REPORT #632

TAX SECTION

New York State Bar Association

Report on Proposed Regulations
Concerning the Issuance of Bearer
Form Debt Obligations

October 5, 1989

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Tax Report # 632

TAX SECTION

New York State Bar Association

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October 5, 1989

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Goldberg:

Enclosed is a Report on Proposed Regulations Concerning the Issuance of Bearer Form Debt Obligations. The principal draftsmen of the Report are S. Douglas Borisky and Esta Eiger Stecher.

The Report comments on the provisions of the Proposed Regulations, responds to the request in the Preamble to the Proposed Regulations for comments relating to the feasibility of allowing the issuance in the United States of registered form obligations that may be converted into bearer form obligations, and discusses certain related issues.

With respect to the provisions of the Proposed Regulations, the Report recommends that sanctions not be imposed on issuers of bearer form obligations for a violation unless the issuer knows, or has reason to know, of the violation before it becomes bound by the subscription or underwriting agreement. The Report also recommends that the "directed selling efforts" restriction be deleted as unnecessary in light of the other restrictions; alternatively, it recommends that in applying the "directed selling efforts", registered and bearer forms be treated as separate "obligations" so that selling efforts for one will not taint the other. In addition, the Report suggests that, to the extent that securities law terms have been incorporated in the Proposed Regulations, the Internal Revenue

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Service should rely on the securities law definitions and interpretations of those terms; should this not be done, t Report urges that the Proposed Regulations be revised to provide clear and complete definitions of those terms for two purposes. Finally, the Report makes a number of comments on the substantive requirements of the Proposed Regulations and suggests means by which certain problems can be remedied.

With respect to the issuance of registered obligations convertible into bearer or targeted registered form, the Report recommends that the Internal Revenue Service permit offers and sales in the United States and to U.S. persons of such obligations and proposes a set of procedures designed to ensure that bearer and targeted registered form obligations resulting from conversions will not be sold to U.S. persons.

Sincerely,

WLB/JAPP
Enclosure

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Tax Report #632

October 5, 1989

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Proposed Regulations Concerning the Issuance of Bearer Form Debt Obligations

This Report, prepared by an *ad hoc* subcommittee of members of the Tax Section,* (1) comments on the proposed regulations on bearer form obligations issued by the Internal Revenue Service (the "IRS") under Section 163(f)(2)(B) of the Internal Revenue Code of 1986, as amended (the "Code"), and published in the Federal Register on August 24, 1989,** and certain proposed amendments to the temporary regulations relating to the repeal of the 30 percent withholding tax on "portfolio interest" (the "Proposed Regulations"), (2) responds to the request in the Preamble to the Proposed Regulations for comments on the feasibility of allowing concurrent offerings of foreign-targeted bearer form obligations to foreign persons and convertible registered form obligations to U.S. persons, and (3) discusses certain related issues that should be addressed in final regulations.

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* The subcommittee is composed of S. Douglas Borisky and Esta Eiger Stecher, who are the principal draftsmen of this Report, Cynthia G. Beerbower, Patricia A. Brown, Herbert L. Camp, John A. Corry, Anne A. Crovitz, H. Douglas Garfield, Stephen L. Gordon, Harold R. Handler, L. Anthony Joseph, Jr., Kenneth S. Kail, Elizabeth Kessenides, Robert J. McDermott, Kevin Rowe, R.J. Ruble, Leslie B. Samuels, John M. Sykes, Suzanne L. Sykora and Willard B. Taylor. Helpful comments were received from Alan L. Beller, Joseph Chubb, Paul B. Ford, Jr., Francis J. Morison, Leslie N. Silverman and William J. Williams, Jr.

** 54 Fed. Reg. 35200 (August 24, 1989).

Background

Under Sections 163(f) and 4701 of the Code (enacted by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA")), a bearer form obligation must be issued in compliance with the requirements of Section 163(f)(2)(B) of the Code in order to avoid the disallowance of the issuer's interest deduction and the imposition of an excise tax on the issuer (the "issuer sanctions").[*] In addition, interest paid on a bearer form obligation not issued in compliance with these requirements will not qualify for the exemption from the 30 percent U.S. withholding tax for "portfolio interest".

Section 163(f)(2)(B) of the Code provides that the issuer of a bearer form obligation will not be subject to issuer sanctions if (i) the obligation is issued under "arrangements reasonably designed" to ensure that it is sold or resold in connection with its original issuance only to non-U.S. persons and (ii) certain other conditions are met.[**]

Regulation § 1.163-5(c)(2)(i) currently specifies two types of offering and placement procedures that satisfy the "arrangements reasonably designed" requirement of

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[*] The issuer sanctions do not apply to obligations (i) issued by a natural person, (ii) not of a type offered to the public or (iii) with a maturity (at issue) of one year or less.

[**] Interest on the obligation must be payable only outside the United States and a legend must appear on the obligation and (under the Regulations) any coupon stating that any U.S. person holding the obligation will be subject to limitations under the U.S. tax laws.

Section 163(f)(2)(B).[*] Regulation § 1.163-5(c)(2)(i)(A) (the so-called "A Rules") applies to obligations that are not required to be registered with the Securities and Exchange Commission (the "SEC") because they are intended for distribution to non-U.S. persons. For these obligations, which constitute the bulk of bearer form obligations offered by U.S. issuers in foreign capital markets, an issuer may rely on a written opinion of counsel to the effect that the obligations need not be registered under the Securities Act of 1933 (the "1933 Act") in demonstrating that it has satisfied the "arrangements reasonably designed" requirement. The A Rules in effect incorporate the 1933 Act rules, including the definition of "U.S. person", into the "arrangements reasonably designed" standard.

Regulation § 1.163-5(c)(2)(i)(B) (the so-called "B Rules") provides procedures for bearer form obligations that are registered under the 1933 Act or that qualify for an exemption from registration other than because they are foreign targeted. The B Rules enumerate specific offering and placement restrictions that generally are intended to reflect the procedures that would be necessary to obtain the securities law opinion required by the A Rules. The B Rules are commonly used for bearer form medium-term note programs of U.S. issuers, which are generally registered under the 1933 Act, and by issuers, such as certain financial institutions, whose debt obligations are exempt from registration under the 1933 Act. They are also relevant to the determination of whether registered form obligations of the U.S. Government and certain U.S. Government-related issuers are "targeted registered obligations".

[*] A third category, under Regulation § 1.163-5(c)(2)(i)(C) (the so-called "C Rules"), generally applies only to foreign issuers and certain foreign branches of U.S. banks that do not engage in interstate commerce in connection with the issuance of the obligations.

On July 10, 1989, the SEC proposed for comment a revised version of proposed Regulation S ("Revised Regulation S"), a delineation of the territorial reach of the registration requirements of the 1933 Act in international capital market transactions.* Revised Regulation S interprets the requirements of the 1933 Act in such a way as to permit relaxation of customary selling restrictions on securities, including bearer form obligations, issued in foreign capital markets by most issuers. Among other things, Revised Regulation S modifies the definition of a "U.S. person" for securities law purposes to exclude U.S. citizens resident outside the United States and in most cases eliminates any requirement of a certification that a purchaser is not a U.S. person.

The Proposed Regulations were issued in response to Revised Regulation S. The Proposed Regulations eliminate the A and B Rules and the consequent dependence, in the case of the A Rules, on the securities laws. The C Rules, largely relevant to foreign issuers, are retained without change. In place of the A and B Rules, the Proposed Regulations adopt the following seven separate and independent tax law requirements (the "D Rules") which, in most cases, will be the exclusive regulatory means of compliance with the "arrangements reasonably designed" standard:

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* The SEC initially published a proposal for Regulation S on June 14, 1988. The SEC's July 10, 1989 reproposal of Regulation S reflects comments received by the SEC on its original proposal.

The SEC's original proposal was the subject of this Committee's "Report on Regulation S," dated August 11, 1988, which examined the SEC's original proposal and suggested alternative courses of action for the IRS to take in response to Regulation S. Although many of our comments are reflected in the Proposed Regulations, we are issuing this Report to comment on particular provisions of the Proposed Regulations.

(1) Neither the issuer nor any "distributor" may engage in "directed selling efforts" as a means of conditioning the market in the United States for the obligation;

(2) Neither the issuer nor any distributor may offer the obligation within the United States or to a U.S. person (other than an "exempt distributor" and certain financial institutions and persons holding through financial institutions (an "exempt purchaser")) during a 40-day restricted period;

(3) The issuer may not, and any distributor must agree that it will not, sell the obligation within the United States or to a U.S. person (other than an exempt purchaser) during the restricted period;

(4) Neither the issuer nor any distributor may deliver the obligation within the United States in connection with a sale of the obligation during the restricted period;

(5) All offering materials used in connection with the original issuance of the obligation must include statements to the effect that the obligation may not be offered or sold in the United States or to a U.S. person (other than an exempt purchaser) during the restricted period;

(6) During the restricted period the issuer or distributor must deliver a confirmation to certain purchasers of the obligation; and

(7) The beneficial owner of the obligation (or a financial institution acting for the owner) must provide a certificate as to its non-U.S. status within 10 days after the end of the restricted period.

