



Public Finance –  
**2011 in Review** and  
the Outlook for 2012

# Public Finance 2011 in Review and the Outlook for 2012

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2011 was an active year for regulation of the municipal market, particularly for matters relating to federal securities laws and federal tax laws. The most notable are summarized below.

## FEDERAL SECURITIES LAWS

### Municipal Advisors

In January 2011, the Securities and Exchange Commission (SEC) proposed final regulations for the registration of municipal advisors. As further described in two *Squire Sanders Public Finance & Infrastructure Alerts* on this topic<sup>1</sup>, the proposed rules would implement Section 975 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Dodd-Frank makes it unlawful “for a municipal advisor to provide advice to or on behalf of a municipal entity or obligated person...with respect to municipal finance products or the issuance of municipal securities...unless the municipal advisor is registered in accordance with this subsection.”

More than 1,000 comments were submitted, the vast majority of which voiced the concern of market participants that the proposed rule would restrict a wide range of activities and require registration with the SEC of a broad range of individuals who would not normally be considered to be acting in the capacity of a financial advisor. In late 2011, the SEC extended the temporary regulations for nine months in order to provide additional time to finalize revisions to the final regulations.

### Downgrade of US Debt

In August 2011, Standard & Poor’s downgraded the rating on United States debt. We addressed the action in a *Public Finance & Infrastructure Alert*<sup>2</sup> and answered questions related to the impact of that downgrade on the filing of material event notices in connection with refunded bonds with escrow funds invested in US government obligations.

### MSRB Rule G-17

The Municipal Securities Rulemaking Board (MSRB) issued a proposed interpretive notice (MSRB Notice 2011-61, issued November 3, 2011<sup>3</sup>) addressing an underwriter’s duty of fair dealing with municipal issuers under existing MSRB Rule G-17. Under the proposed interpretation, Rule G-17 would require an underwriter to make specific disclosures regarding compensation, conflicts of interest and third party relationships, as well as the fact that the underwriter owes no federal fiduciary duty to a municipal issuer. Additionally, if the underwriter is recommending a complex financing structure, the MSRB interprets Rule G-17 to require an underwriter to disclose “all the material risks and financial characteristics of the complex municipal securities financing, as well as the material financial risks of the financing that are known to the underwriter and reasonably foreseeable at the time of the disclosure.”

The proposed notice lays out in detail how the MSRB expects municipal underwriters to comply with

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<sup>1</sup> See [Conduit Borrowers Are Included Under SEC’s Proposed “Municipal Advisor” Regulations and Will Appointed Members of Boards of Municipal Bond Issuers Be Caught Under SEC’s Proposed Regulations for Municipal Advisors?](#)

<sup>2</sup> See [How the Downgrade of US Debt Impacts Issuer Continuing Disclosure Obligations.](#)

<sup>3</sup> See the MSRB’s [website](#).

Rule G-17 when acting as an underwriter in a municipal securities transaction, including in its protection of municipal issuers consistent with Dodd -Frank Act.

The proposed Rule must be approved by the SEC before it is effective. The MSRB has proposed that the notice become effective 90 days following approval by the SEC.

## **Standard and Poor's Downgrade of Assured Guaranty**

Our December Alert<sup>4</sup> addressed S&P's downgrade of Assured Guaranty and summarized the requirements to file a material event notice resulting from S&P's downgrade of bonds insured by Assured Guaranty on November 30, 2011.

## **FEDERAL TAX LAWS**

### **Expanded Form 8038-G and Continuing IRS Focus on Post-Issuance Compliance Procedures**

The new expanded Form 8038-G<sup>5</sup> published by the Internal Revenue Service (IRS) now asks governmental issuers whether written procedures have been put in place regarding post-issuance compliance with respect to tax-exempt bonds. The form requires an issuer to answer whether it has adopted written procedures to take a "remedial action" if it uses an excessive amount of bond proceeds for a private business use and whether it has written procedures to monitor compliance with the arbitrage requirements.

These new questions are similar to questions added to Form 8038 (filed for private activity bonds, including conduit bonds) in April 2011, and are part of the IRS effort to increase compliance by encouraging issuers to adopt written compliance procedures. As an additional incentive, the IRS also announced in 2011 that it will be more lenient in negotiating closing agreements with issuers that have adopted written procedures.

Review our Alert<sup>6</sup> on the Expanded Form 8038-G for a summary of the changes to the 8038-G form.

### **IRS Report on Nonprofit Financings**

On July 13, 2011, the IRS issued its final report on the Tax-Exempt Bond Compliance Questionnaire Project for nonprofit financings. In a July *Nonprofit Finance Update*<sup>7</sup>, we discussed key points of the Report. The Report includes the IRS' conclusions drawn from questionnaires the IRS distributed to a national sampling of nonprofit hospitals, universities, cultural institutions and nonprofit secondary schools to develop a better understanding of compliance levels with certain tax requirements applicable to 501(c)(3) tax-exempt bonds. The Project is just part of the IRS' increased emphasis on compliance, which is also reflected in new portions of the IRS Form 990, increased audit activity and heightened scrutiny of corporate governance issues relating to 501(c)(3) institutions.

