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November 12, 2004

Keith Rake, Deputy Assistant Commissioner
Office of the Assistant Commissioner
Bureau of Public Debt
Department of the Treasury
200 3rd Street, P.O. Box 396
Parkersburg, West Virginia
26101-0396

RE: Docket Number BPD-02-24

Ladies and Gentlemen:

The following comments are submitted to the Bureau of Public Debt of the United States Treasury Department ("BPD") in response to the Notice of Proposed Rulemaking by the BPD regarding the State and Local Government Securities ("SLGS") program under 31 CFR Part 344. The Notice of Proposed Rulemaking was filed in the *Federal Register*, Volume 69, No. 189, on September 30, 2004.

The National Association of Bond Lawyers ("NABL") was incorporated as an Illinois nonprofit corporation on February 5, 1979, for the purposes of educating its members and others in the law relating to state and municipal bonds and other obligations, providing a forum for the exchange of ideas as to law and practice, improving the state of the art in the field, providing advice and comment at the federal, state and local levels with respect to legislation, regulations, rulings and other actions, or proposals therefor, affecting state and municipal obligations, and providing advice and comment with regard to state and municipal obligations in proceedings before courts and administrative bodies through briefs and memoranda as a friend of the court or agency. NABL currently has approximately 3,000 members.

These comments have been prepared at the request of the Board of Directors of NABL by a committee of attorneys with extensive experience in dealing with the SLGS regulations[1]:

SUMMARY

In the Tax Reform Act of 1986, Congress mandated that the State and Local Government Securities ("SLGS") program provide instruments allowing flexible investment of bond proceeds in a manner eliminating the earning of rebatable arbitrage through a program that operated a no net cost to the federal government. Congress wanted these changes to discourage the use of investment purchases on the open market for yield limited funds. The use of such open market investments was thought to lead to diversion of arbitrage profits through a process called "yield burning." In 1996, Treasury again amended the SLGS program for the stated purpose of making the SLGS program more attractive and flexible for state and local government issuers while still achieving policy and cost objectives of the Treasury. These changes were at the request of market participants and state and local government issuers, and came at a time when the Treasury and the Internal Revenue Service were particularly concerned about yield burning in advance refundings of tax-exempt bonds.

The 1996 amendments (and further amendments in 1999 and 2000) created a program that has been investor friendly, very profitable for the BPD, and administratively streamlined for both the Internal Revenue Service ("IRS") and for NABL practitioners. The current program builds in a large degree of flexibility that makes the SLGS program attractive to users, evidenced by the current size of the program now approaching $160 billion in total volume.

The principal purpose of the proposed regulations appears to be the elimination of the practice of using the SLGS Program to allow certain governmental bodies to recover some or all of their "negative arbitrage" by investing at rates that were temporarily more favorable than those available in the open market. Some purchasers of SLGS were using the SLGS program to obtain an advantage, usually based on the embedded options inherent in SLGS subscriptions from 1996 through 2004, within the arbitrage limits imposed by Section 148 of the Internal Revenue Code of 1986 (the "Code").

We do not agree with the underlying premise of the proposed regulations --- that use of the 1996 regulations to recover a portion of "negative arbitrage" is abusive, especially in light of the specific arbitrage-related purposes of the program and the substantial financial benefit that it represents for the BPD ("BPD") Moreover, although some investors may have used the SLGS program to obtain above market returns, we believe that as a whole, through the purchase of below market SLGS, including zero yield SLGS, overall SLGS investors have collectively received below market returns. The SLGS program has actually reduced the borrowing cost of the United States Treasury.

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1 The NABL SLGS Comments Committee:

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In its effort to curtail what it perceived as "cost-free options", the proposed regulations go too far. Many of the routine SLGS purchases, necessary for ensuring compliance with arbitrage and taking remedial actions under the private activity bond regulations, will be difficult, uneconomic, or in some cases impossible. These restrictive new rules – contrary to a specific Congressional mandate - will drive state and local governments out of the SLGS program in large numbers, increasing the cost of funding the federal debt, and recreating the very tax compliance problems which the 1996 revisions were intended to resolve. To a large extent, these proposed SLGS rules are a major step backward in the effort to find a proper balance between federal and state financial relationships.

RECOMMENDATIONS

NABL's principal recommendations for changes in the proposed regulations are that:

-Permit penalty free cancellation of subscriptions, and resubscriptions at higher rates, for up to 60 days;

-Eliminate proposed "reinvestment yield" restrictions on redemptions and subscriptions;

-Retain the existing definition of moneys eligible for SLGS investment

-Retain the flexibility to extend issue dates by up to 7 days, modify subscription amounts by up to $10 million and to specify maturities of choice

At the same time, NABL strongly endorses some of the proposed changes in the SLGS program. Mandatory use of the SLGSafe computer system will substantially eliminate the administrative burdens discussed in the preamble, and will also aid in cash management. Similarly, we agree that requiring proper authorization from subscribers will eliminate an abuse that NABL has never condoned. Finally, requiring appropriate indication of a subscriber's intent to actually issue bonds is an appropriate condition so long as that indication is consistent with industry practice.

PART I: DETAILED DISCUSSION AND COMMENTS

Background: Federal "Arbitrage" and the SLGS Program

The BPD issues SLGS to issuers of tax-exempt bonds, pursuant to 31 CFR 344 et al. Because the SLGS program is tied inextricably to the investment restrictions imposed on municipal borrowings under Section 148 of the Internal Revenue Code of 1986, as amended (the "Code"), proper analysis of the SLGS program requires at least a basic understanding of the federal arbitrage rules.

The federal arbitrage rules of Sections 148 - 150 of the Code, and related regulations in 26 CFR Section 1.148-1.150 (the "Treasury Regs") implement a fundamental principle first adopted by Congress in 1969 and refined in the succeeding 35 years. With certain limited exceptions:

"Proceeds of tax-exempt municipal borrowing may not be invested at yields higher than the yield on the borrowing itself."

As a simple example to be utilized throughout these comments, assume that City A issues $25 million principal amount of 15 year bonds at a yield (or true borrowing cost) of 4% per year. After paying the costs of issuance, the net bond proceeds might be used (i) to fund a 3 year highway construction program, (ii) to establish an escrow account to "advance refund" previously issued bonds redeemable 8 years from now, (iii) to fund a debt service reserve fund equal to about 10% of the bonds, or (iv) for some combination of these uses.[2] In each case, those bond proceeds must be invested before they can be expended. To preserve the favorable tax-exempt status of the interest on its bonds, that investment return is limited by federal arbitrage law to 4% per year.

The City's dilemma is that investment returns on the open market (especially for longer term investments in escrow accounts or reserve funds) are typically higher than 4%. But if the bond proceeds were invested at those market yields, the City's bonds would lose their tax-exempt status. The Treasury Department's Office of Tax Policy recognized his problem while drafting the initial arbitrage regulations in 1971-1972. The SLGS program was therefore developed to provide issuers an alternative source of AAA-quality investments. The mechanism was (and still is) deceptively simple: a city with tax exempt municipal bond proceeds to invest could construct a portfolio of tailor-made SLGS securities to fit its needs: specifying the principal amount, maturity dates, and interest rates on its investments.

The SLGS program was initially only marginally successful, for two principal reasons.

First, for several years after the initial 1972 promulgation of the federal arbitrage rules and the corresponding SLGS program, investment bankers were often able to persuade issuers to pay above-market prices for open market securities in order to "drive down" the yield realized by the issuer to permitted levels. (A 4% coupon security priced on the open market at 94 might be sold to the issuer at 100). Since federal arbitrage law did not then proscribe those markups, bond counsel generally limited their inquiries to assuring that none of the extra mark-up was indirectly repaid to the issuer.

