonds affected by the amendments are held by a broker or dealer acting as a remarketing agent following a mandatory tender; or
- The beneficial owner has given its consent for the broker or dealer to so act; or
- The consent becomes effective only when all other holders consent.

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As a result of the rule change, we would expect nearly all new authorizing documents to contain provisions consistent with the first of the five exceptions listed above – specifically authorizing consents for amendments by holders to be executed on their behalf by underwriters, brokers or dealers upon their offering or remarketing. Similar language will need to appear in the offering documents for such bonds. Sample language for an indenture provision (which would also be disclosed in any offering document of the bonds) would be:

> For the purpose of giving consent under this section, the consent from the underwriter or underwriters of bonds upon their issuance or remarketing shall be deemed to be the consent of the holders thereof as permitted by MSRB Rule G-11 or a successor provision.[*]

Until bonds with such provisions in the authorizing document constitute the requisite percentage of outstanding aggregate principal amount of parity debt, issuers may face problems implementing certain amendment proposals.

Expect More SEC Enforcement Against Municipal Bond Issuers

The SEC has publicly stated that it will be focusing this year on municipal issuers and issuer officials in the wake of a string of 2013 cases against municipalities alleging material misstatements and/or omissions in bond disclosure documents. For example, the SEC, for the first time ever, imposed a monetary sanction against a municipal issuer, the Greater Wenatchee Regional Events Center Public Facilities District (the "District") regarding alleged disclosure deficiencies in an official statement.

In light of the SEC's increased scrutiny of municipal issuers, it is more important than ever for issuers to have ongoing internal review processes in place to comply with initial issuance, annual and material event disclosure requirements.

IRS Actions

IRS Proposed Troublesome "Issue Price" Rules – Stay Tuned for Further Development

The IRS has promulgated proposed new issue price regulations for determining the issue price (generally the sale price to the public) for bond issues which focus on the results of actual sales rather than expected sales. Since the issue price is a factor in the calculation of a bond issue's yield for arbitrage purposes, the new proposed rules could have a major impact. The general terms of the proposal are that:

- Instead of determining issue price based on expectation of sales, the proposed regulations have it based on actual sales of a substantial amount to the public by the underwriters. There is a safe harbor to the effect that the price at which a minimum of 25% of the bonds (typically of each maturity) is sold will be treated as the issue price therefor IF all orders received at that price during the offering period are filled if possible.

- In advance refundings, if the use of actual facts for sales unexpectedly causes the yield on escrow investments to be impermissibly higher than the issue yield, the proposed regulations allow for yield reduction payments to cure the problem.

- Underwriters are to include brokers not in the syndicate purchasing with a view to resell.

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[*] *This language is for illustrative purposes only and may not be applicable or appropriate for your particular transaction documents. You should consult with your own legal and tax advisors in crafting an appropriate provisions.*

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The proposed regulations raise several concerns. For example, suppose 25% of a maturity is sold to the public at 100.5% and a broker not in the syndicate focuses on retail sales and purchases more of the maturity at 100.625% with an intent to remarket to individuals at 101%. If one of his individual customers knows about the "issue price" of 100.5%, it would seem the broker must sell to him at that price (thus losing money) or else the basic safe harbor is not met since not all purchasers desiring to buy at 100.5% were accommodated during the initial offering period.

Another concern is what happens if the actual sale rule causes the issue price to be lower than expected. While there is no real arbitrage problem since the yield will be higher, what about the 2% issue cost rule or the 10% private business test, etc.? Are all those requirements to be calculated on the new issue price (which by definition may not even be known at closing)?

The proposed regulations have been condemned by such groups as the National Association of Bond Lawyers, the American College of Bond Counsel and the Committee on Tax-Exempt Financing of the American Bar Association. Market participants speculate that the proposed regulations will be modified before or upon adoption, so more information on how to handle these problems should be forthcoming.

Working Capital Changes in the Pipeline

The IRS has issued proposed regulations that contain two rules relating to working capital financings. First, the prohibition on the financing of a working capital reserve is removed so long as the limit on the reserve meets the traditional standard of such reserve not exceeding 5% of the issuer's actual working capital expenditures in its previous fiscal year. This will allow issuers seeking to fund working capital costs on a short-term basis to actually have a reserve in hand, which avoids penalizing issuers who in the past have been frugal in this area.

