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Current Issues in Public Finance:

New Regulations & Current Market Trends

Texas Association of County Auditors

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TOPICS OF DISCUSSION

- Introduction
- Dodd-Frank Act, Municipal Advisor Rule
- County Debt Instruments and The Debt Issuance Process
- Primary and Continuing Disclosure Obligations
- Municipal Advisory Council (MAC), Terrence Spencer

REGULATORY REFORM

DODD-FRANK ACT, MUNICIPAL ADVISOR RULE

TEXAS ASSOCIATION OF COUNTY AUDITORS

SECURITIES INDUSTRY REGULATORY REFORM

- Brought on principally by the economic crisis that began in 2007/2008

- Recent regulatory reform in the financial markets has been the most comprehensive since reforms instituted immediately after the Great Depression

- Dodd-Frank Act was a catalyst for widespread financial market reform, including in the municipal market

DODD-FRANK ACT

- **Had several broad goals**
  - Reduce Risk
  - Increase Transparency
- **Created a number of different agencies to study areas of concern and recommend further needed regulation**
- **Included a section that set the groundwork for general reform and increased regulation in the municipal market**
- **Signed into Federal law on July 21, 2010**

SEC MUNICIPAL ADVISOR RULE

- In September 2013, the SEC adopted final rules establishing registration requirements for **Municipal Advisors/Financial Advisors (MA's) required by the Dodd-Frank Act**
- Effective July 1, 2014
- Other ancillary rules to the MA Rule **(pay-to-play, gifts and gratuities, etc.)** are anticipated to come in 2015 from MSRB & SEC
- Has had a broad impact on the **conduct of MA's, Underwriters, and Issuers**

WHO IS A MUNICIPAL ADVISOR

- A "Municipal Advisor" (MA) is defined under the SEC Rule 15Ba1-1 as:

  - A person who is not a municipal entity or an employee of a municipal entity that:

    - (i) **provides advice to or on behalf of a municipal entity or obligated person** with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues;

    - or (ii) undertakes a **solicitation of a municipal entity or Issuer**

WHO IS NOT A MUNICIPAL ADVISOR

- SEC Rule 15Ba1-1 excludes these five groups from the definition of "Municipal Advisor":
  - **<u>Public officials and employees of municipal entities and obligated persons</u>**
  - Accountants
  - Banks
  - Persons responding, orally or in writing, to requests for proposals (RFPs) or qualifications (RFQs)
  - Registered brokers, dealers, and municipal securities dealers serving as an underwriter
  - Investment advisors
  - Commodity trading advisors or persons associated therewith providing swap advice
  - Attorneys offering legal advice
  - Engineers

What Do Issuers Need To Know About The Rule?

- **The rule and the SEC do not mandate the use of a MA**
- **As a practical matter issuers that may not have traditionally used MA's/FA's are considering engaging one**
- **May restrict information flow from underwriters if issuer does not have MA**
  - Without an exemption, an underwriter may not provide "advice" on issuance of municipal securities or municipal financial products
  - GFOA's Best Practice recommends that issuers hire a MA
- The **underwriter must disclose/define their role** with G-17 disclosure letter

How Does The Rule Effect Underwriters?

- **Underwriters do not want to be inadvertently classified as a MA because they cannot be underwriter**

  - Exemptions that allow underwriters to provide "advice"
    - It is in response to an RFP from an issuer
    - Issuer has affirmed in writing that they have "engaged" an MA (aka the Independent Registered Municipal Advisor (IRMA) exemption may be on their website or MAC website)
    - Underwriter is engaged on a specific bond transaction