Second, the SLGS program itself was poorly drafted – offering too little flexibility to make it a viable investment alternative for many issuers.[3]

In 1975, introduction of the "fair market" pricing rule into the federal arbitrage regulations caused a fundamental change in the tax-exempt bond proceeds' investment landscape. Thereafter, the yield on restricted investments would be based **not** simply on what the City paid; but rather on the investment's actual market price. Our 4% investment security would now bear a yield based on its open market value of 94 – rather than the City's artificially high price of 100. Faced with the difficulty of determining "fair market value", many issuers decided to invest yield restricted

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[2] While bond proceeds may be used for many other purposes (such as tax and revenue anticipation borrowing; financing portfolios of low income single family and multi family mortgages, student loans, and current refinancing of outstanding debt), this basic example will illustrate the interplay between the arbitrage rules and the SLGS program. The use of bond proceeds for certain "private activities" (health care, housing, 'small issues', etc) is limited by a separate statutory and regulatory regimen not directly related to the investment of bond proceeds.

[3] As one of the draftsmen of the 1972 SLGS program, the Chair of the NABL SLGS Comments Committee acknowledges partial responsibility for the inadequacies of the original program.

moneys either totally in tailor made SLGS, or in shorter term open market obligations with a commitment to reinvest the maturing balances in "zero coupon" SLGS in order to blend down the yield on all investments to the permitted level.

1986 was another watershed year in the relationship between federal arbitrage law and the SLGS program. Prior to that time, federal arbitrage compliance was based almost totally on the issuer's "reasonable expectations" regarding the investment of bond proceeds at the time the bonds were issued. If the City expected on the date of issue that its bond proceeds would be invested at no more than 4% that expectation was generally controlling regardless of subsequent events.[4] However, in the Tax Reform Act of 1986 (The Internal Revenue Code of 1986), Congress applied "rebate" principles of Section 148(f) of the Code to virtually all issuers of tax-exempt debt. For the first time, the rebate rules required issuers to monitor their investments over time – rather than relying solely on original-albeit reasonable – expectations. Generally, if investment yield exceeded bond yield for any 5-year period during the life of the bonds, the excess is required to be paid over to the IRS as "rebate".

Concurrently with enactment of the 1986 rebate rules, the general market and the municipal industry began developing more sophisticated borrowing and investment techniques, including Capital Appreciation Bonds, variable rate debt, specially designed guaranteed investment agreements ("GICs") and the like. At the same time, additional features were added to investment products – designed at least in part to "burn" the yield on yield restricted investments. Combined with the new monitoring requirements of the 1986 "rebate" rules, this made compliance with the arbitrage requirements even more difficult for issuers of municipal bonds. Finally, in the early 1990s, the IRS launched its own broad scale audit program for tax exempt bonds.

These various developments made a viable SLGS program even more important to the industry: issuers, their advisors, and their counsel needed a flexible, reliable investment vehicle to both satisfy their own increasingly complex financial and legal requirements, while assuring compliance with federal arbitrage law. The BPD, together with the Treasury's Office of Domestic Finance and Office of Tax Policy, plainly recognized and understood this need. In 1996, the SLGS program was updated and modernized – providing issuers the flexibility to move in and out of the program at modest costs and to maximize the investment returns available to them within the parameters of federal arbitrage investment limits.[5] With the addition of the SLGSafe computerized subscription program in 2000, the SLGS program reached its present state.

Effects of the SLGS Program

Since the 1996 revisions, the SLGS program has been an outstanding success for both the U.S. Treasury (including both the IRS and the BPD) and for State and local government issuers of tax-exempt debt. Fulfilling its initial mission as an adjunct to the federal arbitrage rules, the SLGS program today offers state and local governments a convenient, flexible investment vehicle that still assures that no bond proceeds will be invested at a yield in excess of its borrowing cost. ***No***

[4] The one (appropriate) exception to this general principle was that post issuance deliberate actions of the issuer itself were taken into account as though they had been reasonably expected.

[5] This was specifically acknowledged in the Preamble to the 1996 revisions: ***"The Department of the Treasury, Bureau of Public Debt, desires to make the SLGS securities program more attractive and flexible for State and local government issuers of debt obligations that are subject to the arbitrage and rebate rules of the Internal Revenue Code."***

matter how it may manage its SLGS investments, City A can never earn and keep more than its 4% borrowing cost.

The SLGS program has an even more direct financial benefit to the BPD. The BPD keeps all the "positive arbitrage" prohibited to issuers by federal arbitrage law: through the SLGS program, the U.S. Government can borrow at or below municipal tax-exempt costs. When City A borrows $10 million in SLGS from the BPD at 4%, when comparable open market securities may pay 5%, BPD is saving $100,000 per year in borrowing costs paid by U.S. taxpayers. Thus, **no matter how City A manages its SLGS investments, the BPD can never lose money, and may save significantly in interest costs.**

The amounts at stake in the SLGS program are immense. The aggregate principal amount of SLGS currently outstanding approaches **$160,000,000,000 ($160 billion).** Consider the annual savings to the U.S. Government at several different levels of "positive arbitrage" (average spreads between open market investment rates and tax-exempt borrowing rates):

Positive Arbitrage Spread	Annual Savings on $160 billion of SLGS
.05%	$ 80000,000/year
.25%	$ 400,000,000/year
.50%	$ 800,000,000/year
1.00%	$1,600,000,000/year

These are absolutely staggering numbers.[6] They illustrate more dramatically than any text the extent to which the SLGS program has shifted the reinvestment benefits of tax-exempt municipal bonds from state and local governments to the federal government itself! They also dramatize the importance of maintaining a viable SLGS program: changes that drive state and local governments away from the SLGS window will only hurt the Treasury itself.

The Existing SLGS Program

Under current regulations, the principal features of the current SLGS program reflect the flexibility that has attracted such a large volume of state and local government participation:

- Issuers (or their representatives), may subscribe directly to the BPD to purchase SLGS. The purchaser (or "subscriber") specifies the amount, the maturity date and the interest rate. Whatever interest rate is specified (including 0%) is accepted by the IRS as "fair market value" for purposes of federal arbitrage law compliance. It is this feature which allows a municipality to design a "tailor made" portfolio for its cash flow needs, while assuring compliance with federal arbitrage law.

[6] Both current and proposed SLGS regulations specify that "[t]he [interest] rates specified in the [daily SLGS rate] tables are five basis points [.05%] below the then current estimated Treasury borrowing rate for a Treasury security of comparable maturity."31 CFR 344.2(b). Thus, every SLGS obligation represents a minimum annual interest cost savings of .05% - or an aggregate **minimum** program savings of $75,000,000 per year!

- SLGS rates are set at 5 basis points below comparable open market rates – a minimum annual 5 basis point "haircut" to the BPD on **every** SLGS security sold to States and local governments. .

- Maximum SLGS interest rates are published at 8.30 a.m. each morning, effective until midnight of that day. The rates are generally determined based on the preceding daily open market U.S. Treasury yield curve rates ("Constant Maturity Treasuries") reduced by .05%. Thus, if an open market Treasury security maturing in 10 years is priced to yield 4.55 % on the afternoon of a given day, 10-year SLGS ordered the next day would likely pay a maximum interest rate of 4.50%.

- SLGS may be redeemed prior to maturity. The SLGS securities to be redeemed are discounted at the current applicable SLGS rate to maturity, increased by 5 basis points. This 5 basis point redemption cost is **in addition** to the 5 basis point reduction in the SLGS interest rate affixed at initial purchase.