While the procedures described above are similar in some respects to those required under Revised Regulation S, the D Rules impose a separate set of tax requirements, and issuers will be required to establish compliance with the D Rules independently of compliance with the securities laws.* In addition, the D Rules vary in two significant respects from Revised Regulation S. Unlike Revised Regulation S, the D Rules

* In the Preamble to the Proposed Regulations, the IRS states that the D Rules are "separate and independent from rules or interpretations that the SEC chooses to adopt in its administration of the securities laws. The SEC's interpretation of the securities laws will be considered by the Service where appropriate; however, the Service must ultimately base its interpretations on the tax policies underlying Section 163 (f)(2)(B)."

generally require that issuers of bearer form obligations obtain certificates as to the non-U.S. status of the purchasers of such obligations (with exceptions for certain foreign currency denominated obligations targeted to local foreign markets and for commercial paper with an original maturity of 90 days or less). The D Rules also adopt the tax law definition of "U.S. person". Consequently, offers and sales of bearer form obligations to U.S. citizens who are resident outside the United States will not violate U.S. securities laws but will not meet the "arrangements reasonably designed" requirement (unless such U.S. citizens are exempt purchasers).

The D Rules will be effective 30 days after final regulations are published and will not apply to obligations issued before that time, which will be tested under the A and B Rules.

Summary

The IRS and the Treasury Department should be commended for their effort to conform the D Rules to the greatest extent possible to Revised Regulation S. In general, we believe that the Proposed Regulations provide a framework for a set of independent tax law rules governing bearer form obligations that can be made to work. However, to accomplish a workable set of rules, there are changes that the IRS and Treasury should consider that would substantially improve the D Rules and facilitate the application of independent securities and tax law rules to a single issuance of bearer form obligations.

First, we note that the D Rules incorporate several concepts from Revised Regulation S (for example, the prohibition of "directed selling efforts" and the requirements with respect

to “offering materials and documents”) while stating that the securities law definitions and interpretations of those terms will not be controlling for tax purposes. Because those terms do not have an independent significance for tax purposes, their interpretation will be the subject of considerable confusion. We therefore urge the IRS to rely on the securities law definitions and interpretations of the terms borrowed from the securities laws or, failing that, at least to provide clear and complete definitions of those terms for tax purposes.

Second, several provisions of the D Rules as currently proposed could impose issuer sanctions on an issuer if a distributor violates the D Rules, even if the issuer has taken steps to ensure compliance with such Rules. As a general matter, we believe that this standard is inappropriate; an issuer should not be subject to sanctions for the actions of a distributor if the distributor has agreed to comply with the restrictions of the D Rules and, at the time the agreement was entered into, the issuer did not know or have reason to know that the distributor would breach its agreement.

Third, this Report makes a number of comments on the substantive requirements of the D Rules and suggests means by which certain problems can be remedied. For example, the certification requirement of Proposed Rule (D)(7) is unworkable as currently drafted. An issuer is required to obtain certification of a purchaser's non-U.S. status within a specified time period and will be subject to sanctions if such certification is not obtained, regardless of the efforts taken to obtain certification or the reason for non-compliance. Because an issuer generally cannot control the actions of a purchaser, it should not be subject to sanctions for the purchaser's failure to certify, if it has taken steps to obtain certification. Thus, we

believe that a standard similar to that in current Rule (B)(4), which requires that issuers withhold delivery of definitive securities to persuade purchasers to provide the requisite certification, is more appropriate.

Finally, this Report responds to the request by the IRS for comments as to the feasibility of permitting concurrent offerings of bearer form obligations to foreign persons and convertible obligations in registered form to U.S. persons. We commend the IRS for taking this important step in promoting the globalization of the securities markets and believe that registered form obligations that are convertible into bearer form can be issued under procedures designed to safeguard the important policies served by TEFRA. This Report proposes a set of procedures designed to permit the issuance of such convertible obligations in the United States or to U.S. persons while ensuring that bearer form obligations will not be sold to U.S. persons. We recommend that the IRS permit the issuance in the United States and to U.S. persons of convertible obligations that comply with the procedures described below.

Part I of this Report first sets forth our general comments on the D Rules and our comments on certain definitions contained in the D Rules. Our comments on the specific provisions of the D Rules follow, in the order in which those provisions appear in the D Rules. Part II discusses the provisions of the Proposed Regulations affecting pass-through certificates and REMICs. Part III then discusses the feasibility of permitting the issuance of convertible obligations in the United States or to U.S. persons. Finally, Part IV discusses certain other issues that the IRS and Treasury should consider as they revise the regulations relating to the issuance of bearer form obligations.

I. The D Rules.

A. General Comments.

1. Effect of De-linking Tax and Securities Law Requirements. The general approach of the D Rules is to provide a set of tax procedures that must be satisfied in connection with the issuance of bearer form obligations independently of any concurrent securities law procedures. This approach represents a significant departure from the current A Rules, which link tax compliance with securities law compliance, and could create substantial uncertainty regarding the application of the tax requirements.

In several respects (for example, the prohibition of "directed selling efforts"), the D Rules incorporate concepts from Revised Regulation S but do not rely on the securities law interpretation of those concepts. We recognize that the IRS has a legitimate interest in controlling the development of the tax law. Terms such as "United States person," for example, must be governed by tax principles. Many of the concepts and terms adopted from Regulation S, however, have no independent tax law significance. Consequently, the failure to adopt the interpretation of those terms under the securities laws will create considerable confusion in the application of the relevant provisions. This Committee's 1988 "Report on Regulation S" discussed this concern, and reference is hereby made to that Report for a more complete discussion of the issue. We urge the IRS to follow the securities laws interpretations in the D Rules to the maximum extent possible. In this regard, the D Rules should specifically state that the IRS will follow the SEC interpretation of those concepts and terms adopted from Revised Regulation S, such as "directed selling efforts" and "offering

materials and documents", that have no independent tax law significance.

Additionally, the IRS should be mindful that Revised Regulation S remains in proposed form and its provisions are subject to change when it is adopted in final form. Any final regulations adopted under Section 163(f)(2)(B) that incorporate non-tax concepts used in Regulation S should incorporate those concepts as they appear in Regulation S as it is adopted in final form, rather than in the current proposal.

2. Strict Liability Standard. The Code provides that an obligation that would otherwise be a "registration required obligation" may be issued in bearer form if it is issued under "arrangements reasonably designed" to ensure that it will be sold only to non-U.S. persons. The statutory language thus takes the view that issuers do not have absolute liability if there is a sale to a U.S. person, so long as "arrangements reasonably designed" to prevent such a sale from occurring are in place. The

legislative history of TEFRA supports this analysis.* Under several provisions of the D Rules, however, an issuer could be subject to sanctions if either it or a distributor or, in some cases, a third party, violates the D Rules, regardless of the arrangements established to prevent such a violation.

We understand the importance of requiring issuers to comply with the issuance procedures. Nevertheless, in the context of the statutory "arrangements reasonably designed" standard, we believe that as a policy matter the IRS should not impose sanctions on an issuer for the actions of a distributor, if in fact the issuer follows the procedures established for the issuance of obligations in bearer form. We therefore recommend that the D Rules as applied to distributors require only that distributors agree with the issuer to follow the specified procedures. The failure of a distributor to comply with its agreement should not impose liability on the issuer unless the issuer knew or had reason to know at the time the agreement was entered into that the distributor would not comply with its agreement.** In all events, sanctions should not be imposed on an issuer for the actions of a distributor under circumstances broader than under the current Rules.

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* The Conference Committee's report on TEFRA provides that "[a]n exception is provided from the issuer sanctions for certain issues of bonds not intended for distribution (or redistribution in connection with the original issue) to U.S. persons." H.R. Rep. No. 97-760 at 564 (emphasis added).

** This Committee considered whether it would be appropriate to subject an issuer to issuer sanctions if the issuer had actual knowledge before the closing that a distributor had failed to comply with its agreement and the issuer did not "break" the sale, *i.e.*, it delivered the bearer form obligations to the distributor at closing. On balance, however, the Committee does not favor this proposal because it is unlikely that an issuer would learn of such a violation before closing and the fact that such a requirement may force the issuer to breach its agreement with the distributor. If the IRS is concerned that it will be difficult for issuers to know at the time an agreement is entered into that a distributor will not comply with the agreement, the IRS might consider publishing a list of those distributors that it discovers on audit have consistently failed to comply.

3. Blanket Certification. We commend the action of the IRS in adopting rules permitting blanket certification in some circumstances (see Proposed Rule (D)(10)) and in requesting comments as to whether a similar standard is feasible in the context of the certification required by Proposed Rule (D)(7). We believe that the use of blanket certifications will simplify the administration of the D Rules and make it easier for issuers to satisfy the issuance procedures, while protecting the interests of the IRS in assuring compliance with the requirements of Section 163(f)(2)(B) of the Code. The IRS should extend similar rules to the other provisions of the D Rules requiring certification -- Proposed Rules (D)(7) and (D)(9).

