Public Finance – 2012 in Review and the Outlook for 2013

SQUIRE SANDERS

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2012 was another 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

Underwriters Consent to Document Amendments

In February 2012, the Municipal Securities Rulemaking board published Notice 2012-04 asking for comments on its draft interpretive notice relating to underwriters consent to amendments to bond documents. The MSRB was concerned that an underwriter consenting to amendments to bond documents may be in violation of the underwriter's "fair dealing" duties under MSRB Rule G-17. We noted at the time that if this notice becomes final, it would interpret Rule G-17 to prohibit an accepted market practice and would likely restrict the ability of governmental issuers and conduit borrowers to use a cost-effective method of amending bond indentures and bond resolutions. In July 2012, the MSRB published another notice (2012-36) in which the MSRB retracted its interpretation and instead proposed a new Rule G-11 that prohibits underwriters from providing consents except in limited circumstances. The rule effectively limits the ability of issuers to obtain written consents from underwriters of new bonds regardless of whether the issuer's governing bond documents allow this technique. Any final rule published by the MSRB is subject to approval by the SEC.

Voluntary Disclosure of Private Bank Loans and Purchases

The MSRB published Notice 2012-18 on April 3, 2012, encouraging municipal issuers and obligated persons to post information on its Internet portal EMMA regarding private bank loan obligations and/or other non-publicly offered securities. According to the notice, the MSRB "believes that the availability of timely information about bank loan financings is important for market transparency and promoting a fair and efficient market." The publication of the notice followed several months of discussion among market participants at various conferences about the significant increase in the use of private loan financing by large issuers and private nonprofit borrowers such as healthcare institutions as a substitute for publicly offered municipal bonds (including conduit bonds). Investors in an issuer's outstanding bonds were used to being alerted to the issuance of new bonds through the posting of an official statement or other offering which is not typically used for private financing transactions. If an issuer or obligated person chooses to submit information regarding non-publicly offered debt on EMMA, they should consider including precautionary language to dispel any expectation in the market of any continuing obligation to update the information once filed. The MSRB suggested there may be improvements made to EMMA in the future to better accommodate voluntary disclosure filings regarding additional debt and/or lease transactions. However, the notice provides guidance to using EMMA for voluntary disclosure purposes in advance of those improvements. A group of representatives from various industry groups including the National Federation of Municipal Analysts, the Government Finance Officers Association, the National Association of Bond Lawyers and others are expected to publish an article in early 2013 including things issuers should consider when providing voluntary disclosure about bank loans.

SEC Approves MSRB Interpretive Notice Addressing Rule G-17 to Underwriter-Municipal Issuer Relationships

In May 2012, the SEC approved the MSRB's interpretive notice (Notice) explaining an underwriter's duty of fair dealing to municipal issuers under MSRB Rule G-17. The Notice became effective on August 2, 2012, and, with a few exceptions, applies only to negotiated underwritings. Under the Notice, Rule G-17 requires an underwriter to make specific disclosures to its state and local government issuer clients regarding compensation, conflicts of interest and third-party relationships, as well as the fact that the underwriter owes no federal fiduciary duty to such 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."

SEC Releases Report on the Municipal Securities Market

The SEC issued its long-anticipated "Report on the Municipal Securities Market" on July 31, 2012 which contained the SEC's recommendations to improve disclosure provided to investors, especially retail investors, in the $3.7 trillion municipal securities market, as well as recommendations to improve market structure. The report focuses on the SEC's two primary areas of concerns. The first is disclosure, including timeliness and content of financial information provided by municipal issuers, and the adequacy of disclosure relating to pension and other post-retirement benefits, derivatives and conflicts of interest. The second area of the SEC's concern relates to market structure. The Report identifies a number of possible regulatory approaches the SEC could pursue under its existing legal authority, as well as possible legislative changes it could seek, to implement the goals of the Report.

SEC and CFTC Begin to Issue Final Rules Regarding Derivative Instruments

Nearly two years after enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC and the Commodity Futures Trading Commission began to issue final rules and interpretive guidance in 2012 that form the foundation of the regulatory structure for derivative instruments. Virtually all of the burden of the new rules will fall on swap dealers rather than end-users, but certain principal tenents of the regulatory structure will impose certain new requirements on end-users. For example, to promote market transparency, all swaps will be reported to a swap data repository that will then publicly disseminate certain price-related information. The swap dealer will be responsible to report the required information to the swap data repository, but to do so, the end-user must have a "legal entity identifier," which will be the swap-market equivalent of a CUSIP number.

Federal Tax Laws

Several trends in the taxation of tax-favored bonds continued throughout 2012. The IRS broadened and intensified its focus on post-issuance compliance practices and enforcement through its expanding audit program, including its growing use of "soft" contacts (such as questionnaires and the voluntary closing agreement program) as enforcement tools. Congress also continued to consider reducing or even eliminating federal subsidies for state and local bonds as part of broader tax reform. Here are a few of the specific highlights from 2012:

IRS Sends Compliance Check Questionnaires to Issuers of QSCBs and to Issuers of Governmental Use and 501(C)(3) Bonds

In April 2012, the IRS announced that it would send compliance check questionnaires to 111 randomly selected issuers of qualified school construction bonds (QSCBs). Later, in October 2012, the IRS announced that it would send similar questionnaires to issuers of governmental use and qualified 501(c)(3) bonds, focusing on these issuers' post-issuance compliance practices.