Second, the proposed regulations now legitimize a practice already being used in existing issues financing long-term deficits, particularly for states or large municipal governments. In these issues, the maturity is frequently longer than the two-year safe harbor maturity for working capital financings. If the deficit goes away earlier than expected, rather than using "excess revenues" to prepay the bonds, the issuer purchases tax-exempt debt in an amount at least equal to the "excess revenue." This keeps that excess revenue within the issuer's control (to be used later for deficit payments if necessary). The proposed regulations specifically bless this as an acceptable action.

VCAP's New Standards on the Way

The IRS has announced it will issue new resolution standards that correspond with existing policies under its Voluntary Closing Agreement Program ("VCAP"). Under VCAP, resolution standards are used to determine settlement amounts for particular types of violations of bond-related tax rules. Four new standards were announced:

- For a "misinterpretation of the TEFRA approval current refunding exception," the amount will be 7.5% of the taxpayer exposure (taxed at the highest marginal rate on interest paid) for the period from the issue date to the date of the closing agreement.

- For when there is reliance for TEFRA approval on an unqualified person – 5% of the taxpayer exposure for the period from the issue date to the date of the closing agreement.

- For small issue draw-down bonds which exceed the volume cap (primarily due to draws in later calendar years) – $1,000 for each calendar year after the calendar year of the initial draw.

- For issuers who recognize there is a change in use of proceeds after issuance and successfully remediate under Regs. 1.141-12, but fail to file a Form 8038 in connection therewith – $1,000 for each such failure.

The expected announcement will also update or confirm some existing resolution standards in other areas.

Proposed Deadline on Rebate Refunds

The IRS has issued proposed regulations making minor changes with respect to an issuer's ability to seek a refund of an overpayment of rebate amounts with respect to an issue. Under the proposed regulations, such an application (on a specific IRS form) must be made within two years of the final rebate computation date. Further, the IRS may request additional information, and the failure to provide the same within a specified period will be grounds for denial. The regulations provide for the ability to appeal adverse decisions in this area to the IRS Office of Appeals.

Repair Rules

T. D. 9636, published in the Federal Register on September 19, 2013 (vol. 18, no. 182, page 57686) sets forth final regulations under Code Section 263 for the possible capitalization of certain repair and maintenance costs. As stated in the explanation thereof:

> ". . . the final regulations permit a taxpayer to elect to treat amounts paid during the taxable year for repair and maintenance to tangible property as amounts paid to improve that property and as an asset subject to the allowance for depreciation, as long as the taxpayer incurs the amounts in carrying on a trade or business and the taxpayer treats the amounts as capital expenditures on its books and records used for regularly computing income. Under the final regulations, a taxpayer that elects this treatment must apply the election to all amounts paid for repair and maintenance to tangible property that it treats as capital expenditures on its books and records in that taxable year."

The new regulations affect issuers and other persons or entities interested in tax-exempt bonds in several ways. If the entity involved has made the requisite election for the year:

- Repair and maintenance expenses for tangible property may be treated as capital expenditures for purposes of the percentage use tests for bonds (for example, 95% for exempt facilities under Code Section 142, 90% for certain property under Code Section 144, and 95% for 501(c)(3) property under Code Section 146).
- But such costs will also be counted in "other capital expenditures" under Code Section 144 for determining whether the $10 million limit on proceeds and such category of costs for small issue bonds has been exceeded.

Guidance and Technical Advice (Rev. Proc. 2014-4 and Rev. Proc. 2014-5)

Each year, the Service updates its revenue procedures that advise taxpayers on the various forms of guidance the Service can provide, how taxpayers can request advice, and the process the Service will follow responding to such requests. The 2014 revenue procedures (Rev. Proc. 2014-4 and Rev. Proc. 2014-5) largely follow the 2013 revenue procedures, but taxpayers should follow the latest revenue rule procedures and be aware that they are updated annually.

2014 Increases in States' Private Activity Bond Volume Cap

Under Revenue Procedure 2013-35, the formula for calculating private activity bond volume cap has been adjusted such that each state's volume cap ceiling is now the greater of (i) $100 multiplied by the state's population and (ii) $296,825,000. For purposes of this calculation, each state's population can be found in the December 30, 2013 Census Bureau news release, CB13-TPS.111. The following are from the table of the 2014 private activity bond volume cap.

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State	2014 PAB Volume Cap
Georgia	$ 999,216,700
North Carolina	984,806,000
South Carolina	296,825,000
Tennessee	649,597,800
Texas	2,644,819,300
Virginia	826,040,500

Explicit Authorization for Current Refundings of Recovery Zone Facility Bonds

Under Notice 2014-9, the Service has provided guidance that approves current refundings of recovery zone facility bonds (issued under Code section 1400U-3) that take place after January 1, 2011, provided that conditions set forth in the Notice are met. Previously, the statutory provisions were silent as to whether current refundings were authorized after January 1, 2011.