B. Certain Definitions.

Proposed Rules (D)(11) and (D)(8) contain definitions of "restricted period" and "distributor", respectively, which terms are used throughout the D Rules. These definitions should be modified in the following respects:

1. Restricted Period. As discussed in detail below, the D Rules adopt the rule of Revised Regulation S that offers and sales of bearer form obligations during a 40-day "restricted period" are subject to certain restrictions and prohibit delivery within the United States in connection with sales of obligations during the "restricted period". The term "restricted period" is defined in Proposed Rule (D)(11) as the "40-day period beginning on the later of the closing of the offering or the first date on which the obligation (or any other obligation included in the same issue that is identical to the obligation) is offered to a person other than a distributor," provided that "any offer of the obligation by the issuer or a distributor shall be deemed to be

during the restricted period if the issuer or distributor holds the obligation as part of an unsold allotment or subscription."[*]

We believe that the "restricted period", as defined in Proposed Rule (D)(11), may not commence as early as it should. In the usual case, bearer form obligations are offered and sold before closing, with settlement of the sale on the closing date, and we believe that Proposed Rule (D)(11) should unambiguously provide that the term "restricted period" includes the period before closing.[**] Further, it is not clear how the parenthetical reference to "(or any other obligation included in the same issue that is identical to the obligation)" in Proposed Rule (D)(11) should be interpreted. While we assume that it is intended to make clear that the commencement of the restricted period is not determined on an obligation-by-obligation, but rather on an issuance-wide, basis, the use of the undefined terms "same issue" and "identical" raises questions relating to how the restricted period is to be determined in the case of medium-term note and commercial paper programs. Because the definition of "restricted period" refers to "identical" obligations, and obligations with the same economic terms may be offered continuously under a medium-term note or commercial paper program, it is possible to read Proposed Rule (D)(11) as providing that the "restricted period" with respect to all obligations issued under such programs may not end until 40 days after the last date on which any obligations may be offered under the program.

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[*] The definition contained in Proposed Rule (D)(11) is substantially the same as the definition of "restricted period" in Revised Regulation S.

[**] While it might be argued that this period is included in the current definition of "restricted period" because of the second sentence of Proposed Rule (D)(11) relating to an "unsold allotment or subscription", it seems likely that this sentence is intended to pick up obligations that were purchased by an underwriter at closing and not sold at what would otherwise be the end of the "restricted period".

In order to resolve these ambiguities, we recommend that the restricted period begin with the first date on which the obligation (or any identical obligation) is first offered to non-distributors (the "commencement date") and end on the expiration of the 40-day period after the later of the closing or the commencement date. For this purpose, two obligations will be "identical" if they have the same economic terms and the same issue date.

Finally, the second sentence of Proposed Rule (D)(11) relating to an "unsold allotment or subscription" should apply not only to offers but to all activities that may not occur during the restricted period (such as directed selling efforts and sales). To the extent Proposed Rules (D)(9) and (D)(10) require that certain certifications be provided during the restricted period, these Rules should clarify that certifications may be provided within a reasonable period of time after the sale of an obligation that is part of an unsold allotment or subscription.

2. Distributor. Proposed Rule (D)(8) defines the term "distributor" as (i) any affiliate of the issuer; (ii) the lead underwriter; (iii) any person that participates in the original issuance of the obligation pursuant to a contractual arrangement; and (iv) any person acting on behalf of the foregoing, or acting on behalf of the issuer.* As currently drafted, the definition of

* This definition is broader than the definition of "distributor" contained in Revised Regulation S, which does not include the persons described in clauses (i) and (iv) above. Under Revised Regulation S, the persons described in clause (iv) are subject only to the requirement that they appropriately legend any press release or advertisement made or issued by them.

distributor is too broad and causes unnecessary confusion regarding the persons who are subject to the restrictions on distributors.

As an initial matter, it seems unfair to include in the definition of "distributor" persons that are not under the issuer's control and that have no contractual relationship with either the issuer or the lead underwriter. Virtually all the restrictions of the D Rules are imposed on both the issuer and distributors; thus, an issuer could be subject to sanctions for the noncompliance of a distributor over which it has no control and with which neither it nor the lead underwriter has a contractual relationship, leaving the issuer no recourse. We therefore recommend that clause (iv) be deleted or, if it is intended as an anti-avoidance rule, it include only persons who sell an obligation under prearranged circumstances intended to avoid the application of the D Rules.

Further, clause (iii) and, if it is retained, clause (iv), are over inclusive. As currently drafted, clause (iii) may include the fiscal agent, the listing agent, the paying agents and other persons (including members of clearing organizations) who participate in the original issuance of a bearer form obligation pursuant to "a contractual arrangement" but either do not participate in the "distribution" of the bearer form obligation or only participate "pursuant to a contractual arrangement" with a purchaser of the obligation who is not the lead underwriter. Similarly, clause (iv) includes not only those persons that are acting on behalf of the persons described in clauses (i), (ii) and (iii) in connection with the distribution of the bearer form obligations, but also any person acting on behalf of the foregoing for any purpose.

The necessary modifications could be accomplished by redrafting clauses (iii) and (iv) to read as follows:

(iii) any person that participates in the distribution of the obligation pursuant to a contractual arrangement with the issuer or lead underwriter; and

(iv) any person acting on behalf of any of the foregoing, or acting on behalf of the issuer, in connection with the distribution of the obligation,

and by explicitly excluding agents of the issuer such as the fiscal agent, the paying agents and the listing agents, and clearing organizations, members of clearing organizations, lawyers, accountants and printers from the definition of "distributor". As part of these modifications, the term "distribution" should be defined as offers and sales made during the restricted period.

As a final matter, it would be useful if Proposed Rule (D)(8) contained a definition of the term "affiliate". We recommend that the term be defined as any member of an affiliated group (as defined in Section 1504(a) of the Code without regard to the exceptions contained in Section 1504(b) and substituting "more than 50%" for "80%" each time it appears) that includes the issuer.

C. Specific Comments.

1. Directed Selling Efforts. Proposed Rule (D)(1) prohibits issuers and distributors from making "a directed selling effort with respect to [an] obligation (or other obligations included in the same offering that are identical to

the obligation)." "Directed selling efforts" are activities that are intended to, or that reasonably could be expected to, condition the market in the United States for the obligation. The "directed selling efforts" standard was borrowed, without significant change, from Revised Regulation S.

Proposed Rule (D)(1) raises two significant issues. First, the "directed selling efforts" standard arguably applies on an issuance-wide, rather than an obligation-by-obligation, basis, thereby raising the question of whether it is appropriate under Section 163(f), or equitable, to impose issuer sanctions with respect to the entire issue as a result of a single violation by only one distributor. Second, Proposed Rule (D)(1) does not define "same offering" or "identical" and thus provides no guidance for determining when "directed selling efforts" with respect to one obligation or issue will taint another obligation or issue. For the reasons set forth below, we ask the IRS to reconsider the prohibition on directed selling efforts.

Section 163(f) and the present regulations measure compliance on an obligation-by-obligation basis -- that is, issuer sanctions are imposed only with respect to the particular obligations that are not issued in accordance with the required procedures.[*] However, it is difficult to see how the concept of "conditioning the market in the United States . . . for the obligations," which would be prohibited by Proposed Rule (D)(1), could be applied other than on an issuance-wide basis. The specific activities contemplated (for example, advertising) are not activities designed to condition the market for a particular obligation, but focus more generally on an issuer or an entire

[*] See Sections 163(f) and 4701(a) of the Code; Regulation § 1.163-5(c)(1). The Proposed Regulations do not amend Regulation § 1.163-5(c)(1).

issue of obligations. As such, the standard is inconsistent with the statutorily mandated obligation-by-obligation approach.

If the directed selling efforts standard is intended to be an exception to the general obligation-by-obligation approach, we believe that it would impose issuer sanctions inequitably in cases in which a distributor, rather than the issuer, has engaged in prohibited directed selling efforts. In such a case, the action of a single distributor should not taint the entire offering and only the obligations sold by that particular distributor should be treated as having been issued in violation of Proposed Rule (D)(1). Further, we question whether the issuer should be strictly liable for issuer sanctions if such a distributor engages in prohibited directed selling efforts in contravention of an agreement not to do so unless the issuer knew or had reason to know at the time the agreement was entered into that the distributor would breach its agreement. Finally, while it may be possible to calculate the amount of the applicable issuer sanctions if it is determined that a particular distributor engaged in prohibited directed selling efforts, it will be very difficult, if not impossible, to calculate the withholding tax liability of the issuer to the extent such obligations are fungible.

Proposed Rule (D)(1) prohibits directed selling efforts "with respect to the obligation (or other obligations included in the same offering that are identical to the obligation)". Because the D Rules do not indicate when two obligations will be deemed to be included in the "same offering" or to be "identical", the application of Proposed Rule (D)(1) poses serious problems in many cases. It is not clear, for example, that selling efforts made with respect to a domestic private placement of registered form obligations or a domestic offering of SEC registered medium-

term notes will not taint a concurrent offering outside the United States by the same issuer of bearer form obligations having the same economic terms or that selling efforts with respect to a domestic offering of obligations that are SEC registered and in registered form will not taint a concurrent offering outside the United States by the same issuer of targeted registered obligations having the same economic terms. Similarly, although issuers of foreign targeted bearer form commercial paper are not subject to issuer sanctions, it is not clear under Proposed Rule (D)(1) whether selling efforts in connection with a concurrent domestic offering of bearer form commercial paper would disqualify foreign targeted commercial paper from the backup withholding tax and information reporting exemptions (and the 30% withholding tax exemption for commercial paper with a maturity in excess of 183 days) that apply when such commercial paper is issued in accordance with the "arrangements reasonably designed" requirements.

