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PROPOSED REGULATIONS MODIFY ARBITRAGE REGULATIONS

HIGHLIGHTS

The IRS has proposed new regulations governing integration of LIBOR-based swaps, permitting yield reduction payments on certain advance refunding escrows, and permitting electronic bidding of guaranteed investment contracts. The IRS published the proposed regulations on September 26, 2007 (the "Proposed Regulations"), amending the existing arbitrage regulations (the "Existing Regulations"). The Proposed Regulations are not required to be applied currently, but issuers and borrowers may apply some or all of the provisions as of the early application dates described herein. Highlights of those proposed changes are noted below. For a more detailed description and the early application dates, please refer to the corresponding section in the following detailed explanation.

Simple Integration of LIBOR-Based Swaps. Integration permits the borrower to take swap payments into account when calculating yield on an issue of tax-exempt bonds. The swap integration rules will be clarified to provide that a LIBOR-based swap may be integrated with a variable-rate bond only if the Snapshot Rule and the Lookback Rule are satisfied. The Snapshot Rule requires that the difference between the variable rate on the bonds and the floating rate on the swap (the "Rate Difference") not exceed 25 basis points on the date the borrower enters into the swap. The Lookback Rule requires that the average Rate Difference not exceed 25 basis points for the three-year period ending on the date the borrower enters into the swap.

15-Day Rule for Swap Identification. A state or local governmental issuer will be permitted to identify an integrated swap on its books and records up to 15 calendar days after entering into the swap rather than the three days required under the Existing Regulations.

60-Day Rule for Payments. For simple integration, interest payments on the hedged bonds and payments on the swap will be required to be made within 60 calendar days of each other. For "super integration," payments on the hedged bonds and payments on the swap must be made within 15 days of each other.

Super Integration of LIBOR-Based Swaps. Under the Proposed Regulations, a LIBOR-based swap generally cannot be "super-integrated" with tax-exempt bonds. Despite that rule, the IRS is seeking comments on whether a LIBOR-based swap qualifies for super integration where the variable-rate bonds bear interest equal to a percentage of LIBOR.

Yield Reduction Payments on Certain Advance Refunding Escrows. The Proposed Regulations help facilitate advance refundings that utilize swaps to create synthetic fixed-rate bonds. If certain conditions are satisfied, an issuer will be able to make yield reduction payments on a variable-yield advance refunding issue with a simple-integrated variable-to-fixed interest rate swap. Those yield reduction payments can be used to eliminate the Rate Difference between the floating rate received by the borrower under the swap and the variable interest rate paid by the borrower on the hedged bonds.

Modified Bidding Safe Harbor for Guaranteed Investment Contracts. The bidding safe harbor for guaranteed investment contracts is modified to accommodate electronic bidding procedures by permitting bid specifications to be sent electronically to potential bidders and by permitting continuous bidding and a last look if all bidders have an equal opportunity for a last look.

Modified Yield Computation of Fixed-Rate Yield-to-Call Premium Bonds. The yield on fixed-rate yield-to-call premium bonds will be computed by applying the yield-to-call rule on a bond-by-bond basis (rather than the Existing Regulations' rule requiring the lowest yield on the entire issue).

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DETAILED EXPLANATION OF PROPOSED REGULATIONS

On September 26, 2007, the IRS published proposed regulations (the "Proposed Regulations") applicable to tax-exempt bonds that amend the existing arbitrage regulations (the "Existing Regulations") including modifications to the rules governing integration of swaps ("hedges"), rules permitting yield reduction payments on certain advance refunding escrows, and rules permitting electronic bidding of guaranteed investment contracts.

The Proposed Regulations apply to bonds sold 90 days (or more) after publication of final regulations in the Federal Register (the "General Effective Date"), but an issuer may apply certain specified provisions of the Proposed Regulations to bonds sold before the General Effective Date. Except for the changes to the hedging rules that must be applied in their entirety, generally issuers and borrowers may (but are not required to) apply some or all of the Proposed Regulations on and after September 26, 2007 ("Permissive Early Application").

Section 103(a) of the Code generally excludes from gross income interest on a state or local bond, other than an arbitrage bond. Code Section 148 provides two related, but independent, types of restrictions to determine whether a bond is an arbitrage bond: a yield restriction requirement, limiting an issuer's ability to invest bond proceeds at a yield materially exceeding the yield on the bond issue ("Bond Yield") and an arbitrage rebate requirement ("Rebate"), requiring that certain excess earnings above the Bond Yield be rebated to the federal government. Generally, Rebate is paid every five years and at maturity (or earlier redemption) of the bond issue.