- SLGS investments can generally be made only with proceeds of tax-exempt municipal bonds. SLGS may not be sold, traded or otherwise assigned. These limitations clearly differentiated SLGS from other marketable securities – they are carefully limited to only the proceeds of borrowings by state and local governments.

- SLGS may be subscribed for until midnight of the subscription day by mail, fax or via the Internet (through "SLGSafe"). Settlement may be as much as 60 days following the initial subscription. Both the amount and maturity date of the subscription may be modified up to settlement.

- Initial subscriptions may be canceled at the option of the subscriber, followed by new subscriptions with different amounts, maturities and/or interest rates. This very important provision allows a municipality to more precisely tailor its SLGS portfolio to its specific needs – and also provides an opportunity for either deceasing interest rates (to conform to lowered federal arbitrage investment yield limits based on final pricing of the Bonds) or for improved interest rates to ameliorate potential "negative arbitrage". Most issuers consider the ability to cancel and resubscribe the single most important flexibility provision in the program.

- Prior to final settlement, the principal amount of the SLGS subscription may be reduced by the lesser of $10,000,000 or 10 per cent of the amount of the initial subscription.

These features have not evolved by accident. They reflect a series of conscious policy decisions in 1996 to make the SLGS program more attractive to state and local governments. This was intended not only to save interest cost for the BPD, but –equally important – to eliminate many of the compliance problems experienced by both the IRS and practitioners in applying the complex federal arbitrage rules to the investment of restricted yield bond proceeds in open market securities. For that reason, it is not surprising that a number of adverse commentators on the

proposed regulations were actively involved in the development of those 1996 principles as government officials at the time.

PART II: GENERAL COMMENTS ON SLGS PROGRAM RIGIDITY

The common theme characterizing the proposed regulations is a very substantial increase in the rigidity of the program. This in turn reflects a fundamental lack of appreciation of the practical problems faced by state and local governments both in complying with federal arbitrage requirements and in dealing with the specific problems created by the recent development of "negative arbitrage".

Before addressing the specific changes proposed in the regulations, we offer general comments on the overall tenor of the suggested changes and their effect on municipal finance, compliance with federal arbitrage law and the cost of U.S. Treasury borrowing.

The "Negative Arbitrage" Phenomenon

"Negative arbitrage" is a relatively new phenomenon in municipal bond markets, occasioned principally by the unusual compression between taxable and tax-exempt interest rates in recent years. The concept is simple. If an issuer of tax-exempt bonds is unable to invest the proceeds at a yield at least equal to the yield on the bonds themselves, it is suffering "negative arbitrage". If City A can invest the proceeds of its 4% bonds at only 3%, it is suffering "negative arbitrage" of 100 basis points a year. Conversely, even if those same 4% proceeds could be invested at 5% per year, it is no comfort to City A – since federal arbitrage law mandates investment of those moneys in SLGS at the maximum 4% rate. The BPD receives **all** the positive arbitrage; while City A must scramble to minimize its own negative arbitrage.

Ameliorating Negative Arbitrage through SLGS Flexibility

There is no question that certain features of the current SLGS regulations permit some issuers, in some circumstances, to either avoid or recover at least a portion of the negative arbitrage on its investments. That is entirely consistent with the carefully considered 1996 rewriting of the program and is fundamentally fair. The BPD annually retains hundreds of millions of dollars of positive arbitrage through the SLGS program. Why should state and local governments be denied the opportunity to recover the occasional negative arbitrage created by recently inverted market conditions?

Consider City A again. While planning its bond issue, City A recognizes not only that investment yields on funds in its debt service reserve fund may be less than 4%, but also understands that even rates below 4% may vary by as much as 50 basis points (between 3.40% and 3.90%) before its financing is completed. Six weeks before actually issuing its bonds, City A therefore subscribes for SLGS at the then maximum SLGS rate of 3.70%. If rates increase by 10% in the interim, City A will cancel its initial subscription and resubscribe at 3.80%. (Of course, no matter how high rates may go, City A is absolutely prohibited from ever earning more than 4% on its money). Conversely, if investment rates have fallen back to 3.45%, City A will simply hold on to its 3.70% investment and pay for it on the settlement date.

Because of its ability to cancel and resubscribe, City A has been able to at least mitigate the impact of its negative arbitrage. Moreover, (i) City A's investment rate still does not exceed the 4% limit of federal arbitrage law, and (ii) even the 3.80% rate on its eventual SLGS investment is still 5 basis points below comparable open market Treasury borrowing rates for the same maturity. While City A is still losing money on its investment, the BPD is able to retain its minimum 5 basis points savings over the entire investment.

Let us revisit City A on a Wednesday morning 2 years after the issuance of its bonds, with the bond proceeds in its debt service reserve fund invested in 15 year SLGS at 3.80%. The City's financial advisor calls the City Treasurer to let him know that because of strong inflation forecasts just released by the Commerce Department, yields on 15 year open market Treasury securities are spiking rapidly upward. The financial adviser estimates that City A could purchase a block of 3.80% open market securities at a price of 99 – providing an enhanced yield of 3.98%. At the same time, since SLGS rates have been fixed at their 10:00 a.m. publication, the City can order redemption of those bonds at a yield 5 basis points above the applicable SLGS rate for that maturity. Later in the day, City A's Treasurer therefore orders redemption of the SLGS (with the 5 basis point penalty) and simultaneously orders a comparable block of the open market securities at a slightly higher yield. The difference between the redemption price for the SLGS, and the reinvestment price for the open market securities represents at least a partial recovery of the negative arbitrage in the reserve fund, which under the federal tax rules may be used only for certain qualifying purposes.

This is a sensible transaction for City A, for it takes appropriate advantage of two features of the current SLGS program: (i) the ability to redeem previously purchased SLGS at yields only 5 basis points higher than the current SLGS rate table; and (ii) the static character of the SLGS table itself: once published at 10:00 a.m., the SLGS rates used for both subscription and redemption remain unchanged throughout the day. Similarly, since the BPD has been paying a rate on that SLGS security which is 5 basis points below the market, and since the redemption price is calculated with a similar 5 basis point penalty, the BPD loses very little in the transaction.

The investment substitution described for City A goes from SLGS to open market securities. Essentially the same financial considerations apply if City A redeems an existing SLGS portfolio at a lower "a.m." yield, counting on the day's general increase in interest rate levels to produce higher SLGS rate the following day at which the SLGS redemption proceeds can be reinvested. Occasionally, an issuer may even sell open market securities in order to reinvest in SLGS.

The Proposed Regulations' Attack on Negative Arbitrage Recovery

The proposed SLGS regulations are designed to eliminate what its authors characterize as an unacceptable "optionality" in the program: the ability of *some* issuers, in *some* circumstances, to recover *some* of the negative arbitrage associated with the investment of the proceeds of their tax-exempt borrowings. This view runs directly counter to more than 30 years' evolution of the SLGS program in concert with the federal arbitrage regimen, specifically reverses the policy decisions adopted just 8 years ago in the 1996 revisions, and will ultimately cost the federal government tens of millions of dollars in increased interest costs as state and local government issuers flee the program *en masse*.

The proposed SLGS regulations reflect a fundamental underlying fallacy: that ***the SLGS program is just another Treasury borrowing program, subject to the same analyses as any other borrowing program.*** This error is further compounded by the asserted inability to "price" the optionality features of the program.