### **IRS Releases Final Regulations on Solid Waste Disposal Facilities**

In August 2011, the IRS issued long-awaited final regulations providing a definition of solid waste disposal facilities for tax-exempt bond purposes (Final Regulations). The Final Regulations largely follow the proposed regulations published in September 2009 (Proposed Regulations) and implement a policy favoring recycling through the use of solid waste disposal facilities. The Final Regulations generally apply to bonds sold after October 17, 2011.

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<sup>4</sup> See [S&P's Downgrade of Assured Guaranty Likely to Require Event Notice Filing Even Though New Rating Already Posted on EMMA](#).

<sup>5</sup> See <http://www.irs.gov/pub/irs-pdf/f8038g.pdf>.

<sup>6</sup> See [Expanded Form 8038-G Highlights IRS Focus on Written Compliance Procedures](#).

<sup>7</sup> See [IRS Issues Final Report on Bond Questionnaire Project](#).

Despite public comment to the contrary, the Final Regulations continue to exclude radioactive waste and hazardous waste from the definition of solid waste. However, the Final Regulations limit the exclusion to hazardous waste that is required to be disposed of at a regulated facility and radioactive waste that is subject to regulation. We summarized the Final Regulations in our August Alert.<sup>8</sup>

## WHAT TO LOOK FOR IN 2012

### Potential Fireworks Display Regarding the Regulation of Municipal Securities

In 2012, expect to see the report of the Government Accountability Office regarding the state of municipal disclosure. This report is required under the Dodd-Frank Act to be published by July 2012. The GAO has been surveying various market participants (groups and individuals) to form the basis of its report. Many in the market believe the GAO Study will be the basis for legislative action (or inaction) regarding the regulation of municipal disclosure by the SEC.

The SEC has indicated it will produce a Staff Report on the state of the municipal market, which will be based largely on testimony and other information received during the three field hearings the SEC conducted in 2010 and 2011. Market observers expect the Staff Report to be the basis upon which the SEC will seek expanded regulatory power with respect to municipal securities disclosure.

The SEC has also indicated staff is working on an update of the 1994 Interpretive Release regarding municipal securities disclosure issues. This updated interpretive guidance may be incorporated into the Staff Report or may be published as a separate document.

Final regulations regarding municipal advisors are also expected, sometime in the first three calendar quarters. Once finalized, it would be expected that the MSRB actions, including rule amendments, that relate to municipal advisors will then be republished for additional comment. The MSRB had issued and then retracted several notices in 2011 that, in one way or another, depend upon the definition of "municipal advisor."

### IRS Enforcement

The IRS will continue its focus on the determination of issue price of bonds as it recently announced that it has formed a seven-person team that will use the EMMA system and other trading data as tools in reviewing issue prices. In addition, the IRS Business Plan for 2012 describes the enforcement priorities as including its focus on abusive and arbitrage-driven transactions involving long investment periods or large investment amounts, including requests for recovery of overpayment of rebate, examinations of Form 8038-Ts to determine rebate compliance, penalty determination examinations for late filed rebate payments, as well as examinations of bond issues determined by the IRS to have a greater likelihood of arbitrage noncompliance. The IRS expects to complete projects relating to working capital financings, small governmental lease financings, and various types of governmental and charitable financings involving management contracts, research agreements, naming rights, and other public-private partnership arrangements. The IRS will also initiate examination projects focused on specific types of bonds, including student loan bonds, pooled bond financings, independent multi-functional special district (IMFSDI) financings, and advance refunding bonds.

### Tax Legislation

We can expect to continue seeing a wide variety of tax legislative proposals but their likelihood of enactment remains relatively low in this election year of 2012 except in the case of highly targeted and broadly supported proposals. Those proposals will range from relatively narrow bills, such as that recently proposed to authorize up to \$50 billion of tax-credit bonds over six years to finance transportation infrastructure projects. Another bill would permanently exempt middle-class taxpayers

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<sup>8</sup> See [IRS Releases Final Regulations on Solid Waste Disposal Facilities](#).

from the alternative minimum tax, potentially boosting market demand for private-activity bonds. In contrast to these narrow bills, the President has proposed broad, complex legislation under which, beginning in 2013, high-income individuals and families would no longer receive interest on state and municipal bonds that is completely exempt from federal income tax. While most proposals will not make it to the President's desk for signature in 2012, they should not be ignored because unenacted bills often provide insight into future, successful legislation.

## Tax Regulations

As is true each year, Treasury and IRS have a number of priority regulation projects for 2012. One project is to finalize public approval (i.e., TEFRA approval) rules for private-activity bonds that were proposed in 2008. The new rules should modernize the requirements, including publication of hearings on issuer websites. Treasury and IRS also plan to propose guidance for Build America Bonds and other direct-pay bonds. The regulations are expected to address such issues as the consequences of late filings for subsidy payments and miscalculations of those payments, as well as the consequences of violating the tax requirements applicable to these bonds. Proposed arbitrage rules are also expected that should address tax-exempt financing of long-term working capital financings. Treasury and IRS are also projecting "reissuance" regulations applicable to variable rate and "tender option bonds," which were first promised more than 20 years ago.

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