We therefore believe that the IRS should reconsider the appropriateness of the prohibition of directed selling efforts. Other provisions of the D Rules establish adequate procedures designed to ensure that bearer form obligations are not sold to U.S. persons. For example, the D Rules require that offers and sales of bearer form obligations be made only to non-U.S. persons (other than exempt purchasers) and only outside the United States. The D Rules also impose other restrictions, including the requirement of certification of non-U.S. ownership, to ensure that bearer form obligations are not issued to U.S. persons. These procedures are similar to, and in some cases more restrictive than, the current issuance procedures of the A and B Rules. Because an issuance-wide directed selling efforts standard is inappropriate, and in light of the considerable confusion that its application is likely to create and the absence of any real

need for such a prohibition, we recommend that Proposed Rule (D)(1) be deleted from the D Rules.

Alternatively, if Proposed Rule (D)(l) is retained, it is crucial that the scope of "directed selling efforts" be clarified. There are two possible approaches to this. First, because the definition of "directed selling efforts" in Proposed Rule (D)(1) mirrors that in Regulation S, the IRS could adopt the SEC's definition and interpretation of the term. Alternatively, the IRS could specifically describe in the Proposed Rule (D)(1) those activities that constitute "directed selling efforts".

In either case, the IRS needs to provide guidance to clarify (1) whether the directed selling efforts rule is to be applied on an obligation-by-obligation basis, on a seller-specific basis, or on an issuance-wide basis, (2) that issuers will not be subject to issuer sanctions if distributors engage in directed selling efforts in violation of an agreement not to do so, unless at the time the subscription or underwriting agreement is signed the issuer knows or has reason to know that the distributor would violate the agreement and (3) the meaning of the terms "same offering" and "identical", especially as they apply to transactions such as domestic offerings of privately-placed debt, SEC-registered medium-term or other notes and commercial paper that are contemporaneous with offerings of bearer form obligations or targeted registered obligations in foreign capital markets. We recommend that, in defining the term "identical", the IRS state that a registered form obligation is not "identical" to a bearer form obligation and that a registered form obligation or bearer form commercial paper issued in the United States is not "identical" to a targeted registered form obligation or bearer form commercial paper issued outside the United States.

2. Offers in the United States or to U.S. Persons. Proposed Rule (D)(2) flatly prohibits offers of a bearer form obligation by the issuer or a distributor in the United States or to U.S. persons (other than exempt purchasers) during the restricted period. Thus, while Proposed Rule (D)(12) permits offers and sales to international organizations and foreign central banks, Proposed Rule (D)(2) does not permit offers to be made to such persons within the United States.* The effect of Proposed Rule (D)(2) is to negate the benefit of Proposed Rule (D)(12) for many international organizations, such as the World Bank, that do not have investment offices outside the United States. Because international organizations and foreign central banks represent a numerically small, easily-identified group of potential investors and because the IRS has, as a policy matter, decided to permit offers and sales to such institutions, there seems to be no reason to prohibit offers within the United States to such institutions. As noted in 3. below, sales (but not deliveries) in the United States to such purchasers should also be permitted.

Additionally, as described above, we believe that it is generally inappropriate to impose sanctions on an issuer for the actions of a distributor that fails to comply with the D Rules, if the distributor has agreed with the issuer to so comply.

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* Although Revised Regulation S treats such persons as non-U.S. persons, it does not permit offers to such persons to be made in the United States. However, other provisions of the securities laws -- for example, the private placement exemption and, if adopted, Rule 144A -- generally do permit offers and sales to be made to international organizations and foreign central banks within the United States. Further, numerous commentators have urged the SEC to allow such offers and sales under Regulation S.

Consistent with this view, an issuer should not be subject to sanctions if a distributor has agreed not to violate Proposed Rule (D)(2)'s offering restrictions but nevertheless makes such a prohibited offer, unless the issuer knew, or had reason to know, at the time the agreement was entered into, that the distributor would violate its agreement. This would conform Proposed Rule (D)(2) with the provisions of Proposed Rule (D)(3) that require a distributor to agree that it will not sell an obligation in the United States or to a U.S. person (other than an exempt purchaser).

3. Sales in the United States or to U.S. Persons. Proposed Rule (D)(3) prohibits an issuer from selling a bearer form obligation within the United States or to a U.S. person (other than an exempt purchaser) during the restricted period and requires that distributors agree not to make such sales. Although an issuer may satisfy Proposed Rule (D)(3) notwithstanding that a distributor breaches its agreement and actually sells an obligation within the United States or to a U.S. person (other than an exempt purchaser) during the restricted period, the issuer does violate Proposed Rule (D)(3), and thus is subject to issuer sanctions, if it knows of the distributor's breach of its agreement. A literal reading of this knowledge standard would impose sanctions on an issuer even if it learns of the distributor's breach after the sale or the end of the restricted period. A more appropriate standard would subject an issuer to such sanctions only if it knows, or has reason to know, at the time the agreement is entered into, that the distributor would breach its agreement. The suggested alternative would discourage issuers from being negligent in selecting distributors and establishing procedures for compliance, yet would not penalize an issuer for sales over which it has no direct control.

Proposed Rule (D)(3) deems a sale to have been made to a U.S. person if the seller of the obligation has a U.S. address for the purchaser. This Rule should be clarified in two respects. First, the Rule should only apply if the seller has a U.S. address for the purchaser with respect to the particular sale.[*] Requiring distributors, which tend to be large, decentralized financial institutions, to keep centralized customer records so that they can easily determine whether they have any U.S. address for a purchaser anywhere within their records is not practical.

Second, unlike the similar address rule in Proposed Rule (D)(7) (regarding certification), the deemed address rule in Proposed Rule (D)(3) has no documentary evidence exception. Thus, if a seller has a U.S. address for a purchaser but has evidence that the purchaser in fact is not a U.S. person, sales to that person nevertheless would be prohibited. A documentary evidence exception should be added to the deemed U.S. address rule of Proposed Rule (D)(3). If a purchaser is not a U.S. person and the seller has documentary evidence of that fact, there is no reason to prohibit sales of bearer form obligations to such person.

Finally, for the reasons discussed above under "Offers in the United States or to U.S. Persons", Proposed Rule (D)(3) should be modified to permit sales of bearer form obligations to international organizations and foreign central banks located in the United States.

4. Deliveries. Under Proposed Rule (D)(4), neither the issuer nor any distributor may deliver a bearer form obligation within the United States in connection with a sale of the

[*] This would parallel the standard found in Regulation § 1.1441-3(b)(3) regarding the use of a U.S. address to establish an exemption from U.S. withholding tax on dividends.

obligation during the restricted period. Because, in the typical case, bearer form obligations are delivered by the issuer through the fiscal agent, and we recommend that the term "distributor" be clarified to exclude the fiscal agent, Proposed Rule (D)(4) should be modified by inserting "(or its agent)" after "issuer" in the first line of the Rule.

5. Offering Materials. Proposed Rule (D)(5), which is substantially similar to a portion of the definition of "offering restrictions" in Revised Regulation S, requires that all "offering materials and documents" used in connection with the "original issuance" of the obligation include a statement to the effect that the obligation may not be offered or sold in the United States or to a U.S. person other than an exempt purchaser, and specifies places in which the statement must appear. While we recognize the potential in terrorem effect of Proposed Rule (D)(5) (i.e., that legending documents may help to reduce the interest of U.S. persons in purchasing bearer form obligations), Proposed Rule (D)(5) should be modified to resolve the several problems noted below.

First, as in the case of Proposed Rule (D)(1) relating to "directed selling efforts", it is not clear whether a violation of Proposed Rule (D)(5) will taint an entire issue of bearer form obligations (regardless of whether it is the issuer, a distributor or a third party that fails to provide the appropriate legend) or only certain obligations.* If a violation

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* As currently drafted, Proposed Rule (D)(5) presents difficult problems of proof. It requires that "offering materials and documents" used in connection with the "original issuance" of the obligation be legended but does not specify how it is to be determined whether, for example, a certain unlegended advertisement was used in connection with the original issuance of a particular obligation.

taints only certain obligations, it is not clear how the issuer is to determine which obligations are tainted. To the extent that a violation of Proposed Rule (D)(5) is intended to trigger issuer sanctions with respect to an entire issue, Proposed Rule (D)(5) is inconsistent with the statutory mandate of Section 163 of the Code that measures compliance on an obligation-by-obligation basis and we question whether it should be retained in that form. Further, it is inequitable to taint an entire issue as a result of one, possibly unintentional, failure of compliance. To the extent the Rule is intended to taint only certain obligations, it must specify how the issuer should determine which obligations are tainted.

Second, we believe that it is not appropriate to hold an issuer strictly liable for all violations of Proposed Rule (D)(5), particularly because, as currently drafted, the Rule neither defines the terns "offering materials and documents" or "original issuance", nor limits those required to legend "offering materials and documents" to the issuer and the distributors. Assuming that the Rule is retained, the Rule should be revised to provide that the issuer will be strictly liable only for (1) its own actions and (2) the failure to obtain the agreement of distributors in privity of contract with the issuer or the lead underwriter to appropriately legend all "offering materials and documents".

Finally, if the Rule is retained, the IRS must provide further guidance to issuers and distributors regarding the materials and documents that must be legended. The term "offering materials and documents" is not defined in the tax law. Proposed Rule (D)(5) is another area in which it seems unreasonable for the IRS to adopt a securities law concept without permitting issuers and distributors to rely on the securities law

interpretation of the concept or providing specific guidance regarding the tax law definition of the term. Because the term "offering materials and documents" is a term that is better understood under the securities laws, one possible way to define the term for tax purposes is to state that it has the same meaning under the tax law as under the securities laws. We believe that such a cross-reference would not undercut the integrity of the D Rules. Alternatively, the IRS could delete the general reference to "offering materials and documents" and provide a specific list of those places in which it believes the legend should appear. If this alternative is adopted, we recommend that the list consist of the "invitation telex" as well as the prospectus or offering circular and any press release or advertisement.