Changes Related to Simple Integration of LIBOR-Based Swaps. The Existing Regulations permit issuers to compute Bond Yield by taking into account payments made and received under certain interest rate hedges, including swaps. The Existing Regulations provide two ways in which a hedge can be taken into account in computing Bond Yield, commonly known as "simple integration" and "super integration." In simple integration, although the Bond Yield approximates a fixed rate, the hedged bond is not treated as a fixed-yield bond for arbitrage purposes because the "basis risk" is included in the calculation of Bond Yield. "Basis risk" is simply the risk that there will be a Rate Difference between the actual interest rate paid by the borrower on the variable-yield hedged bonds and the actual floating rate received by the borrower from the hedge provider under the swap. If the swap satisfies the more stringent rules for super integration, the basis risk is disregarded and the hedged bond is treated as a fixed-yield bond for arbitrage purposes.

To qualify for either simple integration or super integration, a hedge (including an interest rate swap, an interest rate cap, a futures contract, a forward contract, or an option) must satisfy a series of eligibility requirements, including that: (1) the hedge must be interest-based, (2) the terms of the hedge must correspond closely with the terms of the hedged bonds, (3) the actual issuer must timely identify the hedge on its books and records, and (4) the hedge must contain no significant investment element.

Simple Integration: General Rule. In simple integration, generally all payments and receipts on the hedge and all payments on the hedged bonds are taken into account in determining the Bond Yield. For example, if a borrower enters into a hedge in which it pays a fixed rate to the hedge provider and receives floating-rate payments from the hedge provider (a "variable-to-fixed hedge") with respect to the borrower's variable-rate bonds, all such payments and receipts are taken into account in determining the Bond Yield. Although the Bond Yield may approximate a fixed rate, the hedged bonds are treated as variable-yield bonds for arbitrage purposes, and Bond Yield is computed separately for each computation period (no less frequently than every five years). As a result, yield restriction payments on investments and Rebate are based on the actual Bond Yield for that computation period. For arbitrage purposes, the hedged bonds are treated as variable-rate bonds because any "basis risk" is taken into account in determining the Bond Yield. Despite the basis risk, because the Bond Yield on a variable-rate bond integrated with a variable-to-fixed swap approximates a fixed rate, such hedged bonds are often referred to as "synthetic fixed rate."

Simple Integration: LIBOR-Based Hedges. For simple integration, the requirement that a hedge be interest-based is satisfied if the variable interest rate on the hedged bonds and the floating rate on the hedge are "substantially the same." Under the Proposed Regulations, a hedge rate based on a percentage of a taxable market index such as

LIBOR is treated as "substantially the same" as the variable tax-exempt rate on the hedged bonds if two rules are satisfied—the Snapshot Rule and the Lookback Rule. The Snapshot Rule requires that the actual difference between the variable rate on the bonds and the floating rate on the LIBOR-based swap (the "Rate Difference") be no greater than one-quarter of 1 percent (0.25 percent, or 25 basis points) on the date the borrower enters into the hedge. The Lookback Rule requires that the average Rate Difference not exceed 25 basis points for the three-year period ending on the date the borrower enters into the hedge. In determining whether the LIBOR-based swap satisfies the Lookback Rule, the borrower is required to compare the actual rate on "comparable variable-rate bonds" with an interest rate determined in the same manner as the floating rate on the LIBOR-based swap for the same three-year period. If a borrower did not have comparable variable-rate bonds outstanding during the three-year lookback period, it can use a reasonable proxy bond rate, such as the SIFMA Municipal Swap Index (formerly the BMA Swap Index).

The Proposed Regulations provide the following example: If the floating rate on the hedge is 67 percent of LIBOR, then 67 percent of LIBOR, determined on the same days that the borrower's actual interest rates are determined (or the proxy rates, if applicable), is compared to the borrower's actual interest rates (or the proxy index, if applicable) for the three-year period ending on the date into which the hedge is entered, and the differences are averaged to determine whether the average difference exceeds one-quarter of 1 percent. ***Early Application Date for Hedging Rules.*** Proposed rules relating to integrated swaps may be applied *in whole, but not in part*, for swaps and other hedges entered into on or after September 26, 2007. Those proposed rules are described here and below.

Miscellaneous Rules Regarding Swap Integration.

- The Proposed Regulations extend the date by which an issuer must identify a hedge on its books and records from three days to "15 calendar days," but the identification must still be made by the actual state or local governmental issuer, not the conduit borrower.

- The Proposed Regulations provide that for simple integration, payments on the hedged bonds and payments on the hedge must be made within 60 calendar days of each other. For super integration, payments on the hedged bonds and payments on the hedge must be made within 15 days of each other.

- The Proposed Regulations clarify that "cost of funds" hedges can be integrated for purposes of determining Bond Yield.

- The Proposed Regulations expressly limit the size and scope of a qualified hedge to the amount reasonably necessary to hedge the issuer's interest rate risk on the hedged bonds. If the hedge is based on the issuer's principal amount of bonds and reasonably expected interest requirements rather than on a greater notional amount or an interest rate level greater than the expected interest requirements, it satisfies the size and scope limit of the Proposed Regulations.

- The Proposed Regulations clarify that the termination payment for an actual or deemed termination of an integrated hedge is the fair market value of that hedge on the termination date.

- The Proposed Regulations do not address "offsetting hedges," other than to solicit comments on clarifying the circumstances in which an offsetting hedge is deemed to terminate an existing hedge.