2014 Increases to the Safe Harbor Rules for Broker Commissions on Guaranteed Investment Contracts or Investments Purchased for a Yield Restricted Defeasance Escrow

Revenue Procedure 2013-35 increased the safe harbor limits under which a broker's commission on guaranteed investment contracts or investments purchased for a yield restricted defeasance escrow is reasonable. Under the new safe harbor, a broker's commission is reasonable if (i) the amount of the fee treated by the issuer of the bonds as a "qualified administrative cost" does not exceed the lesser of (a) $38,000 and (b) 0.2% of the computation base (set forth in Regs. 1.148-5(e)(2)(iii)(B)(2)) or, if more, $4,000 and (ii) the issuer does not treat more than $108,000 in brokers' commissions as qualified administrative costs for all guaranteed investment contracts or investments purchased for yield restricted defeasance escrows purchased with gross proceeds of the issue.

Sequester News

Sequestration of federal payments, including for direct pay Build America Bonds ("BABs"), Qualified School Construction Bonds ("QSCBs"), Qualified Zone Academy Bonds ("QZABs"), New Clean Renewable Energy Bonds ("New CREBs"), and Qualified Energy Conservation Bonds ("QECBs"), began on March 1, 2013, at a rate of 8.7%. That rate was applicable for the federal fiscal year ending September 30, 2013. On September 30, 2013, the IRS has announced that for the federal fiscal year beginning October 1, 2013, and ending September 30, 2014, the sequestration rate will be 7.2%. Questions may be addressed to IRS Customer Account Services at (877) 829-5500.

Proposed Deadline for Issuing New Clean Renewal Energy Bonds and Energy Conservation Bonds.

In December 2013, the staff of the Joint Committee on Taxation released a "Technical Explanation of the Senate Committee on Finance's Staff Discussion Draft to Reform Certain Energy Tax Provisions." One of the proposed reforms under the bill discussed would allow for the issuance of more new clean renewable energy bonds and energy conservation bonds but with an issuance deadline of December 31, 2016.

In Other News…

Proposed New Liquidity Rules for Banks Contemplate Excluding Municipal Securities as High Quality Liquid Assets ("HQLA").

The Office of the Comptroller of the Currency, the Federal Reserve System and the Federal Deposit Insurance Corporation issued a notice of proposed rulemaking that would implement, *inter alia*, a liquidity coverage ratio standard for most large banks, consistent with the standard established by the Basel Committee on Banking Supervision. It is contemplated that municipal bonds would not qualify as High Quality Liquid Assets under such standard, regardless of their rating or credit worthiness. Market

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participants have expressed concerns that this exclusion may make it more costly for banks to own municipal bonds, increase both the fixed-rate borrowing costs and the costs of borrowing in the short end of the market, and adversely affect issuer balance sheets as increased costs incurred by banks for the holding deposits of public sector funds is passed onto the issuers.

National Federation of Municipal Analysts Recommends Best Disclosure Practices

On January 14, 2014, the National Federation of Municipal Analysts ("NFMA") issued a white paper on its recommendations for improved offering and disclosure practices for municipal bonds. Among many concepts in the white paper, the following are notable:

- The terms "general obligation" and "full faith and credit" should be explained with specificity as to which taxes or other revenues or funds are pledged limitations on the raising of taxes, authorizations needed for the raising of taxes, enforcement mechanisms and related points.
- For "high-grade, lower risk transactions such as GO bonds and essential service revenue bonds rated single-A or better" three full business days should elapse between the release of the POS and the pricing date. For "higher-risk transactions, which include hospitals and project finance bonds" there should be at least 10 business days in between.
- The name of the bond issue should reflect the revenue/repayment stream rather than the purposes of the issue.
- Given recent events, the security or risks section should include discussion of the issuer's eligibility to seek bankruptcy protection or to be subject to state law receivership proceedings.
- If a new issue is parity secured with an issue privately placed, disclosure should be made as to the material terms and covenants of such prior issue.
- In an advance refunding, disclosure should be made as to whether there is a legal or merely economic defeasance of the prior issue.
- If bond counsel is relying on another opinion, that opinion should be attached to the POS and the reliance described in the body of the POS.

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