We also note that the term "original issuance" could appropriately be changed to "distribution" (as defined under "Distributors", above); and we question why the required statement must appear in the tax section of the prospectus if it is already on the cover or inside cover page or in the underwriting section. Also, we believe the Rule should not apply to offering materials and documents for "targeted offshore offerings" defined in Proposed Rule (D)(7)(iii).

6. Confirmations. Proposed Rule (D)(6) provides that if the issuer or any distributor sells a bearer form obligation during the restricted period to a person who receives a selling concession, fee or other remuneration in respect of the securities sold, the seller must send a "confirmation" (either in writing or electronically) to such purchaser stating that the person is subject to the restrictions on offers, sales and deliveries described above. This Rule should be modified in several respects.

First, while we assume that the IRS intended in Proposed Rule (D)(6) to limit those sales as to which confirmations must be sent, we question whether the Rule as currently drafted achieves that objective. The Rule requires that a confirmation be sent to any person receiving a selling concession or other remuneration in respect of the securities sold, without specifying from whom the other remuneration is received. Because any person who purchases a bearer form obligation from a distributor may receive a fee from a person who purchases from it, a distributor will not know, in most circumstances, whether its purchaser will receive such a fee. Consequently, distributors are in effect required to send confirmations to all purchasers. Assuming that this result was not the intention of the IRS, we recommend that the phrase "directly or indirectly, from the person selling to it" be added after "receives" in the first sentence of Proposed Rule (D)(6) in order to clarify that a confirmation is required only in those situations where the seller grants the purchaser a selling concession or otherwise pays the purchaser to resell the security.

Second, we believe it is not necessary to require the issuer of a bearer form obligation to send a confirmation to any distributor who agrees in writing to comply with the restrictions on offers, sales and deliveries. Such a requirement would be redundant.

Finally, the specific terms of Proposed Rule (D)(6) differ from the confirmation requirement of Revised Regulation S in certain technical respects that may cause confusion in the application of the Rule. Proposed Rule (D)(6) requires that a "confirmation" be "sent" while Revised Regulation S requires

“delivery” of a “confirmation or other notice”. We hope that on this point the SEC adopts the “sending” standard.

The term “confirmation” generally means the written document which both confirms the trade and delivers any required notices. Revised Regulation S states that the addition of the term “other notice” is intended to accommodate paperless transactions and “could include a notice given on a screen rather than on paper or a notice given on the telephone, provided that the seller kept written records of notices given.”[*] Proposed Rule (D)(6) should incorporate this concept of “other notice” in the definition of “confirmation”.

Delivery of confirmations is largely a ministerial task and the confirmation requirements of Revised Regulation S apply to a broad category of securities. It is therefore likely that distributors will develop procedures that comply with Revised Regulation S. Thus, we believe that the IRS should require confirmations (defined to include other notices) to be delivered in accordance with the requirements of Revised Regulation s.

Regarding the issuer's liability for failure to comply with the Rule, we believe, consistent with the view expressed above, that the issuer should not be subject to sanctions for a distributor's failure to comply with Proposed Rule (D)(6) if the issuer obtains an agreement from the distributor to comply with the Rule, unless the issuer knew or had reason to know when the agreement was entered into that the distributor would not comply with its agreement. It is inequitable to impose issuer sanctions where a distributor agrees but fails to send a confirmation.

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[*] Securities Act Release No. 33-6838, fn. 43.

7. Certification. In general. Except in the case of a "targeted offshore offering" or an offering of certain short-term obligations, Proposed Rule (D)(7) requires that the issuer or a distributor receive, not later than the 10th day after the last day of the restricted period, a certificate stating that the owner of the obligation on the last day of the restricted period either was not a U.S. person or was a U.S. person that was an exempt purchaser. The certificate must be signed (or sent) by either the owner of the obligation or by a financial institution or clearing organization through which the owner holds the obligation. If a certificate is provided by a clearing organization, it must be based on certificates provided to it by its members. The certificate may be provided in writing or may be provided electronically if the person receiving the certificate maintains adequate records and the person sending the certificate has agreed in writing with the person receiving it that the electronic certificate has the effect of a signed certificate.

The certification requirement of Proposed Rule (D)(7) represents a significant departure from the A and B Rules and from market practice and, in its current form, is unworkable. Current procedures require only that the issuer or distributor receive certification before it delivers definitive obligations (or, under the B Rules, issues securities, if obligations in definitive form are not delivered) and, under most circumstances, before it pays interest. Thus, under current practice, a purchaser, who will be deprived of the definitive obligation and may not receive an interest payment, has an economic incentive to comply with the certification requirement. In contrast, Proposed Rule (D)(7) does not prevent delivery of the obligation in definitive form or payment of interest without certification and instead unconditionally requires the issuer or distributor to obtain certification within a specified period of time. If the

certification is not received, the issuer will be subject to issuer sanctions, regardless of the efforts undertaken by the issuer and distributors to comply with the certification requirement. We believe that the imposition of issuer sanctions in these circumstances is completely inappropriate.

As a practical matter, once bearer form obligations have been delivered in definitive form to the purchaser, the purchaser has no incentive to provide the certification to the issuer or distributor. Thus, we see no alternative other than to eliminate the requirement that the issuer or distributor receive a certificate and instead require that the issuer withhold delivery of definitive obligations (or issuance of a permanent global security if definitive obligations will not be made available) and withhold payment of interest until it receives the appropriate certificate from the purchaser (or its agent). In effect, we recommend that Proposed Rule (D)(7) be replaced with a certification requirement that is similar to the certification requirement of Regulation § 1.163-5(c)(2)(i)(B)(4).

In recommending that the IRS adopt a certification requirement similar to that of Regulation § 1.163-5(c)(2)(i)(B)(4), we find it necessary to address the potential application of Rev. Rul. 89-9, 1989-4 I.R.B. 4, to the revised Rule. In that ruling, a corporation issued a seven-year obligation designated a "temporary" global security that satisfied all the pre-delivery requirements of the B Rules. However, the corporation never issued the definitive bearer bonds nor received certification of non-U.S. status from the purchasers, and the temporary global security remained outstanding for its full term, after which the corporation paid its indebtedness in full and the security was cancelled.

Under Regulation § 1.163-5(c)(2)(i), a "temporary" global security is not required to satisfy the B Rules. Rev. Rul. 89-9 states that "[t]he reason for this exception is that a temporary global security is retired promptly at the close of the offering after the underwriter obtains the statement described in section 1.163-5(c)(2)(i)(B)(iv) and delivers the bearer obligations in definitive form" and holds that (1) the term "temporary" global security does not include an obligation that is not retired within a reasonable period of time after completion of the initial offering and (2) a temporary global security that remains outstanding beyond a reasonable time after completion of the initial offering must satisfy the B Rules.

As an initial matter, the ruling incorrectly describes the procedures typically followed in foreign capital markets in connection with the issuance of temporary global and definitive securities. The ruling states that

> A temporary global security is typically issued to the underwriter at the outset of an offering, and interests in the security are given to bond purchasers pending delivery of the bonds. At the close of the offering, the underwriter obtains statements that no United States person owns an interest in the security, the bonds are delivered, and the security is promptly retired.

In fact, in the usual case, the temporary global security is issued only on the closing date. Before that time, purchasers merely have the right to purchase the obligation, which is typically evidenced by a confirmation. At the closing, the issuer deposits the temporary global security with a bank acting as a depositary on behalf of clearing organizations which credit the accounts of their members with interests in the temporary global security. On or after the "exchange date", which is after the closing date, clearing organizations present certificates to the fiscal agent (or trustee) based on certificates received from

their members and the fiscal agent (or trustee) delivers definitive obligations to the clearing organizations. Under the B Rules, the exchange date typically has been set at 45 to 90 days after the closing.

Presumably, the rule of Regulation § 1.163-5(c)(2)(i) that provides that a temporary global security need not satisfy the "arrangements reasonably designed" requirement reflects a recognition on the part of the IRS that it is very difficult, if not impossible, for an issuer to obtain certifications at the time the temporary global security is issued on the closing date. In light of the current market procedures relating to the issuance of temporary global and definitive securities, the holdings of Rev. Rul. 89-9 should be clarified. Under the ruling, an issuer that does not receive certifications at the issuance of the temporary global security will be subject to the issuer sanctions if the certifications are not received "within a reasonable period of time after the completion of the initial offering", notwithstanding that (1) it will likely be almost impossible to obtain the certifications before the temporary global security is issued, (2) at the closing the issuer will not know whether or not the temporary global security will be retired within a reasonable period, (3) the issuer makes definitive securities available within a reasonable period of time and (4) the issuer cannot force a purchaser to make the required certification within a reasonable period of time. While it is clear that Rev. Rul. 89-9 was intended to stop an abusive transaction, its holding in fact applies to all obligations issued under the B Rules and would presumably apply to transactions under the D Rules as well.