The Treasury's attack on the recovery of negative arbitrage has two major components:

> -Proceeds from the redemption of SLGS or the sale of open market securities may not be reinvested at a yield higher than the yield at which they were redeemed or sold – whether the subscriber is going from SLGS to SLGS, SLGS to open markets, or even open markets to SLGS. These very harsh restrictions apply even though the overall yield on investments of bond proceeds is still below the maximum permitted arbitrage yield.
>
> -Once filed, subscriptions may not be canceled for replacement by higher yielding SLGS or open market securities – even though the overall yield on investments of bond proceeds is still below the maximum permitted arbitrage yield. Moreover, that cancellation would still be discretionary. The subscriber will have to make an affirmative case to the BPD as to the **bona fides** of the cancellation.

Together, these two proposals effectively "freeze" a state or local government into the SLGS program at its ***initial*** investment yield (whether that initial investment is in SLGS or in open markets), totally without regard to the federal arbitrage investment limits already imposed on that subscriber. Consider our earlier example of City A, which has issued bonds at 4%. If open market investment yields are at 5%, the federal arbitrage regulations deny the City those extra 100 basis points of "positive arbitrage": all of that positive arbitrage is retained by the BPD. But if the best yield available on SLGS is 3.75%, and the City elects to invest in SLGS at that level, it is stuck with the 25 basis points of negative arbitrage forever.

The BPD justifies these draconian measures on the ground that "[these] provision[s permitting recovery of negative arbitrage] provide...feature[s] that [are] not available for marketable securities and result in hidden costs to the federal taxpayer". We believe this reflects an unrealistic understanding of the SLGS program. <u>State and local governments are **not** like other investors</u>, and SLGS themselves are by definition **not** "marketable" securities". Unlike issuers of state and local government debt, the general market is not already saddled with the investment limits of federal arbitrage law. Nothing prevents CitiGroup, Goldman, Sachs or Merrill, Lynch from achieving the highest possible return on their investments, and no responsible government official would allow either of them – or any other private entity not subject to federal arbitrage rules – to either "ride the yield curve" through subscription/resubscription, or to take advantage of the lag in the SLGS rate table to effect redemption/reinvestment transactions.

City A is in a wholly different position, as are its fellow cities, counties, states, authorities, school districts and other municipal entities throughout the country. They are subject to the federal arbitrage investment yield restrictions, and that simple fact alone makes all the difference.

The net effect of these proposed hurdles in the SLGS program is to further restrict the investment options available to state and local governments. In addition to the limits imposed by federal arbitrage law, they will from time to time be subjected to even harsher penalties because of

their inability to recover any negative arbitrage. Already saving literally **hundreds of millions of dollars** per year from the traditional positive arbitrage denied to municipal borrowers, the BPD would now deny those same municipalities the ability to even reach the investment ceiling already mandated by federal arbitrage law.

These fundamental proscriptions on the recovery of any negative arbitrage, together with certain other onerous administrative requirements discussed below, will drive issuers away from the SLGS program in droves.

Consider again City A, beginning to plan the same bond issue **after** the effective date of these proposed regulations. Facing negative arbitrage, the City now has little reason to invest in SLGS. First, SLGS by definition provide a yield at least 5 basis points below the market: most investment bankers and financial advisors are today sufficiently sophisticated to construct a portfolio combining open market investments and guaranteed investment agreements which will provide a higher reinvestment yield than SLGS. Moreover, these arrangements can be, and will be, designed with at least some flexibility for the issuer – certainly more than would now be available under the new SLGS regimen. Even faced with positive arbitrage, City A will still be reluctant to commit its bond proceeds to SLGS, if only because of the new rigidity in the rules. For example, City A's actual borrowing costs may increase between the date of it original subscription and the sale of the bonds – turning a positive arbitrage scenario into a negative. Under the proposed regulations, the City is either denied permission to cancel the SLGS subscription (because it plans to invest in higher yielding open market securities), or it must seek positive permission from an unnamed Treasury official to do so.

Following the liberalizing rules in the 1996 regulations, the volume of SLGS outstanding increased from an estimated $95,000,000 as of September 30, 1996, to a reported $160.5 billion as of October 31, 2004. These regulations, if adopted in their current form, will reverse that trend: we would not be surprised to see **at least half** of the current SLGS volume transferred in some fashion to other forms of investments. Even assuming the absolute **minimum** interest cost savings of 5 basis points per year, a loss of $80 billion in SLGS volume would cost the BPD some $40 million per year in additional interest cost. At a more realistic estimated annual interest cost savings rate of just 15 basis points, the cost to the Treasury jumps to $120 million per year –in added interest cost on the federal debt. **That** will be the real dollar cost to the U.S. taxpayer.

As a practical matter, if maximum rate SLGS produce *negative* arbitrage, the BPD proposals will in every case result in a situation where nobody will purchase SLGS. They will always purchase higher yielding market securities with a least the possibility of subsequently finding a way to increase the yield within applicable federal arbitrage limits.

In the case of situations where maximum rate SLGS produce positive arbitrage, some escrows will be structured either entirely with SLGS or a mix of open market securities and zero SLGS. But even in positive arbitrage circumstances, many more sophisticated issuers will shy away from such a rigid program, searching instead for alternative investment structures that preserve the flexibility to respond to future changes in their own financial situations, or future changes in federal law. [7]

[7] From conversations with a number of our NABL colleagues, we are convinced that a substantial number of large, sophisticated issuers are already prepared to abandon the SLGS Program if the September 30th proposals are adopted. It is entirely possible that our estimate of a 50% defection may be understated.

The flight from SLGS will have serious indirect effects as well. From consultations among the Comment Committee, within their several law firms, and with colleagues in other firms, both state and local governments, and their advisers, are worried about the increased complexity of financial structures utilizing open market securities while attempting compliance with federal arbitrage rules. NABL attorneys, in particular, typically advise on the application of federal arbitrage rules, deliver legal opinions regarding federal arbitrage compliance, and may subsequently be required to justify those opinions on an IRS audit.

Duration of Reinvestment Yield Limitations

If the Treasury nevertheless determines to adopt reinvestment yield restrictions in the SLGS program, we believe that the approach of the proposed regulations could be improved.

Under the September 30th proposal, two yield test restrictions would apply to proceeds of the early liquidation of investments:

a) Liquidation proceeds of investments may not be invested in SLGS at a yield above the liquidation yield ,and

b) Proceeds of the early redemption of SLGS may not be invested in **any** investment at a yield above the SLGS liquidation yield.

The two rules are clearly intended to prevent recovery of negative arbitrage in which lower yielding investments are replaced with higher yielding investments (presumably available only because of pricing inefficiencies). We question whether such a rule is necessary at all when the BPD will be removing most of the pricing inefficiencies for SLGS. However, if the rules are adopted, **the rules should be crafted to expire when the liquidated investment would in any case have matured.** Assume for example that gross proceeds are temporarily invested in a United States Treasury Bill maturing two months after purchase. Assume that the issuer wants to reinvest the amount in three year SLGS. If it waits until the maturity date of the T-Bill, it may make the reinvestment at a yield in excess of the two month T-Bill rate. If however, the Issuer liquidates the T-Bill prior to maturity (even one day prior to maturity), the SLGS reinvestment rate would be limited to the liquidation yield on the T-Bill. This yield would likely be very low because it would be based on the yield from liquidation date to maturity date of the investment (potentially, a 1-day rate). The concern is not alleviated by an intervening investment. If the issuer wants to invest proceeds in SLGS, it will have to check the liquidation yield of any temporary investment, even ones that would have matured earlier if held to maturity. Application of the yield limitation rule in this context does not relate to the replacement of a lower yielding investment with a higher yield investment.

The solution to the problem is to limit the application of the rule to replacement investments that are purchased prior to the date on which the original investment would have matured if it had not been redeemed or liquidated early. If Treasury does decide to implement this new policy, we would propose the following alternative language:

"3(i) ...