These questionnaires were different from prior questionnaires in one respect – for the first time, recipients were required to complete the questionnaire online. The questionnaires also continued a trend in recent IRS questionnaires – focusing on the post-issuance compliance practices of issuers and conduit borrowers, specifically whether those parties have implemented written post-issuance compliance procedures.

As mentioned in our original client alerts on these questionnaires, we would suggest that issuers confirm that they have adopted such written procedures, review the procedures, and confirm that they are implementing the procedures. Following these suggestions will increase the likelihood that an issuer will be able to provide responses to the questionnaire that will not ultimately result in a full IRS audit.

IRS Clarifies Qualified Energy Conservation Bond Provisions

In more substantive guidance, in late June 2012, the IRS issued Notice 2012-44. This Notice clarifies two narrow issues related to the qualified energy conservation bond (QECB) program. Although Congress has not created any additional QECB issuance authority since the end of 2010, the issuance authority provided for 2009 and 2010 carries forward indefinitely until it is fully used.

An issuer may use QECBs for capital expenditures to reduce energy consumption in publicly owned buildings by at least 20%. The Notice describes how the energy consumption is calculated. The Notice also provides that so long as an issuer reasonably expects that the QECB-financed project will reduce energy consumption in a publicly owned building by at least 20%, the QECBs will satisfy the 20% requirement. The issuer can demonstrate its reasonable expectations by obtaining an engineer’s certificate.

An issuer may also use QECBs for capital expenditures to implement a “green community program.” The Notice further defines this term. It provides a list of permitted purposes for a green community program and sets forth a requirement not previously stated - the green community program must provide property or loans that are available to the general public.

Potential Effect of Sequestration on Direct Pay Subsidies

In September 2012, the Office of Management and Budget (OMB) reported that if Congress did not reduce the deficit to prevent the impending budget “sequestration,” then the federal government would reduce the amount of its interest subsidy payments on the various direct-pay bonds issued under the American Recovery and Reinvestment Act of 2009. In addition, sequestration could reduce other federal payments to states and local governments, including federal grants for capital projects and health and education programs.

However, on January 1, 2013, the very day that sequestration was to begin, Congress enacted the American Taxpayer Relief Act of 2012, which delays sequestration until March 1, 2013. Of course, the potential reduction in the direct-pay subsidy and the other related issues described above will again be hotly debated as the delayed sequestration date approaches. As mentioned in our prior client alert on this topic, issuers of direct-pay bonds should review the bond documents to determine what options they have if the subsidy is reduced – including redeeming these bonds early, which could be funded with proceeds of tax-exempt bonds.

What To Look For In 2013

Federal Securities Laws

With a newly appointed Director on board in the Office of Municipal Securities, the SEC is expected to take several actions in 2013, including: finalizing the municipal advisor rules early in 2013, an update to the SEC’s 1994 Interpretive Guidance on disclosure obligations of municipal issuers and additional amendments to SEC Rule 15c2-12, possibly to mandate the types of disclosures required by issuers in their initial official statements and continuing disclosure filings. Still possible but less likely in 2013 would be for the SEC to be successful in having legislation drafted and passed that would significantly expand its authority over municipal issuers.

IRS Enforcement

The IRS will continue its focus on the determination of the "issue price" of bonds (i.e., the correct resale price of the bonds). In recent interviews, IRS officials have indicated that they plan to open audits of issues of build America bonds, with an emphasis on probing whether the issuer properly determined the issue price.

In addition, the IRS likely will focus its examination efforts on the following areas: abusive arbitrage-motivated transactions, pooled financing bonds, tax and revenue anticipation notes and other working capital financings, tax promoter penalties, tax increment bonds, advance refunding bonds, independent multi-functional special district (IMFSDI) financings, student loan bonds, 501(c)(3) bonds, governmental bonds, and other specialty bonds and tax-credit bonds, including the build America bond issue price audits described above.

It also is clear that the IRS now realizes that "soft" contacts, such as questionnaires and the voluntary closing agreement program (VCAP), have all of the power of an audit but require significantly less resources. In 2012, the IRS created a specialized VCAP focusing on a very narrow arbitrage issue related to a very narrow subset of the tax-favored bond universe (student loan bonds). The IRS strongly implied that they would audit any student loan bond issuers that had taken the action that the IRS believed was a violation and that did not enter into this specialized VCAP. Many issuers doubted whether the IRS was correct that the targeted action actually violated tax law, but most of these issuers nevertheless entered into the specialized VCAP agreements because they feared being forced to pay an exorbitant amount on audit. In recent public comments, the IRS has stated that it plans to expand this targeted VCAP approach to other specific legal issues regarding other types of tax-favored bonds.

Tax Legislation

The key issue in Congress is how broader tax reform efforts may impact the federal subsidy of state and local bonds. For example, last year the President proposed broad legislation under which high-income individuals and families would no longer receive interest on state and municipal bonds that is completely exempt from federal income tax. While it is not apparent whether there is any Congressional support for such a proposal, issuers should not ignore this proposal and similar proposals because unenacted bills often provide a starting point for future, successful legislation.

Apart from these sweeping reform proposals, any legislation related to tax-favored bonds in 2013 likely will take the form of very targeted technical fixes or reauthorizations of existing provisions scheduled to expire. For example, in the American Taxpayer Relief Act of 2012, Congress made permanent a more generous small issuer rebate exception for public school construction issues and authorized an additional $400 million of qualified zone academy bond issuance authority.

Tax Regulations

As is true each year, Treasury and IRS have a number of priority regulation projects for 2013. One project is to finalize the 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 to 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 almost 25 years ago.

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