We believe it is not appropriate to subject an issuer that makes definitive obligations available within a reasonable

period of time after the closing to sanctions if a temporary global security is not in fact completely retired within a reasonable period of time, because the purchasers and not the issuer control when the temporary global security is retired. However, we recognize the interest of the IRS in preventing abusive transactions. We therefore suggest that the IRS implement our recommendation as follows:

1. Replace the first sentence of Proposed Rule (D)(7)(i) with the following:

> The issuer (or its fiscal agent, trustee or paying agent) delivers the obligation in definitive form (or issues the obligation, if obligations in definitive form will not be made available by the issuer within a reasonable period after the end of the restricted period) or pays interest on a temporary global security, only upon presentation of a certificate stating that the owner of the obligation is not a United States person or is a United States person described in paragraph (c)(2)(i)(D)(9) or paragraph (c)(2)(i)(D)(10) of this section.

2. Add the following at the end of the definition of "temporary global security" in Regulation § 1.163-5(c)(2)(i):

> , provided, however, that a security that would otherwise satisfy this definition shall not be considered to be a temporary global security unless the issuer makes available to the purchasers obligations in definitive form within a reasonable period of time after the end of the restricted period.

3. The preamble to the final regulations should indicate that the holding of Rev. Rul. 89-9 has been incorporated into the final regulations.[*]

Under our recommendation, as under current procedures, purchasers of current coupon bearer form obligations will likely provide the required certification no later than the first interest payment date. While we recognize that purchasers of zero coupon obligations do not have the same economic incentive to provide certification within a similar time frame, we believe that holders do not distinguish between obligations on that basis and, because it is typical in foreign capital markets to do so, nevertheless provide certification.

Additionally, because those obligations for which certificates have not yet been provided are not fungible with those for which certificates have been provided, it is our understanding that those obligations for which no certificates have been provided are blocked by the clearing organizations and no settlement of trades within the clearing system is possible. This provides an incentive to holders of zero coupon obligations, as well as current coupon obligations, to provide certification within a reasonable period of time.

Under Proposed Rule (D)(V)(ii), purchasers of bearer form obligations may provide the required certification electronically. We applaud this decision. However, we do not understand the purpose of the requirement that the person sending and the person receiving the electronic certificate agree <u>in writing</u> that the certificate have a specified meaning.

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[*] If our recommendations regarding certification and Rev. Rul. 89-9 are not adopted, it is imperative that the exact parameters of the phrase "reasonable period of time", as used in the ruling, be defined.

If, for example, the rules of a clearing organization that must be followed by all members specify that the electronic certificate has the assigned meaning, we believe that the requirement of a written agreement is superfluous.

Finally, we strongly urge the IRS and Treasury to allow purchasers of bearer form obligations to provide "blanket certifications" under Proposed Rule (D)(7) on a periodic basis. Blanket certifications will substantially streamline the distribution process and in fact will facilitate the retirement of temporary global securities, both those representing current coupon and those representing zero coupon obligations. The benefits of blanket certifications cannot be underestimated, because this procedure would substantially increase the efficiency of the administration of the capital markets. The rules governing such blanket certifications could operate in a manner similar to the rules relating to foreign targeted registered obligations. We suggest, however, that the strict limitations currently imposed with regard to the time period within which certification must be provided in the context of foreign targeted registered obligations not be imposed with respect to blanket certifications. Rather, the IRS could require that blanket certifications be given annually and provide that the certifications would be effective for the calendar year in which given.

Exception for "Targeted Offshore Offerings". Proposed Rule (D)(7)(iii) provides an exception to the certification requirement of Proposed Rule (D)(7)(i) for an obligation that is sold during the restricted period in a "targeted offshore offering". A "targeted offshore offering" is an offering of

obligations that (1) is targeted to the domestic capital markets of a single foreign country in accordance with customary local practices and documentation, (2) is neither listed nor subject to a listing application on a securities exchange outside the targeted foreign country, and (3) consists solely of obligations denominated in the local currency of the targeted foreign country, provided that neither the issuer nor a distributor knows or has reason to believe that a substantial portion of the offering will be sold or resold outside the targeted foreign country in connection with the original issuance.

We commend the IRS and Treasury for including this exception to the general certification requirement of Proposed Rule (D)(7)(i) but are concerned that the "substantial portion" limitation, in the absence of a definition of "substantial", may limit the effectiveness of the exception. One possible solution would be to amend the Rule (1) to define the term "substantial" and (2) to clarify that the "knows or has reason to believe" standard applies at the time the subscription or underwriting agreement is signed. We suggest that 20-25% would be appropriate for the definition of "substantial".*

In addition, we believe that the exception from the certification requirement of Proposed Rule (D)(7) for "targeted offshore offerings" should apply in the case of obligations the principal of <u>or</u> interest on which is

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* We note that the current definition of "targeted offshore offering" would not exempt a significant number of offerings denominated in Deutschemarks from the certification requirements of Proposed Rule (D)(7), because a very substantial portion of such offerings are sold outside of West Germany.

denominated in the local currency of the targeted foreign country and should not apply in the case of foreign currency denominated obligations that are linked to the U.S. dollar in a way which in effect converts the obligations to U.S. dollar denominated obligations.

Certain Short-Term Obligations. The Proposed Regulations exempt original issue discount obligations having a maturity of 90 days or less from the certification requirement of Proposed Rule D(7).* This exemption acknowledges the practical difficulties inherent in obtaining certification in connection with commercial paper. Because the commercial paper market currently is structured to operate without certifications, difficulties will still be encountered under the Proposed Regulations in obtaining certifications with respect to commercial paper having a maturity longer than 90 days.

The Eurocommercial paper market currently does not require certification of non-U.S. status. If U.S. issuers of commercial paper are required to obtain certification of non-U.S. status only to establish an exemption from information reporting and backup withholding, such issuers will be disadvantaged vis-a-vis foreign issuers who are not subject to such requirements. In order to issue obligations in the same market as foreign issuers, U.S. issuers either will be limited to issuing commercial paper having a maturity of 90 days or less or will be required to pay higher yields to investors to compensate for the imposition

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* Although debt obligations having a maturity (at issue) of one year or less technically are not "registration required" obligations, such short-term obligations of U.S. issuers nonetheless must generally comply with the rules of Section 163(f)(2)(B) in order to be exempt from information reporting and backup withholding. In the case of debt obligations having a maturity of more than 183 days, compliance with the rules of Section 163(f)(2)(B) also is required to avoid the 30% withholding tax.

of a certification requirement. These additional costs, when added to the cost of administering a certification requirement, will place U.S. issuers at a financial disadvantage to foreign issuers in the same market.

The majority of the commercial paper issued in foreign capital markets has a maturity of 183 days or less. Because original issue discount obligations having a maturity of 183 days or less already are subject to a separate tax regime (to establish an exemption from information reporting and backup withholding), 183 days would be a reasonable and workable upper limit to the commercial paper certification exemption of the Proposed Regulations. Such a change would have the added benefit of reducing confusion in the commercial paper markets by avoiding the creation of a third category of commercial paper (i.e., that having a maturity of 91 to 183 days) that would be subject to issuance restrictions different from that having either a longer or a shorter maturity.

8. Definition of "Exempt Distributor". Proposed Rule (D)(9) defines an "exempt distributor" as a distributor that provides certification in writing to the person selling to it that (1) it is purchasing for the purpose of resale and (2) if it retains the obligations for investment, it will provide the certification required by Proposed Rule (D)(10). In the case of an exempt distributor that decides to retain the obligations for investment, Proposed Rule (D)(9) requires that the certification required by Proposed Rule (D)(10) be provided to the selling issuer or distributor "no later than the 40th day of the restricted period". We are concerned that the Rule establishes procedures that will require unnecessary paperwork,

and believe that the purpose of Proposed Rule (D)(9) can be accomplished in a much less burdensome manner, as follows:

1. A distributor that is a U.S. person and is in privity of contract with the issuer or the lead underwriter should not be required to provide special separate certifications in connection with each purchase of bearer form obligations. Proposed Rule (D)(9) should simply require that such a distributor represent in its contract with the issuer or the lead underwriter, as the case may be, that it is purchasing for the purposes of resale and that if it retains the obligations for investment, it will comply with the requirements of Section 165(j)(3)(A), (B) or (C) and the regulations there under.

2. In the unusual case of a distributor (such as an affiliate of the issuer) that is a U.S. person not in privity of contract with the issuer or the lead underwriter, Proposed Rule (D)(9) should require only one certification at the time of purchase that includes the certification required by Proposed Rule (D)(10) by stating that the distributor is purchasing for resale but that if it retains the obligations for investment, it agrees to comply with the requirements of Section 165(j)(3)(A), (B) or (C) and the regulations there under. Because such a distributor presumably would purchase the obligation from a distributor that is in privity of contract with the issuer or lead underwriter, the issuer and lead underwriter could require each distributor with which they are in privity of contract to agree to obtain this Proposed Rule (D)(9) certification from any distributor that is a U.S. person not in privity of contract with the issuer or the lead underwriter to which it sells an obligation during the restricted period. Moreover,

blanket certification should be permitted as a way of meeting this certification requirement.

3. Proposed Rule (D)(9) should allow a distributor that is a U.S. person not in privity of contract with the issuer or the lead underwriter to provide the required certification electronically in light of the movement in the market towards paperless transactions. Compare Proposed Rule (D)(V)(ii).