"(A) If the issuer is purchasing a SLGS security with proceeds of the sale or redemption (at the option of the holder) before maturity of any marketable security and such purchase of a SLGS security occurs prior to the scheduled maturity date of the sold or redeemed marketable security then, the yield or such SLGS security, does not exceed the yield at which such marketable security was sold or redeemed; and

"(B) If the issuer is purchasing a SLGS security with proceeds of the redemption before maturity of a Time Deposit Security, and such SLGS security purchase occurs before the scheduled maturity date of the redeemed Time Deposit Security, then, the yield on the SLGS security being purchased does not exceed the yield that was used to determine the amount of redemption proceeds for such redeemed Time Deposit Security.

"(ii) Upon submission of a request for redemption before maturity of a Time Deposit Security subscribed for on or after the date of publication of the final rate, the issuer must certify that prior to the scheduled maturity date of the Time Deposit Security being redeemed no amount derived from the redemption, will be invested at a yield that exceeds the yield that is used to determine the amount of redemption proceeds for such Time Deposit Security."

PART III: SPECIFIC COMMENTS

For analytic purposes, the SLGS Program may be divided into three "stages":

- **Initial SLGS Subscription**
- **From Initial SLGS Subscription to SLGS Purchase, and**
- **Redemption of Previously Purchased SLGS Securities**

Initial SLGS Subscription

A number of the proposed changes in the SLGS regulations address the conditions for initial SLGS subscriptions, including the setting of rates, the period during the day when SLGS subscriptions may be filed, and certifications required to accompany the subscription.

"Cost-free Options" vis-à-vis the .05% "Haircut" on SLGS Interest Rates and Redemptions.

The repeated references to "cost free options" in the preamble and text of the proposed regulations suggests that the BPD does not recognize **any part** of the current .05% reduction in SLGS interest rates (or the additional .05% "haircut" on redemptions) to be attributable to such options. Currently, and under the proposed regulations, the table of maximum interest rates is intended to be computed as .05% below the corresponding open market yield, and redemption prices are calculated with a similar .05% increase in yield. There are presumably multiple purposes for these .05% "haircuts" under the current rules::

1. To cover administrative costs of running the SLGS program,

2 To reduce the likelihood that SLGS rates might be higher than corresponding open market rates because of movement in the open market rates after SLGS rates are fixed, and .

3. To cover a portion of the cost of the option inherently embedded in the SLGS program.

The full .05% haircuts on rates and redemptions can certainly not be fully justified merely as compensation for the cost of administering the SLGS program, particularly for large purchases, and particularly with mandatory use of SLGSafe in the future.

Similarly, the second justification for the .05% "haircuts" (reducing the likelihood that SLGS interest rates exceed open market rates) would scarcely justify a .05% spread when the time period during which the SLGS rates are available is reduced from the present 32 hours to the proposed 9 hour limit.

The inescapable conclusion is that **the .05% "haircuts" are already principally allocable to the options embedded in the program.** Contrary to the assumptions underlying the proposed regulations, and totally without regard to the very substantial positive arbitrage already built into the program, the BPD is already being paid for those imbedded options.

The SLGS Rate table.

Under the current regulations, SLGS rates for a given day are determined (and published) at 5 p.m. the preceding day. From time to time, this "overnight lag" causes SLGS rates for a given day to be considerably higher than current open market rates. That allows some issuers to recover a portion of their negative arbitrage, and is therefore of concern to the BPD.

Treasury therefore proposes to limit issuers' opportunities to take advantage of the "overnight lag" between BPD setting SLGS rates on the afternoon of one day, and municipal issuers filing either new SLGS subscriptions or the notice of redemption for existing SLGS on the next day. Thus, instead of determining the next day's SLGS rates on the afternoon of the preceding day (current practice), BPD would wait until the 10:00 a.m. (Eastern time) on the following morning to determine and publish the table in effect for that day.

NABL has no objection to this proposal, since it will allow SLGS rates to more closely correspond to that same day's rates on comparable open market securities. In fact, NABL would urge BPD to consider implementing this change alone– suspending implementation of the harsher proposals. This would allow a reasonable amount of time to determine if the elimination of the overnight "lag", together with the mandatory use of SLGSafe and certification of authorization, will be sufficient on their own to alleviate the BPD concerns about "free options".

Keeping the SLGS Window Open.

While current regulations permit subscriptions or redemptions until midnight of a given day, the proposed regulations would effectively limit the SLGS business day (its "window") to the

period from 10 a.m. through 6 p.m., Eastern time. NABL considers that limited time frame not only unduly harsh for all issuers, but especially unfair to those on the West Coast for whom 6. p.m. in the East is only 3 p.m. in their business day. Particularly with the mandatory use of SLGSafe, there is no reason why all issuers should not be able to do business at the SLGS window all the way through to midnight.

Even on the East Coast, shutting down the SLGS window at 6 p.m. simply does not work for many issuers. In several states, for example, many issuers do not meet until the evening and for one reason or another, may not wish to commit themselves to investments until they approve the bond issue. Unless they can subscribe early the next morning before new rates are set, or subscribe before midnight of the night of approval, the newly proposed limited timeframe could cause problems, especially if there could be added restrictions on cancellations.

An issuer may have procedural requirements for approving a bond issue, or at least the exact amount of a bond issue (final sale). If the latter is needed before subscribing for SLGS, then nothing can be filed until the bond issue and BPA are approved, which may be after the 6 pm cutoff time.

"Proceeds"

The 1996 regulations expanded the moneys that could be invested in SLGS to include both bond proceeds and certain other amounts to assist in compliance with the federal arbitrage regulations. The proposed regulations return to the more restrictive limit of "proceeds", presumably as that term is defined for federal arbitrage law purposes.

The change to a simplistic "proceeds" limitation fails to recognize the complexity of the underlying arbitrage regulations. Certain amounts can actually not be "gross proceeds" at the time of subscription, but may become characterized as "proceeds" at some later time. Examples are transferred proceeds from a taxable refunding, amounts which become replacement proceeds, or amounts which are temporarily deallocated by operation of the universal cap rule. In other cases, the State or local governmental issuer may be seeking to comply with federal tax rules by issuing taxable bonds in conjunction with tax-exempt bonds, either for advance refunding or construction projects. The language of the current regulation allows investment of both "gross proceeds" and amounts which "assist in complying with applicable provisions relating to the tax exemption." This allows the issuer to invest both tax-exempt and taxable bond proceeds in a refunding or project fund in the same investment vehicle.

NABL is unaware of any "abuses" under the current relatively broad definition of moneys that can be invested in SLGS securities; and we therefore recommend that the present language be retained.

An alternative approach that would somewhat alleviate the problem for State and local governments would be a change in the new definition from mere "proceeds" to "gross proceeds or amounts that may become gross proceeds of a bond issue". It is also important to use language like "*gross proceeds* of a bond issue" (as opposed to mere *"proceeds"*) to recognize that under the IRS regulations, some amounts may not be proceeds of the new refunding bond issue (the bond issue which presumably would be identified in the new subscription process), but instead are ***gross*** proceeds of the refunded bond issue.