County Debt Instruments

and

Issuance Process

AUTHORIZATION

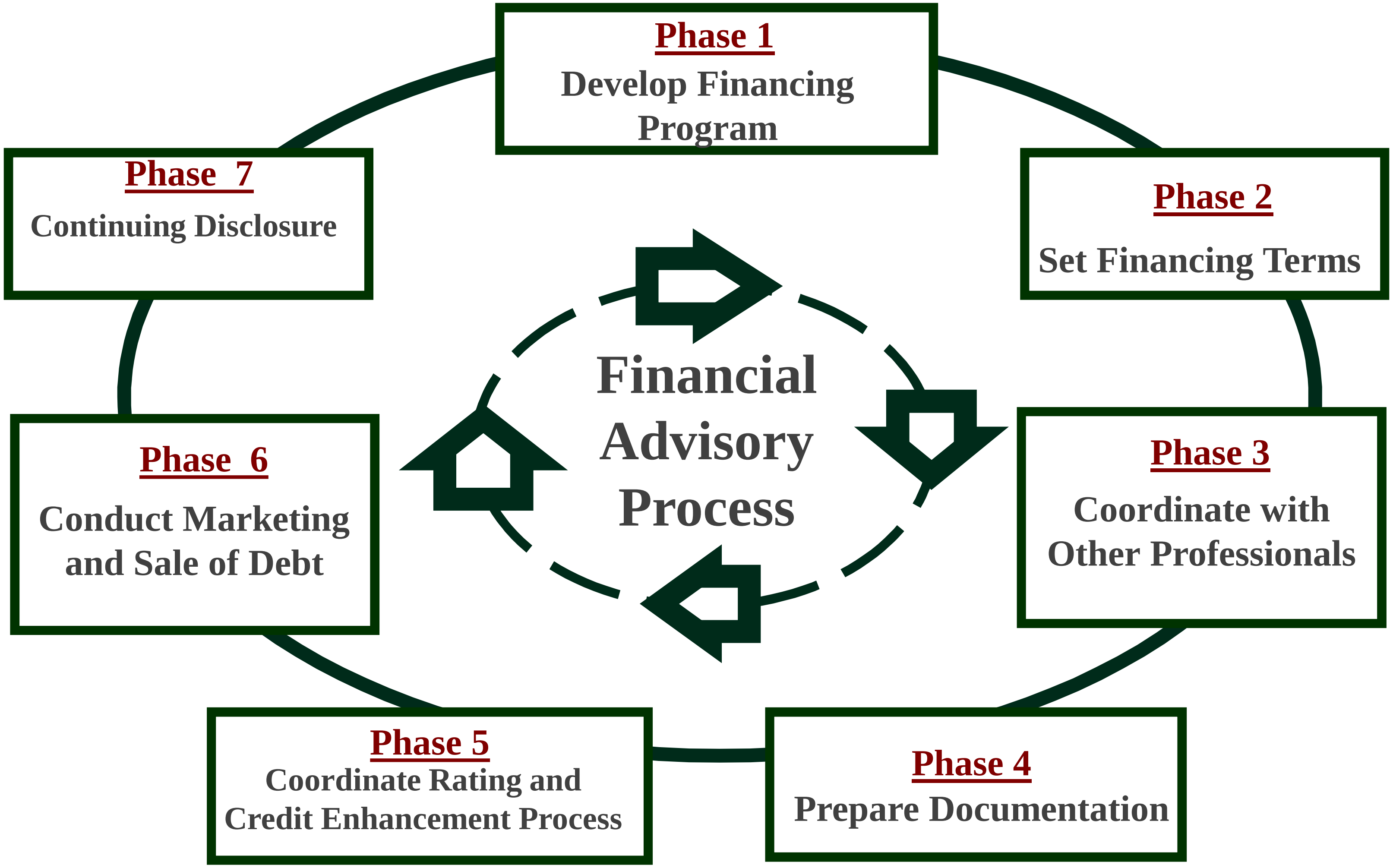
- When issued for public purpose, **interest earnings on municipal bonds are exempt from federal taxation**

- Pursuant to the 1876 Texas Constitution, a **County must have specific authorization to sell debt**

- If debt is incurred in ways other than those authorized by State law it is not enforceable

- **The Attorney General approves all bond issues** as to conformance with State law; once approved the bonds become incontestable

THE DEBT ISSUANCE PROCESS



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County Debt Instruments

- Property Tax Obligations – secured by pledge of ad valorem property taxes
    - **Viewed as County's most secured obligations.**
    - General Obligation Bonds, Certificates of Obligation, Contractual Obligations, Anticipation Notes.
- Revenue Obligations – secured and paid solely from certain revenues (Convention Center/County Events Center, Parking System Revenue, Hotel Occupancy Taxes, Sales Taxes, Land Fill, and other pledgeable revenues)

GENERAL OBLIGATION BONDS

- **Require a bond election** for authorization **(must be voted on one of the two uniform election dates in May and November), and bonds are specifically authorized and issued for public purposes.**

- **Unlimited Tax:** County Road Construction, debt to Assessed Valuation may not exceed 25% of Real Property Value.

