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Securities Law

Republicans Warn Federal Agencies Against Finalizing Rules

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WASHINGTON – Republican leaders are warning the heads of federal agencies, departments, and commissions against finalizing pending rules during the last days of the Obama administration.

The warnings, made in letters to agency heads, could affect muni rules pending in the Treasury Department and the Internal Revenue Service as well as the Securities and Exchange Commission.

"Should you ignore this counsel, please be aware that we will work with our colleagues to ensure that Congress scrutinizes your actions – and, if appropriate, overturns them – pursuant to the Congressional Revenue Act," House Majority Leader Kevin McCarthy, R-Calif., and the committee chairs told the agency heads.

Neither Treasury nor the IRS or SEC had any immediate comment.

The Republicans said that by refraining from final action, the agencies will give the new administration a chance to review the rules.

"By refraining from acting with undue haste, you will ensure that agency staff may fully assess the costs and benefits of rules, making it less likely that unintended consequences will harm consumers and businesses," the Republican lawmakers wrote.

"Moreover, such forbearance is necessary to afford the recently elected administration and Congress the opportunity to review and give direction concerning pending rulemakings."

Treasury and IRS officials have said they would like to finalize issue price rules before the end of the year.

Issue price is important because it is used to help determine the yield on bonds and whether an issuer is complying with arbitrage rebate or yield restriction requirements, as well as whether federal subsidy payments for direct-pay bonds such as Build America Bonds are appropriate.

Under existing rules, the issue price of each maturity of bonds that are publicly offered is generally the first price at which a substantial amount, defined as 10%, are reasonably expected to be sold to the public.

But tax regulators became concerned that some dealers were "flipping" bonds -- selling them to another dealer or institutional investor who then sold them again almost simultaneously, with the prices continually rising before the bonds were eventually sold to retail investors. They felt the stated "reasonably expected" issue prices for bonds were not representative of the prices at which the bonds were actually sold.

Treasury and the IRS tried to tighten the rules in 2013 by proposing new ones that replaced the "reasonable expectations" standard with actual sales and increased the definition of "substantial amount" to 25% instead of 10%. Those rules drew loud complaints from most market groups so Treasury and IRS scrapped them.

The tax regulators then repropose the rules in June 2015. Under those rules, the issue price for each maturity of bonds sold on a negotiated or competitive basis would generally be the first price at which 10% of the bonds are actually sold to the public.

If 10% of a maturity hasn't been sold by the sale date, issuers could employ an "alternative method" for determining issue price. Under that method, the issue price would be the initial offering price of the bonds sold to the public, as long as the lead or sole underwriter certified to the issuer that no underwriter filled an order from the public after the sale date and before the issue date at a higher price than the initial offering price. An exception could be made if the market moved after the sale date, but the underwriter must document any market movements justifying a higher price.

Those rules were also criticized, but market participants focused on pushing for an exemption or special rules for bonds sold on a competitive basis.

Treasury officials have said they will probably provide special rules for competitive transactions before finalizing the issue price rules.

Meanwhile, the Municipal Securities Rulemaking Board is waiting for the SEC to finalize rules on markup disclosure for retail investors. Those rules have been criticized by dealers who worry they will not be able to comply with them through automated systems.

The proposed rules would require a dealer, which buys or sells munis for or from its own account to a retail customer and engages in one or more offsetting transactions on the same trading day in the same security, to disclose its markups and markdowns in the confirmation it sends the customer.

The proposal establishes a waterfall of factors for determining prevailing market price (PMP), which dealers would then use to calculate their compensation. Dealers would initially look at their contemporaneous trades of the same muni with other dealers or customers to establish a presumption of the PMP. They would then make a series of other successive considerations if that data is not available. They can look at contemporaneous trades of the muni in interdealer trades, then trades of the muni between other dealers and institutional investors, then trades on alternative trading systems or other electronic platforms.

Further down the waterfall, firms could look at contemporaneous trades of similar securities. The MSRB included a list of "non-exclusive factors" like credit quality, size of the issue, and comparable yield that could be used to determine if securities are similar. The bottom of the waterfall allows dealers to use prices or yields derived from economic models.