Interplay with the safe-harbor bidding rules for open market securities

Treas. Reg. Section 1.148-5(d)(6)(iii)(C)(2)(ii) provides a safe harbor for the purchase of open market securities for a yield-restricted investment only if the lowest cost bona fide bid is not greater than the cost of the most efficient portfolio comprised exclusively of SLGS at the time bids are received. Because the proposed SLGS regulations effectively impose a one-time opt-in/opt-out regime with respect to SLGS investment, the interplay between the SLGS regulations and the safe harbor bidding rules could, under certain market conditions, produce the extremely unfair result that an issuer wishing to invest in open-markets will be forced to invest instead in SLGS with substantial negative arbitrage, with no prospect of ever recouping any of that negative arbitrage. Either the safe harbor bidding rules would have to be amended or the opt-in/opt-out nature of the proposed SLGS regulations would need to be modified (or jettisoned) to avoid this result.

Certification of Bond Authorization

Section 344.2(e)(2) of the proposed regulations states that "[u]pon starting a subscription, the subscriber must certify that the issuer has authorized the issuance of the state or local bonds."

Among the many governmental issuers, there is no consistent practice as to when the issuer formally "authorizes" the bonds. In some cases, a state may adopt a "blanket" authorization for a maximum amount of bonds to be issued over a future time period. Is that an "authorization" for any subsequent bonds whose proceeds are to be invested in SLGS? By contrast, in many other cases, formal authorization may not occur before SLGS subscriptions are filed. For many typical governmental advance refunding bonds, the bond sale is in the morning, the SLGS are subscribed for midday and verified by the accountants, and the board of the governing body (e.g., city council, county commissioners) meets that evening to approve the sale and authorize the issuance of the bonds. The governmental unit cannot authorize the bonds until the size is known; the size is based on the SLGS rates; if the BPD goes to same day pricing, the rates need to be locked in before the governing body meets. Under this common timetable, it is possible for the governmental body to decide not to authorize the bonds, but all market participants understand that such a failure is extremely rare, and the market accepts the risk. When open market escrow securities are purchased, the seller is willing to take the risk that the governmental body will fail to formally authorize the bonds, and is willing to sell the escrow securities subject to the subsequent actual issuance of the bonds[8]

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[8] In many advance refunding bond issues, this exact size of the issue cannot be determined until SLGS or other investments intended for the advance refunding issue are selected. In the case of SLGS, this means that a subscription for those SLGS must be filed no later than the date of the determination. The following is an example of a typical time line for the sale and authorization of a bond issue.

1. Underwriting firm pre-sells the to-be-issued tax exempt bonds.

2. Underwriters runs calculations determining the proposed issue's bond yield, the SLGS to be purchased, and anticipated savings from the issue.

3. Issuer staff, and possibly board members as well as the issuer's lawyers and financial advisors are shown the results of the underwriter's calculations.

Because of the wide variety of practices in the marketplace, the absence of any perceived "abuse" and the difficulty of applying the proposed "authorization" rule, NABL strongly urges the BPD to simply eliminate this requirement from the new rules. However, if BPD determines to include this provision in the final regulations, NABL recommends that the BPD clarify that the standard it intends to enforce with this requirement will be set at a **very low threshold**, such as legislative authorization or some form of official action (including under Treasury Regulations Section 1.150-2), and that BPD will defer to local practice rather than imposing an independent "authorization" requirement solely as a condition of participating in the SLGS program.

"Agency" Certification

NABL strongly endorses this requirement: no one should be permitted to access the SLGS program ostensibly on behalf of a state and local government without proper authorization from a duly constituted official of that issuer. We would further suggest that the sanction for violation of this requirement be harsh: perhaps banning the offender from any participation in the SLGS program for some extended period of time.

General Prohibition on Creating a "cost-free option"

Section 344.2(f)(1)(i) of the proposed regulations makes the flat statement that after the effective date of the new regulations, "...it is impermissible... (f) To use the SLGS program to create a cost-free option." Piled on top of the various investment yield restrictions and other limitations in the new rules, this is simply overkill, and should be deleted.

First, as spelled out in Part II, whatever "optionality" exists in the SLGS program is not "cost –free": issuers forego 5 basis points of yield on entering the program, and an additional 5

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4. An accounting firm verifies that the underwriter's calculations are mathematically accurate.

5. Issuer staff, attorneys, financial advisors, and possibly a board member agree with the underwriters on the terms of a bond purchase agreement. Attorneys draft a bond resolution or ordinance, an official statement, a bond purchase agreement, and other necessary documents.

All of the above are normally completed by 5:00 local time. Note, however, that the Bonds have not yet been authorized by the governing board.

6. At an evening meeting, the Board adopts the Bond Resolution or Ordinance authorizing the Bonds.

7. At any time after completion of Step 4 above, the Issuer or its agent files a SLGS subscription form. Most commonly this is begun during normal business hours because a commercial bank is the agent completing the subscription.

Under the proposed regulations, the SLGS subscription form could not be filed at night after the evening meeting, but could also not be filed prior to the authorizing meeting. The Issuer cannot simply wait until the following business day to file the subscription because the SLGS rate table might then be different requiring a new bond size.

basis points when they redeem early. While the BPD may question whether that cost is sufficient, it is a real cost.

Secondly, this position would put issuers at the mercy of subsequent, unanticipated interpretations of the regulations. Under the current regulations (which lack that bold prohibition), even Treasury officials have acknowledged that the forms of "cost- free options" to which they now object are nevertheless permitted under the law. It is crucially important for any issuer using the program to have that certainty.

Maximum Maturities

The maximum SLGS maturity is now 40 years. Rates payable on those longer maturities are generally extrapolated from rates established for earlier years' maturities. BPD notes that the 40-year maturity was added to the program in response to a specific request in 1996, but that there has been very little demand for SLGS beyond 30 years.

SLGS currently have maturities of up to 40 years. But the Treasury's own open market borrowing is now limited to 10 year maximum maturities. This means that the average life of outstanding open market Treasury debt is steadily declining, making it gradually more difficult to assign accurate market-based interest rates to longer term SLGS.

NABL notes, and the proposed regulations recognize, that there is a strong case for retaining maturities of as long as possible, principally to accommodate the defeasance to maturity of outstanding municipal bonds with as many as 25 or more years to maturity. We can offer numerous examples of defeasances to maturity to effect changes in outdated indentures, to accommodate the consolidation of two or more political entities, to achieve short-term debt service relief, to remediate a change in use, etc. For this reason, the *availability* of longer term SLGS is generally more important than the interest rate itself. Issuers would likely not object to a flat extension of rates. But if long term SLGS are not available for municipal reinvestment, issuers will be forced back in to the open market for these investments.

Limited Maturities

New Section 344.2(f) (1) (iv) of the proposed regulations for the first time prevents an issuer from purchasing a SLGS security with a maturity "longer than is reasonably necessary to accomplish a governmental purpose of the issuer." No explanation is provided on the rationale behind this rule. It will be difficult to administer, by both practitioners and SLGS personnel, and should simply be deleted.

From SLGS Security Subscription to SLGS Security Purchase

Cancellation of Subscription

Under current SLGS regulations, subscriptions for new SLGS are good for as long as 60 days, plus an additional 7 days on request. During this period, issuers are permitted to withdraw (or "put") their subscriptions, and simultaneously resubscribe for (or reinvest in) a similar portfolio at higher rates. When interest rates are rising in a negative arbitrage environment, this allows an issuer a free option on interest rates for that time.

The practice of withdrawals/resubscriptions was unusually widespread in the summer of 2003, when intermediate term interest rates increased by nearly 100 basis points over a short 6-week period, while overall rates were still negative in relation to municipal yields. BPD reports that it was simply swamped with continuous withdrawals/resubscriptions from all over the country. Not only was the Treasury providing municipalities a cost-free put option on interest rates; it was being overwhelmed in the process. (The few exceptions to the administrative problems were issuers whose representatives used the computerized SLGSafe system to affect both withdrawals and resubscriptions, since that system is fully automated).