- **Limited Tax:** Permanent improvements such as Jails, Buildings, etc. secured solely from a County's $0.80 tax rate. The Attorney General will generally not approve bonds if the maximum debt tax rate exceeds $0.40 at 90% collections.

- Upon a successful bond election, the County can issue all or a portion of the GO bonds as needed.

CERTIFICATES OF OBLIGATION

- **No Bond Election Required, a Notice of Intent to issue required to be published in newspaper of general circulation in County at least 31 days before the sale date.**

- **COs are subject to referendum by petition of at least 5% of the registered voters.**

- **When secured by pledge of ad valorem tax only:**

  - Constructing and equipping Jail facilities
    - Private use issues affect tax exempt status

  - County owned building, bridges, acquisition of right-of-way

- **When secured by combination tax and revenue pledge**

  - All the above, plus road improvements, machinery, equipment, land, etc.

- **COs sell at rates equal to the County's GO Bonds.**

  - Paid from the $0.80 tax rate

CONTRACTUAL OBLIGATIONS

- **Acquisition of personal property only**. Multiple equipment acquisitions can be grouped in a single issue. Used as a cost effective alternative to lease financing.
- **No voter authorization or notice of intent,** authorized by an order adopted by the Commissioners Court.
- Considered as debt for effective tax rate calculation purposes when backed by tax, so not subject to rollback.
- Paid from $0.80 tax.

ANTICIPATION NOTES

- **No voter approval, not subject to petition**
- **Any Public Purpose:**
  - Purchase buildings, land, machinery, equipment, etc.
- **Can be secured by and are payable from a pledge of taxes, revenues or both**
- **Order authorized by the Commissioners Court**
  - Maximum maturity of <u>seven years</u>.
- **Not subject to rollback, paid from $0.80 tax.**

REVENUE BONDS

- **Secured and paid solely from certain revenues such as:**
  - Toll Roads
  - Convention Centers/Community Events Centers
  - Parks
  - Land Fill
  - Other statutory authorized purposes
  - Parking System taxes, Hotel Occupancy, Sales Tax, Venue Taxes
- **Typically rated below a County's general obligation (tax supported) debt which leads to higher interest rates**
- **Require a debt service reserve fund to be maintained; usually equal to one year's annual debt service requirement**
- **Require bond covenants such as an additional bonds test and rate covenants to produce a minimum debt service coverage factor**
- **Rating/marketability sensitive to historical operations**

Common County Debt Instruments Summary

	General Obligation Bonds	Certificates of Obligation	Contractual Obligations ("PPFCOs")	Anticipation Notes	Revenue Bonds
Issuing Entity	County	County	County	County	County
Approval Process	Bond election (May and November)	Commissioner's Court approval of Notice of Intent	Commissioners Court	Commissioners Court	Commissioners Court
Security/Pledge	Taxes only	Taxes and/or revenues	Taxes and/or revenues	Taxes and/or revenues	Enterprise revenues, Venue taxes, Sales tax, Hotel occupancy, etc.
Other Considerations	If the election fails, how does the city address needs?	Subject to petition by 5% of registered voters	May only be issued for personal property	Maximum maturity - 7 years	Coverage requirements, additional bonds rest, debt service reserve fund requirement
Typical Projects	Any public purpose	Limited purpose with no revenue pledge Any public purpose with reserve pledge	Personal property	Any public purpose (7 yrs) and cash flow deficit (1 yr)	Airports, parks, sports facilities.
Ratings	Highest rated credit based on ad valorem tax pledge				Typically 1 to 2 notches lower than a county's tax credit