Changes Related to Super Integration of LIBOR-Based Hedges. In the case of super integration where the payments on the hedge and on the hedged bonds sufficiently correspond so that the yield on the hedged bonds is fixed and determinable, taking into account certain assumptions, the hedged bonds are treated as fixed-yield bonds for arbitrage purposes. In super integration, any Rate Difference between the floating-rate payments on the hedge and the variable-rate interest payments on the hedged bonds is ignored in determining Bond Yield through an assumption that treats those floating and variable rates as the same.

The Proposed Regulations do not permit super integration of LIBOR-based swaps because the IRS feels that there is insufficient correlation between a LIBOR-based swap and the variable rate on a tax-exempt bond. Despite that rule, the IRS is seeking comments on whether a LIBOR-based swap qualifies for super integration where the variable-rate bonds bear interest equal to a percentage of LIBOR.

Yield Reduction Payments on Certain Advance Refunding Escrows. The Proposed Regulations will make it easier for borrowers to monitor synthetic fixed-rate advance refundings. Under the Existing Regulations, an issuer could not reduce the yield on an investment in an advance refunding escrow by making yield reduction payments. Instead, for synthetic fixed-rate advance refunding bonds, issuers and borrowers have been required to monitor the Bond Yield and, when necessary due to a Rate Difference, to reduce the escrow yield by depositing additional money to a sinking fund solely to reduce the yield on the escrow investments, by restructuring the escrow, or by using other cumbersome means.

The Proposed Regulations permit an issuer to make yield reduction payments ("YRPs") on a variable-yield advance refunding issue that has a simple-integrated variable-to-fixed interest rate swap. Basically, the Proposed Regulations allow an issuer to pay YRPs to eliminate the Rate Differences between the hedge and the hedged bonds. This modification permits issuers to pay YRPs to reduce the yield on proceeds (including sale proceeds, investment proceeds, and transferred proceeds) of an advance refunding issue deposited into an advance refunding escrow if: (1) the borrower has entered into a qualified variable-to-fixed hedge on *all* of its variable-rate bonds that are allocable to the advance refunding escrow, (2) the hedge covers the entire escrow period (from the issue date of the bonds until the final payment is made from the advance refunding escrow), and (3) the yield on the advance refunding escrow is not reasonably expected to exceed the Bond Yield (determined by taking into account the fixed payments that the borrower is expected to make under the hedge and by assuming that the corresponding variable-interest payments to be made by the issuer on the hedged bonds and to be received by the issuer on the hedge are equal and paid on the same date). This new YRP rule applies separately for each Bond Yield computation period. Where the escrow period exceeds five years, there may be two or more applicable Bond Yields. Issuers are not permitted to pay YRPs to reduce yield on an advance refunding escrow unless the change in reasonably expected Bond Yield is a result of the Rate Difference between the bond rate index and the hedge index. ***Early Application Date for YRP Rules.*** Proposed rules governing YRPs may be applied to investments purchased on or after September 26, 2007.

Modified Bidding Safe Harbor for Guaranteed Investment Contracts. In the past few years, various electronic bidding procedures and internet platforms for bidding guaranteed investment contracts ("GICs") have been used in the tax-exempt market. The electronic bidding process permits potential GIC providers to bid continuously and to view the current high bid (on a "no names" basis). The IRS believes those procedures offer constructive potential for increasing transparency in the pricing process.

Existing Regulations provide a safe harbor for bidding GICs that generally relies on a prescribed bidding procedure, the receipt of at least three bids from independent parties, the requirement that all bidders be given an equal opportunity to bid with no opportunity to review other bids (that is, "no last look"), and the requirement that the bid specifications be provided to prospective bidders "in writing."

The Proposed Regulations amend the bidding safe harbor for GICs to accommodate electronic bidding procedures by (1) permitting bid specifications to be sent electronically over the internet, by fax, or by other similar electronic media that is regularly used to post bid specifications to potential bidders, and (2) amending the "no last look" rule to provide that a last look is not prohibited if all bidders have an equal opportunity for a last look—in other words, "no exclusive last look." ***Early Application Date.*** Proposed rules modifying the GIC bidding rules may be applied to GICs entered into on or after September 26, 2007.

Modified Yield Computation of Fixed-Rate Yield-to-Call Premium Bonds. Where callable fixed-rate bonds are sold with a substantial premium above par, the Existing Regulations require that Bond Yield be computed as if the bonds were redeemed on the early call date that results in the lowest Bond Yield—an adjustment that lowers the Bond Yield. The Proposed Regulations simplify the yield calculations for those fixed-rate yield-to-call premium bonds by applying the yield-to-call rule on a bond-by-bond basis. The new rule requires that Bond Yield be computed on the basis of the redemption date that results in the lowest yield on the particular premium bond (rather than the Existing Regulations' rule requiring the lowest yield on the entire issue). ***Early Application Date.*** Issuers may apply the proposed computation rule to bonds sold on or after September 26, 2007.

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