In response to this phenomenon, the proposed regulations simply ban **all** cancellations of subscriptions – except in cases where the issuer can satisfy the BPD that the cancellation is not for purposes of securing a "cost-free option". This proposed rule, of course, effectively bars an initial subscriber from any opportunity to mitigate anticipated negative arbitrage. More than any other part of the new regimen, this is the provision that will drive state and local governments out of the SLG program back in to open markets.

NABL representatives have previously suggested, and the NABL Comments Committee reiterates, that instead of such a blanket ban on the cancellation of subscriptions, issuers should be allowed to cancel and resubscribe for 30 days (instead of the present 60 days). One immediate effect would be to double the "cost" of the resultant "cost- free option".

Change in Issue Date

Although current regulations allow an issuer to modify the purchase date for SLGS for up to 7 days, Section 344.5(a) of the proposed regulations deny **any** flexibility at all.

The change to a "cannot change the issue date" rule from the current permitted seven day rule creates a significant competitive disadvantage for the SLGS program. Dealers of market Treasury securities are generally willing to adjust closing dates by at least seven days, while maintaining the originally contracted yield. As indicated below with respect to cancellations, it is extremely rare for bonds that are sold to not close. Problems do sometimes arise, but they are usually resolved in a short period of time, and the current seven day extension is a practical approach to dealing with such problems.

While the ability to delay the closing date for up to 7 days is theoretically an "embedded option", it is to the best of our knowledge not used by anyone to obtain above market yields. It is used when unforeseen difficulties delay the availability of funds for investment. Elimination of this "option" is overkill. The current rule should be retained.

Modification of Principal Amount

Current law allows issuers the important flexibility of modifying the amount of their subscriptions by the greater of (i) $10 million, or (ii) 10 percent of the amount originally specified. This is particularly important in both advance refunding and multi-project financing, where last minute changes in interest rates or other previously unpredictable factors require either an increase or decrease in the size of the issue and the corresponding size of the SLGS investment.

The proposed regulations eliminate the $10 million alternative. Hereafter, no change of more than 10 percent is allowed.

No reason is offered for this proposal, but it plainly discriminates against smaller issuers (those issuing bonds of under $100 million). The City which initially planned to issue $40 million in bonds may modify the size of its investments by no more than $4 million, while its neighbor with a $125 million issue may modify its investments by a full $12,500,000. We recommend retaining the present rule. The cost to the U.S. Treasury would be minimal, but it would make the SLGS program easier to use by issuers who sometimes do not know the exact amount available for investment at the beginning of the subscription process.

If the Treasury nevertheless feels compelled to make a change in this area, we would suggest that the $10 million adjustment simply be reduced to a lower level of perhaps $7 million, or $5 million – rather than a total elimination of that flexibility.

Redemption of Previously Purchased SLGS Securities

General

Treasury officials, and the preamble to the proposed regulations, express concern over the recent phenomenon of issuers redeeming SLGS at lower yields (higher prices) based on the previous days' closing interest rates, then reinvesting the redemption proceeds at the next day's higher yields (lower prices) in either open market securities or a new portfolio of SLGS. Since the SLGS window is open until midnight of the publication date, issuers have a "free option" period during which to decide whether to subscribe or redeem. Treasury has an instinctive view that this "free option" is simply not "fair", that it causes volatility in overall Treasury debt management, and generates additional paperwork for BPD.

On the other hand, Treasury recognizes that "escrow substitution" is a recent phenomenon principally attributable to the negative arbitrage in advance refunding escrows Treasury also acknowledges that the practice is not prohibited under present SLGS regulations, but questions whether it is consistent with the spirit of those rules.

As noted above, the SLGS program was originally designed as an accommodation to state and local governments to comply with federal arbitrage rules restricting the yield on the reinvestment of tax-exempt bond issues. Since the SLGS program gives all positive arbitrage to the Treasury, Treasury should not object if some issuers are able to recover some of their negative arbitrage within the four corners of the regulations themselves.[9] As amended in 1996 and 2000, the program works very well. Since the negative arbitrage of the past several years is presumably a temporary occurrence, the Treasury should avoid making radical changes in the program.

[9] Until fairly recently, yields available on open market Treasury investments were higher than the yields on the corresponding tax-exempt bonds whose proceeds needed to be invested. Whenever an issue elects to invest those moneys in SLGS, ***it is lending money to the U.S. government at tax-exempt rates*** – rates normally well below the rates which the Treasury would pay on the open market. This is why the BPD has worked hard over the past 10 years to make the SLGS program more accessible and attractive to municipal issuers. Combined with the concerns generated by the IRS' audits of "yield burning", the Treasury has attracted tens of billions of dollars of municipal bond proceeds into the SLGS program at below market, tax-exempt cost.

Nonetheless, the proposed regulations prohibit the reinvestment of redemption proceeds at a yield higher than the redemption yield, extend that prohibition to reinvestments in both SLGS and open market securities, and require the issuer redeeming an investment to certify that it is not doing so for those prohibited reinvestment purposes.

Settlements of Redemptions

The minimum settlement time between notice of redemption and settlement is currently 10 days. When volume is high, the sheer amount of paperwork involved can create administrative difficulties for the BPD. Largely for administrative purposes, the Treasury has proposed extending that settlement period to 14 days. NABL has no objection to that change, even though mandatory use of SLGSafe will likely make that change unnecessary.

Cancellation of Redemption Notice.

Although not specifically discussed in the proposed regulations, a related problem is the ability of a municipal issuer to cancel its notice of redemption at some point prior to the date scheduled for that redemption. Until recently, the BPD has often allowed such cancellations on an informal, case-by-case basis, providing nonbinding letters to municipal issuers giving some assurance of their subsequent ability to cancel a redemption notice. We understand that that informal practice has recently been suspended.

Just as issuers have been allowed – and in our view should continue to be allowed - to automatically withdraw a SLGS subscription prior to settlement, there is no policy or administrative reason why an issuer should not be allowed to automatically cancel a redemption notice, so long as it provides adequate advance notice to the BPD. Under this regime, the BPD is exactly where it was before the notice of redemption, the municipal issuer is protected against unforeseen circumstances offsetting the anticipated need for the redemption, and the current informal practice of allowing case-by-case redemption cancellations would apply to everyone. Finally, an automatic cancellation rule would reduce the paperwork currently associated with reviewing individual requests and providing nonbinding letters on the subject to some issuers.

If option hedging is nevertheless not permitted, redemptions and reinvestments will be extremely rare, just like cancellations. In that case, we suggest that the BPD could more simply achieve its desired result with respect to redemptions and reinvestments by applying the same process it proposes for cancellations. Such a rule would provide that (i) cancellation would not be permitted unless the subscriber establishes to the satisfaction of Treasury that it is required for reasons unrelated to use of the SLGS program as a cost-free option, (ii) redemption would not be permitted unless the subscriber establishes to the satisfaction of Treasury that it is required for reasons unrelated to use of the SLGS program as a cost-free option, (iii) a subscriber must certify that it is not purchasing SLGS with the proceeds of the sale or redemption of marketable securities unless the subscriber establishes to the satisfaction of Treasury that the purchase is being made for reasons unrelated to use of the SLGS program as a cost-free option, and (iv) none of these limitations would apply for the cancellation, purchase or redemption of zero interest rate SLGS (on the premise that zero rate SLGS are never used as a cost-free option).

Some of the concerns raised with the Treasury proposal relate to situations where a reserve fund is invested in SLGS and it needs to be redeemed for non-hedge purposes. The approach described above would allow a reserve to be liquidated if it is necessary.

