INTERNATIONAL MUNICIPAL LAWYERS ASSOCIATION
2011 ANNUAL CONFERENCE – CHICAGO, ILLINOIS

THE ELEPHANT IN THE ROOM

THREE KEY TOPICS IN MUNICIPAL FINANCE

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In today's economic climate, more and more municipalities are turning to creative financing arrangements in order to raise much needed funds. As lawyers, we are charged with knowing the ever-increasing number of rules and procedures imposed by regulatory bodies on such arrangements. This outline highlights three key topics with which the municipal lawyer must be intimately familiar.

I.	Regulation of Municipal Advisors – MSRB and SEC Rules/Dodd-Frank Act
II.	Post-Issuance Compliance Written Procedures – An IRS Priority
III.	The Rise of Multi-State Issuers – Important Considerations For Local Governments

I. Regulation of Municipal Advisors – MSRB and SEC Rules/Dodd-Frank Act

Most units of government consult with municipal advisors when reviewing their finances and considering structuring debt. The conduct of municipal advisors is significantly impacted by rules proposed or finalized by the Municipal Service Rulemaking Board ("*MSRB*") and the Securities and Exchange Commission (*"SEC"),* and the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111-203 (the "*Dodd-Frank Act*"). Municipal lawyers should be aware of the rules regarding municipal advisors in order to fully protect the municipality. Municipal lawyers as a practice should confirm that the municipal advisor is registered with both the MSRB and the SEC as required under the applicable federal rules.

A. Who is a "Municipal Advisor"?

1. Firms and individuals who provide advice to municipal entities and obligated persons on municipal financial products or the issuance of municipal securities. *See Dodd-Frank Act, Sec. 975.*

2. Firms and individuals that solicit certain types of business from municipal entities on behalf of third-party broker-dealers, investment advisors, and municipal advisors (which, together with 1 above constitutes "Municipal Advisory Activities"). *See Dodd-Frank Act, Sec. 975.*

3. Not the lawyer for a municipal entity or a registered broker-dealer acting on behalf of a municipal entity.

B. Individuals Deemed Municipal Advisors If Engaged In Municipal Advisory Activities:

1. Financial Advisors

2. Guaranteed Investment Contract Brokers

3. Placement Agents

4. Swap Advisors

5. Third-Party Marketers

C. Regulation of Municipal Advisors

1. Fiduciary Duty and Fair Dealing

a) Municipal advisors owe a federal fiduciary duty to municipal clients. "Fiduciary duty" includes a duty of loyalty and a duty of care. This duty requires the municipal advisor to put his client's interests ahead of his own. *See Proposed MSRB Rule G-36.*

b) These duties do not apply to solicitors, those involved solely in marketing activities.

c) Municipal advisors must deal fairly with all persons and shall not engage in any fraudulent, manipulative, deceptive, dishonest, or unfair act or practice. The duty of fair dealing extends even to non-clients. *See the Dodd-Frank Act and MSRB Rule G-17.*

d) Municipal advisors are required to (i) disclose to clients all material conflicts of interest; (ii) obtain written acknowledgement or consent to any such conflict(s); (iii) provide written disclosure of direct and indirect compensation; (iv) provide written disclosure of conflicts of interest with respect to compensation structures; (v) seek compensation which is not excessive; (vi) make truthful and accurate representations to clients; (vii) not receive kickbacks or enter certain fee-splitting arrangements with underwriters or dealers; (viii) undertake only those engagements for which the capacity, resources and knowledge to render informed advice are available; (ix) the municipal advisor must conclude

that any transaction or product recommended be appropriate (can be disclaimed) and (x) disclose material risks relating to transactions or products, regardless of who recommended such transaction or product (can be disclaimed). *See Proposed Interpretive Notice to Rule G-17.*

2. Registration

a) Any firm or individual engaged in municipal advisory activities must register with the MSRB and the SEC. *See SEC Rule 15Ba2-6T (remains effective through December 31, 2011).* A municipal lawyer should consult the MSRB and SEC websites to ensure that a municipal advisor is registered.

b) A Sampling of Registered Municipal Advisors as of August 1, 2011:

(1) Abacus Investments, Inc.
(2) Bank of America, N.A.
(3) Barclays Capital , Inc.
(4) BMO Harris Bank, N.A.
(5) Cabrera Capital Markets, LLC
(6) Credit Suisse Securities (USA) LLC
(7) Deutsche Bank Securities, Inc.
(8) J.P. Morgan Securities, Inc.
(9) Loop Capital Markets
(10) Merrill Lynch Pierce Fenner & Smith/Fixed Income
(11) Oppenheimer & Co., Inc.
(12) Popular Securities, Inc.
(13) Ramirez & Co., Inc.
(14) U.S. Bank Municipal Securities Group
(15) Wells Fargo Bank, N.A. Municipal Products Group