TEXAS ASSOCIATION OF COUNTY AUDITORS

PROFESSIONALS INVOLVED

- **Financial Advisor("FA")/Municipal Advisor ("MA")**
  - Liaison between the bond market and County; Fiduciary to the County
  - Possesses specialized knowledge with main goal to net the most advantageous financing to the County
- **Bond Counsel**
  - Researches the law at the direction of the County and its FA for effective financing and structuring options
  - Renders legal opinion that ensures bonds are exempt from Federal income taxes
  - Assembles the transcript to submit to the Attorney General for approval
- **Underwriter (Not "MA")**
  - Purchases the bonds at either public or private sale and markets bonds to the ultimate holders

PROFESSIONALS INVOLVED (CONT.)

- **Paying Agent**
  - A financial institution, retained by the County, that tracks ownership of the bonds and coordinates the process of bond payments for the County to the bondholder

- **Rating Agency**
  - Organizations representing the bond market that evaluate the credit quality of a debt instrument and assign credit ratings (Standard & Poor's, Fitch & Moody's)

- **Insurance Provider**
  - Bond insurance companies that guarantee the payment of principal and interest to bondholders for a one-time upfront fee. Bond insurance is only purchased if it makes economic sense
    - Bond insurance is not as prevalent in the market as it once was

Sources of Financing

➢ Open Market Financing

- **Public Sale**
  - Requires offering document (Official Statement) and Ratings
  - Underwriter sells bonds to multiple investors
  - Can be competitively bid or negotiated directly with the underwriters

- **Private Sale (Private Placement)**
  - Generally does not require ratings or offering documents
  - Can be bid or negotiated

FACTORS INFLUENCING SALE METHOD

Competitive

- High credit quality of bonds
- Well known/frequent issuer
- Stable bond market
- Simple bond structure such that bond size is not dependent on how the bonds are priced

Negotiated

- Need for flexibility in pricing due to structure (advance refundings or revenue constraints) and/or timing
- Need for active pre-marketing due to market saturation, complicated or troubled credit, or unknown credit

RATING FACTORS

- **Comparing the County to a set of predetermined standards and other similar issuers across the nation**

- **Combination of objective and subjective analysis**

- **Credit ratings are based on a variety of factors:**

  - Revenue source and legal covenants pledged to the bonds
  - Diversification and stability of the County's tax/revenue base
  - On-going capital needs, financial reports and historical trends
  - Financial policies/procedures
  - Management

Credit Rating Scales

	Fitch Investors Service	Moody's Investors Service	Standard & Poor's Rating Service
Highest	AAA	Aaa	AAA
	AA+	Aa1	AA+
	AA	Aa2	AA
	AA-	Aa3	AA-
	A+	A1	A+
	A	A2	A
	A-	A3	A-
	BBB+	Baa1	BBB+
	BBB	Baa2	BBB
	BBB-	Baa3	BBB-
Lowest	NON-INVESTMENT GRADE		

Rating vs. Interest Rate

Has Inverse Correlation

Rating Assigned	Interest Rate

The higher the rating the lower the interest rate and the cost of bond insurance.

The opposite applies as well.