If the IRS decides to retain the Proposed Rule (D)(9) requirement of two separate certifications with respect to any distributor that is a U.S. person, the time period within which the certificate must be provided should be amended. Since, as suggested above under "Certain Definitions", the "restricted period" should begin on the date the obligation (or any identical obligation) is first offered to a non-distributor, the 40th day of the restricted period may occur prior to the end of the restricted period and a distributor may have difficulty determining the date that is the 40th day after the first offer of the obligation to a non-distributor. Therefore, Proposed Rule (D)(9) should only require that the second certificate be provided within a reasonable period of time after the end of the restricted period. Also, as noted above, blanket certifications should be permitted as a way of minimizing confusion and administrative burdens with respect to (D)(9) certificates.

Finally, the last sentence of Proposed Rule (D)(9), which treats obligations retained by an exempt distributor for investment as an "unsold allotment or subscription" for purposes of the definition of "restricted period", is not consistent with Proposed Rule (D)(10), under which a bearer form obligation purchased for investment by a U.S. distributor that is a "financial institution" within the meaning of

Regulation § 1.165-12(c)(1)(v), is not so treated. We see no reason for treating the bearer form obligation differently merely because the distributor first thought it would resell the obligation and later either changed its mind or found that it could not resell and kept the obligation for investment. Once a distributor decides to keep the obligation for investment and agrees to comply with the requirements of Section 165(j)(3)(A), (B) or (C) and the regulations there under, the obligation should not be considered to be part of an "unsold allotment or subscription" for purposes of the D Rules.

9. Definition of "Certain United States Persons". Proposed Rule (D)(10) provides that a bearer form obligation may be offered and sold outside the United States and its possessions to a U.S. person that is a financial institution (as defined in Regulation § 1.165-12(c)(1)(v)) purchasing for its own account, or to a U.S. person that is a customer of, and holds the obligation through, such a U.S. financial institution, provided that the financial institution certifies no later than the end of the restricted period that it will comply with the requirements of Section 165(j)(3)(A), (B) or (C) and the regulations there under. The certification may be given with respect to each purchase or a "blanket certificate" may be provided. We recommend that Proposed Rule (D)(10) specify that certification with respect to each particular purchase may be given electronically and permit any required certification to be given within a reasonable period of time after the end of the restricted period.

10. Effective Date. The Proposed Regulations provide that any bearer form obligation that is not described in the C Rules and is issued more than 30 days after final regulations are published must be issued in accordance with the D Rules.

This effective date will present practical difficulties in the case of medium-term note and commercial paper programs. Under these programs, the obligations of the issuer and the distributors, as well as the terms and conditions of the notes and, in the case of medium-term notes, the indenture or fiscal agency agreement (which includes samples of the certifications that must be provided by purchasers) have been fixed. Further, these programs are established to allow issuers to issue medium-term notes and commercial paper on a continuous basis without necessarily consulting their legal advisors before each particular obligation is issued. While these agreements, like any contract, can be amended, it will take a significant amount of time to do so. We therefore recommend that the final regulations permit issuers to issue medium-term notes and commercial paper pursuant to programs in place on the date the final regulations are published in the Federal Register in accordance with the A Rules (based on pre-Regulation S practices) or the B Rules, as the case may be, until the earlier of (1) the date the issuance procedures of the program are amended and (2) a date that is 4 months after the date the final regulations are published.

In addition, the Proposed Regulations require that any obligation issued more than 30 days after final regulations are published pursuant to the exercise of a warrant or the conversion of a convertible obligation, which warrant or convertible obligation was issued before the effective date of the D Rules, be issued in accordance with the A or B Rules, as the case may be. We suggest that the final regulations allow the issuance of such obligations in accordance with the D Rules because the obligations may be issued at a time when the procedures commonly utilized by both issuers and the clearing organization are based on the D Rules.

II. Modification of Temporary Regulations Relating to Pass-Through Certificates and REMICs.

The Proposed Regulations amend Temporary Regulation § 35a.9999-5(e), Q&A-21 to provide that interest paid to the holder of a residual interest in a real estate mortgage investment conduit ("REMIC") will be treated as being paid on or with respect to the obligations held by the REMIC. This rule is consistent with the general treatment of REMIC residual interests as pass-through investments. See Section 860C. The rule apparently was drafted to clarify that payments on residual interests may be treated as portfolio interest that is exempt from U.S. withholding tax. However, as currently drafted, the Proposed Regulations could be read as not providing such an exemption for residual interests in certain REMICs.

Many REMICs hold directly mortgage loans of individuals rather than pass-through certificates or debt obligations backed by those mortgages. Although such mortgage loans may be in bearer form, they are not "registration- required" obligations and therefore will not have been issued in accordance with "arrangements reasonably designed" to ensure their sale to non-U.S. persons. Thus, interest paid on such mortgages will not qualify for portfolio interest treatment pursuant to Sections 871(h)(2)(A)(ii) and 881(c)(2)(A) and, under the proposed amendment to Q&A-21, foreign holders of residual interests in such REMICs may not be entitled to portfolio interest treatment with respect to their investment. Although this may appear to be consistent with the general look-through treatment of REMIC residual interests under the Code, it ignores the pooling aspect of REMICs and the pooled nature of an investment in a residual interest. It is not clear whether this result was intended, or

whether the proposed amendment to Q&A-21 intended to treat REMIC residual interests in a manner similar to pass through certificates, which would qualify for portfolio interest treatment in such a case.

Q&A-21 currently provides that, in determining whether interest paid to the holder of a pass-through certificate qualifies as portfolio interest, the interest will be deemed to be paid on or with respect to the certificate and not the underlying obligations. However, in making such determination, the pass-through certificate will be treated as having been issued after July 18, 1984 only to the extent the underlying obligations were so issued. Thus, if a pass-through certificate represents an interest in obligations issued after July 18, 1984 and the certificate is issued in accordance with the "arrangements reasonably designed" standard, interest paid on or with respect to the certificate will be eligible for portfolio interest treatment, without regard to whether the obligations underlying the certificate would be so eligible.

We recommend that a standard paralleling that applied to pass-through certificates be applied to residual interests in REMICs. Thus, the Proposed Regulations could be amended to provide that, for purposes of Sections 871(h) and 881(c), interest paid on or with respect to a residual interest in a REMIC will (subject to the rule for excess inclusions) be treated as being paid on or with respect to a pass-through certificate, in accordance with the provisions of Temporary Regulation § 35a.9999-5(e), Q&A-21(i).*

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* We also note that there is an apparent typographical error in Proposed Regulation § 46.4701-1(b)(5). The cross-reference to "§ 1.153-5T(e)" should read "§ 1.163-5T(e)".

III. Convertibility.

The IRS has requested comments on the feasibility of allowing concurrent offerings of bearer form obligations to foreign persons and registered form obligations, convertible into bearer form obligations, to U.S. persons.

Present regulations effectively prohibit convertibility and require that obligations offered or sold in the United States or to U.S. persons be permanently in registered form, notwithstanding that the market for obligations of the same issue outside of the United States is for bearer form obligations.*
Convertibility will permit the issuance in domestic and foreign markets of "fungible" obligations, i.e., obligations that may be sold between markets.*

We applaud the decision of the IRS to take this preliminary step in facilitating the globalization of the

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* The original Temporary Regulations under Section 163(f)(2)(B) of the Code, published on November 15, 1982, reserved on the circumstances under which obligations that were not issued in accordance with the "arrangements reasonably designed" standard would be regarded as in registered form if they could be converted into bearer form. Subsequently, Proposed Regulations published on September 2, 1983 provided that an obligation that was otherwise in registered form and which by its terms was convertible into bearer form would be considered to be in registered form if (1) it was part of a larger offering that included bearer form obligations sold in accordance with the "arrangements reasonably designed" requirements, (2) at all times during which the obligation was in bearer form, the place of payment and legending requirements of Section 163(f)(2)(B) were satisfied and (3) conversion was accompanied by a certificate stating that the holder of the bearer form obligation would either be a non-U.S. person or a "financial institution" described in Section 165 and the regulations there under.

The decision to permit conversion of registered form obligations was reversed one year later in Temporary Regulations published on August 22, 1984. The present Regulations, published on December 19, 1986, continue this rule.

* Convertibility will also further the objectives promoted by the SEC's attempts (through its proposals in Regulation S and Rule 144A) to reduce barriers to the globalization of the securities markets.

securities markets. We believe that regulations can be developed that will promote liquidity both in the domestic and foreign capital markets and will safeguard the tax policies that restrict the ownership of bearer form obligations in the United States and by U.S. persons.

Regulation § 5f.103-l(e)(2) provides that an obligation will not be in registered form if it may be transferred at any time prior to maturity by any means other than (i) the surrender of the obligation by the holder and the reissuance of the registered form obligation or the issuance of a new registered form obligation by the issuer and/or (ii) through a book-entry system maintained by the issuer or its agent. Thus, an obligation that would be in registered form but for its convertibility into bearer form (a "convertible obligation") will not be treated as a registered form obligation. Accordingly, such a convertible obligation generally may not be offered or sold in the United States or to U.S. persons without the imposition of the issuer sanctions and the loss of portfolio interest treatment for interest paid to non-U.S. persons.

We recommend that the Regulations be modified to permit offers and sales of convertible obligations inside the United States and to U.S. persons if there are "arrangements reasonably designed" to ensure that the bearer form obligations into which the convertible obligations may be converted will not be sold to U.S. persons (other than exempt purchasers). If appropriate safeguards are followed, the offer or sale (and any subsequent conversion) of the convertible obligations should not subject issuers to issuer sanctions or to the loss of portfolio interest treatment for interest paid to non-U.S. persons.