3. Supervision of Municipal Advisory Activities. Municipal Advisors must establish and maintain a system to supervise the municipal advisory activities of associated persons. The minimum requirements of a supervisory system include:

a) Written procedures;

b) Identifying one or more Municipal Advisor principal(s) based on experience or training;

c) Designating the Municipal Advisor principals and their responsibilities regarding supervision; and

d) Conducting an annual compliance interview or meeting to discuss compliance matters. *See MSRB Draft Rule G-44.*

4. Political contributions. If certain partners, directors, officers, and employees of a firm, or any individual engaged in municipal advisory activities with a municipal entity, make political contributions in any jurisdiction, the contributions must be documented and reported to the MSRB. These firms or individuals may not be able to be compensated for the performance of municipal advisory activities in a jurisdiction where such contributions are made. *See MSRB Proposed Rule G-42*.

5. Gifts and gratuities

a) Firms or individuals engaged in municipal advisory activities will not be permitted to make or allow gifts to be made, directly or indirectly, in relation to their municipal advisory activities, to any municipal entity officials or affiliated parties of more than $100 per year.

b) Limited Exclusions: (i) certain occasional gifts of meals or tickets to theatrical, sporting, and other entertainments; (ii) certain legitimate business functions; (iii) certain gifts of reminder advertising; and (iv) contracts for employment or compensation provided that they are in writing, in place prior to the employment or rendering of services, and written consent from the such party's employer has been received. *See MSRB Proposed Rule 20.*

c) Recordkeeping: Municipal Advisors have to create, maintain and preserve records of any gifts and contracts referred to in 5a and 5b as well as any compensation paid pursuant to said contracts. *See Proposed Amendments to MSRB Rules G-8 and G-9.*

D. Additional Information

1. Laws, rules and proposed rules cited herein.

2. SEC and MSRB Websites.

3. MSRB Webinar, "MSRB Fiduciary Duty and Fair Dealing Requirements For Comment" - http://www.msrb.org/msrb1/online-education.asp

E. Latest Developments – to be provided at the Conference presentation.

II. Post-Issuance Compliance Written Procedures – An IRS Priority

The Internal Revenue Service (the "IRS") has indicated that best practices require that municipalities create written post-issuance compliance procedures. *See IRS amended Form 8038.* In addition, the IRS sent out an Advance Refunding Bonds Compliance Check Questionnaire (the "*Questionnaire*") to certain issuers and conduit borrowers which specifically asked whether issuers or conduit borrowers have certain procedures in place relating to the advance refunding of bonds.

Post-issuance compliance written procedures has become a high priority for the IRS. Local governmental issuers of tax-exempt debt should either have written procedures in place or make sure that conduit borrowers have written procedures in place before responding to any questionnaires or completing any Form 8038 so that they can respond affirmatively to any IRS inquiry and avoid a possible audit.

A. IRS Form 8038 specifically require the issuer to note if:

1. The issuer has established written procedures to ensure that all nonqualified bonds of the issue are remediated in accordance with the requirements under the Internal Revenue Code of 1986 (the "*Code*") and Regulations. (*See line 43 of IRS Form 8038, "Information Return for Tax-Exempt Private Activity Bond Issues")* and

2. The issuer has established written procedures to monitor the requirements of Section 148 of the Code (relating to arbitrage rebate). (*See line 44 of IRS Form 8038, "Information Return for Tax-Exempt Private Activity Bond Issues").*

B. The Advance Refunding Questionnaire – On May 2011, the IRS prepared a questionnaire to evaluate the post-issuance compliance and record retention policies and practices of issuers and conduit borrowers of tax-exempt advance refunding bonds. The IRS sent out the questionnaire to 269 governmental units that issued advance refunding bonds between July 1, 2009, and June 30, 2010, to refinance governmental bonds and 31 exempt organizations benefitting from advance refunding bonds issued between July 1, 2009, and June 30, 2010, to refinance qualified 501(c)(3) bonds.

1. The questionnaire asked about procedures in the following areas:

a) Debt management

b) Assuring compliance with federal tax requirements related to advance refunding

c) Arbitrage yield restriction and rebate

d) Determining issue price

e) Record retention

f) Post-issuance compliance and educational resources

C. Advantages to a Pro-active Approach By Municipalities. Municipal lawyers should advise and assist municipalities in developing and adopting written post-issuance compliance procedures well in advance of responding to any IRS questionnaires or completing any new Form 8038. A pro-active versus reactive approach has the following advantages:

1. Municipalities have enough time to develop well thought-out procedures consistent with a municipality's institutional capabilities and processes.