Zero Coupon SLGS

If the final regulations continue to have a yield-based rule for reinvestment of redemption proceeds, they need to address redemption of zero rate SLGS. In the formula for computing redemption proceeds under prior regulations, as well as the proposed regulations, the redemption amount is generally determined by pricing the original SLGS (bearing its originally requested interest rate) at current market yields (this pricing is referred to as the "market charge"). Current regulations provide an exception that for redemption of zero interest SLGS, the redemption amount is always par. This is a very useful rule. An issuer minimizes the redemption penalty, and thus preserves some rights to fix inadvertent mistakes, if it blends down to the bond yield using to a mix of zeros and maximum rate SLGS, rather than reducing all the SLGS rates to bond yield.

It is not at all clear under the proposed regulations whether redemption proceeds of zero rate SLGS (which are effectively redeemed at a yield of zero) could be reinvested at a yield above zero under the proposed rule. We believe that this is just a drafting problem, and that a sentence therefore needs to be added to Section 344.2(e)(3)(ii) stating that no yield certification is required for the redemption of zero rate SLGS that are not subject to a market charge under 344.6(d)(2). It is simply impossible for zero rate SLGS to constitute an abusive cost-free option.

Miscellaneous Topics

SLGSAFE PROGRAM

SLGSafe is an Internet interface to the BPD's SLGS window, introduced in 2000 on a trial basis. Any entity with access to the Internet can access SLGSafe through a short set up period with BPD. With SLGSafe, an issuer or any authorized representative can file subscriptions and withdrawals over the Internet, and eliminate most of the paperwork otherwise associated with the program. In addition, issuers themselves, and certain trustees, are also permitted to file redemption notices over the Internet via SLGSafe. [10]. SLGSafe eliminates all paperwork (including unwieldy late night faxes) associated with subscriptions, resubscriptions, and redemptions, and provides both better and faster record keeping for all financing participants. Active participants in the SLGSafe program swear by the system.

The proposed regulations require that after the effective date of the new regulations, any entity (issuer, trustee, bond counsel, financial adviser, nvestment banker, or other financing participant) which accesses the SLG system in a year would be *required* to use SLGSafe for all SLGS transactions: subscriptions, withdrawals, redemption notices, etc. At the same time, individual issuers and/or their one-time representative could request a waiver from the SLGSafe mandate for cause. We would hope that those waivers would be initially granted fairly liberally.

NABL endorses this change. While this mandate would exempt the occasional user (such as a local government which files its own subscriptions), it would greatly streamline the SLGS operations, and virtually eliminate the administrative burdens underlying several of the concerns discussed above. NABL recognizes that industry technology has advanced to the point that participation in SLGSafe would not impair local governments' access to the program: it would

simply force those who have not yet signed on to the system to invest the modest time and effort required to do so.

Simplification of Yield Computation Conventions

Section 344.2(3) of the proposed regulations would impose yield comparisons that would be **in addition to** those already imposed by the Internal Revenue Code. The definition of yield included in Proposed Treas. Reg. Section 344.1 is based upon the yield definition contained in the arbitrage regulations, Treas. Reg. Section 1.148-1. However, the definition of yield in the proposed regulations requires the use of certain day counting and compounding conventions that are not included in the income tax regulations.

The definition of yield used in the arbitrage regulations is intended to allow a proper comparison of the effective rates of return of any investments or obligations regardless of the way interest is computed on such obligation or the frequency of payments. The income tax regulation do not specify a particular set of compounding or day counting conventions, but do require consistency for all computations for a particular bond issue. It is a fundamental attribute of the arbitrage yield comparison rules that semiannual pay, monthly pay, or even irregular pay investment on obligations can all be compared using a single set of conventions. Most often such comparisons are actually made using semi-annual compounding and a 360 day year convention.

Conversely, the proposed SLGS regulations not only permit, but actually force, the use of inconsistent conventions for comparison of yields on investments. Consider the case of the early liquidation of a SLGS certificate of indebtedness that is to be reinvested in a SLGS note. The proposed rules would require the comparison of a simple annual yield (does this mean annual compounding?) to a semi-annual compounded yield. In fact, the present rule is not even internally consistent. Interest on SLGS notes (like interest on marketable Treasury notes and bonds) is computed using actual day counting divided by 181, 182, 183 or 184 days depending on the number of days in the complete half year ending on the first investment payment date. This day count convention would be required to be used to compare the yield on or SLGS note to an open market investment. However, a separate portion of the definition requires "bond equivalent yield." Bond equivalent yield is, by standard convention, computed by treating all semiannual periods as being 180 days.

There is no need to specify the day counting or compounding conventions. Yield comparisons are appropriate so long as the same conventions are used throughout the comparison. The arbitrage regulations under Code Section 148 recognize this. We believe that the definition of yield in Section 344.1 of the proposed regulations should be replaced by the simple statement:

> "Yield of a debt instrument has the same meaning as it has for purposes of Section 148 of the Internal Revenue Code of 1986."

Effective Dates

SLGS already purchased before the effective date of the proposed new regulations represent a contract between the local issuer and the BPD, including current provisions governing the determination of daily interest rates, which determine the redemption price of those securities.

Consequently, the proposed regulations quite properly affect only *new SLG subscriptions* on or after the effective date of the final regulations under Section 344. This approach is consistent with both past practice and with the Contract Clause of the United States Constitution.

Because of the extent and complexity of the proposed new rules, NABL would recommend a deferred effective date, perhaps 30 to 60 days beyond the publication of the final rules in the Federal Register (and perhaps on the following January 1 or later with respect to the portion of the final regulations that mandates the use of SLGSafe) to enable issuers and other users to ensure that they have procedures in place to facilitate full compliance with the final regulations.

Request for Public Hearing

We formally request that a public hearing be held before final publication of any regulations affecting the SLGS program. We believe the issues are sufficiently important to solicit additional comments form not only industry associations (such as NABL) but from directly affected state and local government officials as well.

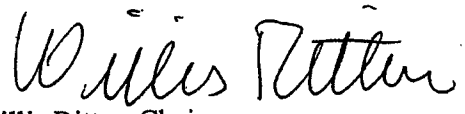
CONCLUDING OBSERVATIONS

NABL appreciates the administrative and cash flow management issues which have stimulated some of the changes suggested in the proposed regulations. We believe that most of those issues are adequately addressed by making SLGSafe mandatory, by eliminating the overnight "lag" in the setting of SLGS rates, and by requiring appropriate authorization from the putative subscriber for SLGS. Beyond that, however, we think the proposed rules go way too far in eliminating much of the flexibility deliberately added to the program in 1996.

The flexibility afforded by current SLGS regulations is fully consistent with a program in which the BPD itself benefits directly from retaining all of the positive arbitrage. Moreover, negative arbitrage is clearly an historic aberration, which does not justify imperiling the entire program. A principal long-term goal of both the IRS (in enforcing the federal arbitrage rules) and of the BPD (in managing the cost of the national debt) has been to attract tax-exempt bond proceeds to SLGS, instead of to the open market. To the extent that any of these proposed changes makes the SLGS program less attractive, we are convinced from discussion with our issuer clients that they will rapidly return to open market investments. Treasury representatives should therefore proceed very cautiously in modifying a program that now works so well for both the Treasury and the municipal finance community.

NABL especially applauds the BPD's proposal to make the SLGSafe program mandatory. SLGSafe is not only far more efficient, but it also provides more accurate reports for participants in a municipal financing transaction. Industry-wide adoption of SLGSafe for all SLGS transactions will virtually eliminate the administrative and budgetary concerns that underlie many of the BPD concerns.

Respectfully Submitted,



Willis Ritter, Chair
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