We believe that the issuance of convertible obligations, in accordance with the safeguards described below, is consistent with the statutory requirement that bearer form obligations be issued pursuant to "arrangements reasonably designed" to ensure their sale only to non-U.S. persons.* We recommend that Regulation § 5f.103-1(e)(2) (or, alternatively, Regulation § 1.163-5(c)(1) or (2)) and Temporary Regulation § 35a.9999-5(c), Q&A-18, be amended to provide that convertibility into bearer form of a registered form obligation meeting the following requirements will not cause the obligation to be treated as a bearer form obligation for purposes of Section 163(f)(2)(B):

(i) the convertible obligation may be converted into bearer form only (A) at an office of the issuer or its agent (the "Exchange Agent") outside the United States and (B) upon receipt by the issuer or the Exchange Agent of a certificate stating that the bearer form obligation (the "converted bearer obligation") is not being acquired by or on behalf of a U.S. person, or, if a beneficial interest in the obligation is being acquired by a U.S. person, that such person is a U.S. financial institution purchasing for its own account or for the account of a customer that holds the bearer form obligation through such U.S. financial institution, and

* While the convertible obligation would be the "obligation" described in Section 163(f)(2)(B)(i), that Section should be read merely as requiring that, at the time of the original issuance of a debt obligation, there are arrangements reasonably designed to ensure that the obligation will be initially sold in bearer form only to a person who is not a U.S. person.

that the U.S financial institution agrees to comply with the requirements of Section 165(j)(3)(A), (B) or (C) and the regulations there under. When a certificate is provided by a clearing organization, it must be based on statements provided to it by its member organizations, including statements made pursuant to a blanket certification of a type described above. For purposes of this paragraph, the conversion of a convertible obligation should be considered to take place outside the United States notwithstanding that the convertible obligation is delivered to the issuer (or its agent), or the book-entry system that reflects the convertible obligation is maintained, in the United States, provided that the converted bearer obligation is delivered outside the United States;

(ii) if the convertible obligation is presented for conversion at a time that the bearer form obligations are still represented by a temporary global security and the issuer has not yet made definitive bearer form obligations available, the person entitled to delivery of the converted bearer obligation may not receive such obligation from the issuer or the Exchange Agent and may only receive an interest in the temporary global security;

(iii) the converted bearer obligation must comply with the leg ending and place of payment requirements of Regulation § 1.163-5(c)(1)(ii); and

(iv) if any distributor of bearer form obligations that are a part of the offering that includes the convertible obligation acquires a converted bearer obligation

during the restricted period, such distributor will be subject to all of the restrictions of Regulation § 1.163-5(c)(2)(i)(D) with respect to that converted bearer obligation.

These procedures are designed to ensure that converted bearer obligations are initially held only by non-U.S. persons (or by exempt purchasers) outside the United States and are consistent with the statutory requirement of Section 163(f)(2)(B)(i) of the Code. More generally, the proposed restrictions would appropriately treat a converted bearer obligation in the same manner as obligations initially offered in bearer form. During the restricted period, any converted bearer obligation held by a distributor would be subject to all of the restrictions that the D Rules impose with respect to any other bearer from obligations of that offering held by the distributor. Both during the restricted period and thereafter, the conversion restrictions described above would provide further assurance that resales of convertible obligations or converted bearer obligations would not contravene the policies underlying Section 163(f).

Because our recommendations would amend the definition of "registered form", convertible obligations would be so treated for purposes of Section 165(j) while in registered form. This is sensible since there will, in fact, be record ownership during any such period.

We recognize that the IRS and Treasury are concerned that offers or sales of convertible obligations in the United States or to U.S. persons, without adequate safeguards, may increase the likelihood that bearer form obligations will enter the U.S. market. We believe, however, that the foregoing

procedures satisfy the "arrangements reasonably designed" standard of Section 163(f)(2)(B) and that offers, sales and subsequent conversions of convertible obligations under such circumstances will create no greater risk of the distribution of a bearer form obligation inside the United States or to a U.S. person than does an original issuance of bearer form obligations under either the current or the Proposed Regulations.

Additionally, the Regulations that permit offers and sales in the United States or to U.S. persons of registered form obligations that are convertible into bearer form should also permit the conversion of registered form obligations originally issued in the United States or to U.S. persons into targeted registered form obligations, assuming that procedures similar to those described above are satisfied.

IV. Other Recommendations.

In connection with the reconsideration by the IRS of issues relating to short-term bearer form obligations sold in foreign capital markets and the proposed revisions to the pass-through certificate rules, we believe that the following three issues should be considered:

1. Q&A-6 of Temporary Regulation § 35a.9999-5(a) provides that U.S.-source original issue discount on an obligation that is payable six months or less from the date of its original issue* is exempt from information reporting and backup withholding if the requirements of Q&A-5 are met, among which is the requirement that the obligation have a face amount

* Presumably, this provision was intended to apply to obligations described in Section 871(g) of the Code, i.e., those with a maturity at issue of 183 days or less.

of not less than $500,000. While the Proposed Regulations amend Q&A-6 to provide that an obligation with a maturity at issue of 90 days or less is exempt from the certification requirement of Proposed Rule (D)(7), the minimum denomination requirement was left intact.

Presumably, the $500,000 minimum denomination requirement is intended to ensure that these short-term obligations are not purchased by U.S. individuals. Q&A-5, however, also requires that such obligations be issued in accordance with Section 163(f)(2)(B) (with the exception of the legending requirement of Section 163(f)(2)(B)(ii)(II)) and the regulations thereunder. There is no corresponding restriction on the denomination of bearer form obligations with an original maturity of more than 183 days, which must be issued in accordance with Section 163(f)(2)(B) of the Code in order for interest to qualify as portfolio interest under Sections 871(h) and 881(c) of the Code, and it is therefore unclear why any minimum denomination is necessary to ensure that original issue discount obligations described in Q&A-6 are not sold to U.S. persons. The fact that the holder sanctions of Sections 165(j) and 1287(a) of the Code do not apply is irrelevant, since the holder sanctions are equally inapplicable to obligations with a maturity of more than 183 days but not more than one year.

Additionally, there is an ambiguity in the $500,000 requirement for foreign currency-denominated commercial paper. Q&A-5 requires that the face amount of the obligation be at least $500,000 but does not state, in the case of a foreign currency-denominated obligation, when satisfaction of the $500,000 requirement is to be determined. Thus, an obligation issued in foreign currency, the face amount of which, if converted to U.S. dollars on the date of issuance, would exceed $500,000 could be

deemed to fail to satisfy Q&A-5 if the foreign currency depreciates such that the face amount of the obligation, measured in U.S. dollars on the maturity date, is less than $500,000. If the $500,000 requirement is retained, the regulations should confirm that, with respect to obligations denominated in a currency other than U.S. dollars, compliance will be measured as of the obligation's issue date.

In our experience, the $500,000 minimum denomination rule has impeded access by U.S. issuers to foreign commercial paper markets, putting them at a competitive disadvantage. In the absence of any clear compliance benefit, we would recommend its elimination.

2. Section 871(h)(2)(A) of the Code provides that "the term 'portfolio interest' means any interest (including original issue discount) . . . which is paid on an obligation which is not in registered form, and is described in section 163(f)(2)(B)". Section 163(f)(2)(B) requires, among other things, that on the face of the obligation there be a statement that any U.S. person who holds the obligation will be subject to limitations under the U.S. income tax laws.

In the case of a bearer form obligation that is not issued by a natural person, is of a type offered to the public and has a maturity at issue of more than one year, the bearer form obligation will be issued in accordance with the requirements of Section 163(f)(2)(B) in order to avoid the imposition of issuer sanctions. While there is no difficulty in complying with the provisions of Section 163(f)(2)(B) in connection with the original issuance of bearer form obligations with a maturity at issue of 365 days or less (other than the difficulties relating to certification discussed above), we

believe that the IRS should consider eliminating the requirement that these obligations contain a statement that a U.S. person holding the obligation will be subject to limitations under the United States income tax laws. Because the holder sanctions of Sections 165(j) and 1287(a) are not applicable to holders of these obligations, the statement is both incorrect and misleading.

3. Temporary Regulation § l.l63-5T(d)(1) provides that "a pass-through certificate evidencing an interest in a pool of mortgage loans . . . treated as a trust of which the grantor is the owner (or similar evidence of interest in a similar pooled fund or pooled trust) ('pass-through certificate') is considered to be a 'registration-required obligation' under Section 163(f)(2)(A) and § 1.163-5(c) if the pass-through certificate is described in Section 163(f)(2)(A) and § 1.163-5(c) without regard to whether any obligation held by the fund or trust to which the pass-through certificate relates is described in Section 163(f)(2)(A) and § 1.163-5(c)." This provision has widely been interpreted as applying to pass-through certificates evidencing an interest in either secured or unsecured debt obligations. This interpretation is consistent with the legislative history of the repeal of the withholding tax on portfolio interest, which indicates that Congress considered all readily-negotiable pass-through certificates to be subject to the TEFRA registration requirements, not only those backed by mortgages.[*] We propose that Temporary Regulation § 1.163-5T(d)(1) be amended to confirm that the rules of that section apply to pass-through certificates backed by both secured and unsecured debt and recommend that this be done by deleting the word "mortgage" from the first sentence of the section.

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[*] See "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984," Joint Committee on Taxation, p. 396, fn.19.