2. Municipalities have enough time to develop procedures that are correct and take into account any differences among different varieties of bond issues.

3. Municipalities do not have to revisit the post-issuance compliance question every time they issue a Bond.

4. Municipalities that adopt written post-issuance compliance procedures as a priority are more likely to ensure that borrowers of tax-exempt will also have good written post-issuance compliance procedures.

D. Recommendations

1. Prepare and adopt post-issuance compliance written procedures.

2. Identify parties responsible for implementing procedures.

3. Written procedures should include the monitoring of:

a) Use/ownership of project

b) Expenditure of tax-exempt debt proceeds

c) Investment of tax-exempt debt proceeds

d) Private use

e) Financial contracts

f) Change of use

g) Remediation procedures

h) Arbitrage rebate procedures

i) Record retention

j) Advance refunding of bonds

4. Municipalities should enter into an agreement with conduit borrowers that outlines procedures for responding to any IRS inquiry.

III. **The Rise of Multi-State Issuers – important considerations for local governments**

Multi-state issuers of tax-exempt debt ("*Multi-State Issuers*") have become more prevalent in recent years as alternatives to traditional local conduit issuers. Multi-State Issuers are incorporated "authorities" that can issue conduit tax-exempt debt for projects located outside of the state where the Multi-State Issuer is located.

A. Two General Categories. Multi-State Issuers can be divided into two general categories:

1. Those that issue tax-exempt debt to finance out of state projects for borrowers who have a nexus to the state where the Multi-State Issuer is incorporated; and

2. Those that issue tax-exempt debt to finance out of state projects for borrowers whether or not the borrower has a nexus to the state where the Multi-State Issuer is incorporated.

B. Multi-State Issuers include:

1. Public Finance Authority ("PFA")

2. Colorado Educational and Cultural Facilities Authority ("CECFA")

3. Missouri Health & Educational Facilities Authority ("MHEFA")

4. Industrial Development Authority-City of Phoenix Arizona ("IDAPA")

5. California Statewide Communities Development Authority ("CSCDA")

6. Virginia Small Business Financing Authority ("VSBFA")

7. California Municipal Finance Authority ("CMFA")

8. Indiana Financing Authority ("IFA")

9. Colorado Health Facilities Authority ("CHFA")

C. Multi-State Issuers' Issuing Authority. Multi-State Issuers rely on federal laws and the laws of the state in which they are incorporated for their issuing authority. As a result, even though certain projects almost completely by-pass local government scrutiny and control, they obtain tax-exempt debt financing which allows them to operate within local municipalities. Local governments do, however, retain some discretion as approval by the government in which the project is located is frequently required by federal tax law in order for the Multi-State Issuer to issue the tax-exempt debt *("TEFRA Host Approval").*

D. Reasons For Local Government Control and Oversight of Multi-State Issuers.

1. Control and oversight of economic development in the community.

2. Ability to apply public policy consistently.

3. Local government and community participation in decision-making regarding tax-exempt debt.

4. Protection of the community from any economic and physical risk.

5. Elimination of local government from any liability related to non-compliance with federal laws and regulations.

6. Control and oversight of project based in local government's jurisdiction.

E. Local governments should consider a myriad of issues when approached by a Multi-State Issuer or prospective conduit borrower with a request for approval of a proposed project.

1. Familiarity with the conduit borrower of tax-exempt debt proceeds.

2. Is project consistent with public policy?

3. What is the risk to community?

4. Who is accountable if project fails?

5. What is financial strength of project?

6. What is economic impact of the project?

7. What is local community's opinion regarding the project?

8. What assurance is there that the Multi-State Issuer and/or conduit borrower will comply with all applicable laws and regulations relating to the tax-exempt debt, including post-issuance compliance?

F. It is recommended that municipal lawyers adopt a formal policy that addresses the above issues and includes the following:

1. Application procedure

2. Information gathering

3. Payment of a fee (perhaps waiveable)

4. Require a standard set of indemnifications from Multi-State Issuer and conduit borrower.

5. Require continuing oversight of project and continuing disclosure from conduit borrower.

6. Require the conduit borrower and/or Multi-State Issuer to adopt written post-issuance compliance procedures and covenant to follow said procedures in the tax-exempt debt financing documents (e.g. tax certificate).

7. Require an agreement with conduit borrowers and/or Multi-State Issuer that outlines procedures for responding to any IRS inquiry.

G. Multi-State Issuer Topic Webinar.

Council of Development Finance Agencies webinar "Issuing Authorities with Nationwide Jurisdiction" - http://www.cdfa.net/cdfa/cdfaweb.nsf/pages/webcast14.html

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