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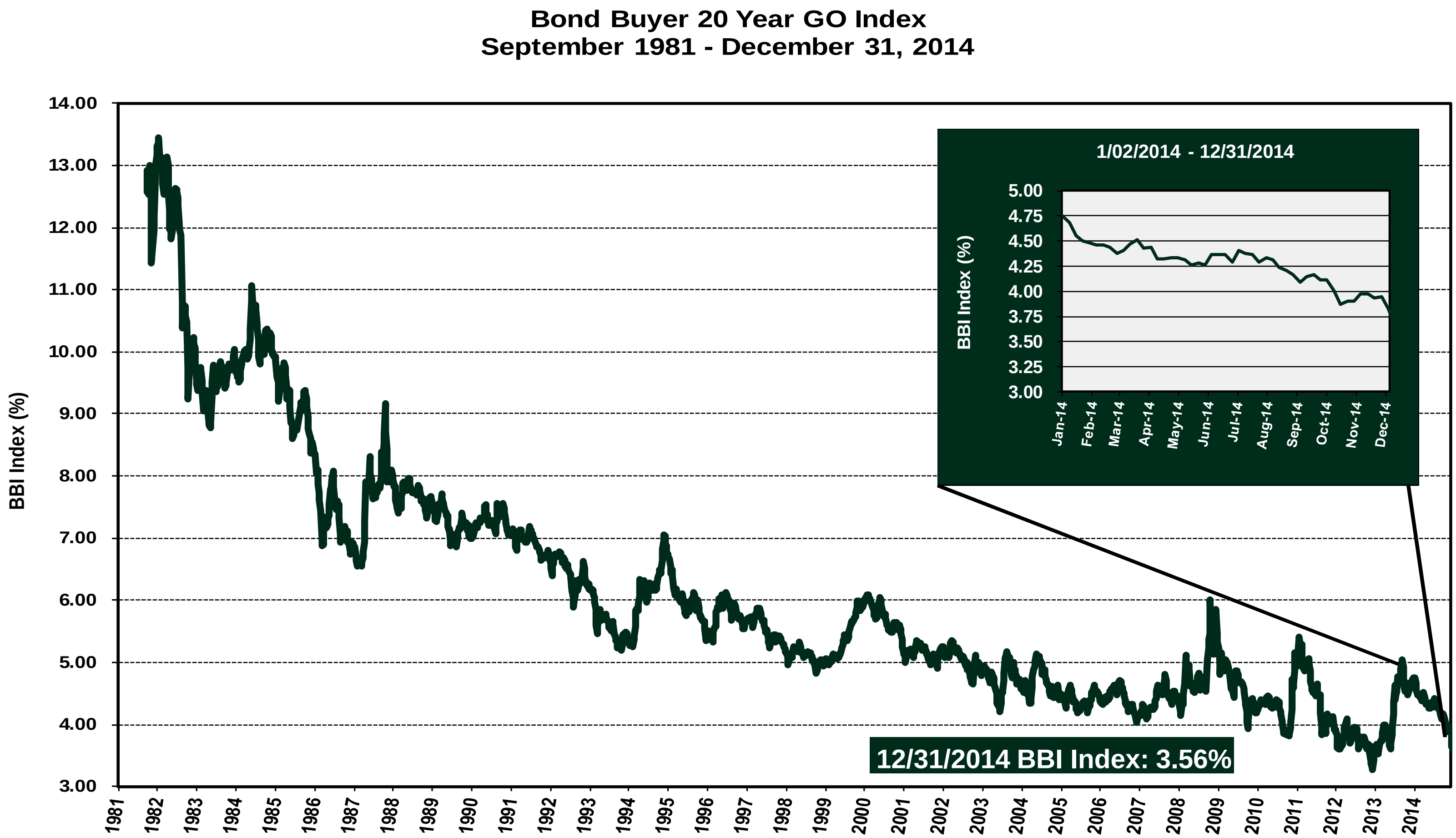
MUNICIPAL BOND INTEREST RATE ENVIRONMENT



Bond Buyer 20 Year GO Index is a weekly index estimating the composite yield on 20 general obligation bonds rated "A" or better.

This graph depicts historical interest rates. Future interest rates are dependent upon many factors such as, but not limited to, interest rate trends, tax rates, the supply and demand of short term securities, changes in laws, rules and regulations, as well as changes in credit quality and rating agency considerations. The effect of changes in such factors individually or in any combination could materially affect the relationships and effective interest rates. These results should be viewed with these potential changes in mind as well as the understanding that there may be interruptions in the short term market or no market may exist at all.

THE IMPORTANCE OF PRIMARY AND CONTINUING DISCLOSURE

PRIMARY AND CONTINUING DISCLOSURE

- **Primary Disclosure** – Official Statement; representations to rating agencies, initial sale of the obligations
- **Continuing Disclosure** – Annual obligation to file timely and accurate information including timely filings of material events

CONTINUING DISCLOSURE - SEC RULE 15C2-12 (ANNUALLY)

- Obligates issuers to **file accurate annual financial information** and notices of material events to improve disclosure in Secondary Market

- Prohibits dealers and underwriters from buying new offering of municipal securities unless the 15c2-12 obligation is met

REQUIRED DISCLOSURE EVENTS (10 BUSINESS DAYS FROM OCCURRENCE)

1. Principal and interest payment delinquencies
2. Unscheduled draws on debt service reserves reflecting financial difficulties
3. Unscheduled draws on credit enhancements reflecting financial difficulties
4. Substitution of credit or liquidity providers, or their failure to perform
5. Adverse tax opinions
6. Defeasances
7. Rating changes
8. The issuance by the IRS of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the securities
9. Tender offers
10. Bankruptcy, insolvency, receivership or similar proceeding

(CONT.)

11. Non-payment related defaults
12. Modifications to rights of security holders (changes to bond covenants or the continuing disclosure agreement)
13. Bond calls
14. Release, substitution, or sale of property securing repayment of the securities
15. Mergers, consolidations, acquisitions, the sale of all or substantially all of the assets of the obligated person or their termination
16. Appointment of a successor or additional trustee or the change of the name of a trustee

IMPORTANCE OF DISCLOSURE

- The SEC has direct authority over investment banking firms and MA's - **currently, it does not directly oversee the municipalities**

- With no action from Congress, the SEC turned to one of its most powerful tool - "**enforcement actions**"

- The agency filed its first securities case against a state in 2010, charging it with misleading investors about two major pension funds and also fined four former City officials for misleading investors about the city's fiscal problems

- The obvious message is regardless of size and frequency of issuance the <u>SEC is motivated</u>, and is devoting the resources necessary to detect and prosecute violations

RESULT OF NON-COMPLIANCE

- Restricts access to the market
- Disclosure for 5 years in Official Statement
- Could effect borrowing costs and bond ratings, and even issuance timing
- Whether positive or negative disclosing accurate and complete information is critical to issuers, investors and muni-market
- **Inaccurate statements could be considered securities fraud**
- **Issuers, are ultimately responsible for content of their documents – Primary (initial sale) and Secondary (continuing disclosure)**

SEC'S MCDC SELF-REPORTING INITIATIVE

- **In March 2014, SEC passed the Municipalities Continuing Disclosure Cooperation (MCDC) Initiative**

- **Opportunity for issuers, as well as underwriters, to self-report inaccurate statements regarding disclosure compliance made in the last five years in an issuer's official statement**

- **Limits the penalties to both issuers and underwriters if they self-report**
  - September 9, 2014 deadline for underwriters
  - December 1, 2014 deadline for issuers
  - SEC threatened harsher settlement/penalties for violations that are not self-reported

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SEC's MCDC Self-Reporting Initiative

- **For issuers**
  - Agree to cease and desist; no civil penalty
  - Bring disclosure filings up to date and establish procedures to ensure future compliance
  - Cooperate with SEC's review of any false statements related to disclosure compliance, including the parties involved in making them
  - Disclose settlement with the SEC for a 5 year period in any official statements

- **For underwriters, among other items, a monetary penalty that is capped for each firm**

RECOMMENDED POLICIES AND PROCEDURES

- **Individual responsible for filing deadlines of continuing disclosure**
- **Process for draft and review for accuracy of information**
- **Identify roles of professionals**
  - Financial Advisor
  - Bond Counsel
  - Disclosure Counsel
  - Underwriters Counsel for primary disclosure and Continuing Disclosure

WHERE TO GO FOR INFORMATION

- Provides information required for disclosure and use of Electronic Municipal Market Access (EMMA)
- MSRB created a State and Local Government Toolkit at http://www.msrb.org/MSRB-For/Issuers/Issuer-Toolkit.aspx
- GFOA Best Practices http://www.gfoa.org/index.php?option=com_content&task=view&id=1588
- Municipal Advisory Council (MAC) https://www.mactexas.com/