Avoiding Troubled Tax-Advantaged Bonds

A Study of Issuer Compliance Considerations

by

The IRS Office of Tax Exempt Bonds

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Forward

The IRS Office of Tax Exempt Bonds (TEB) has been in a unique position for more than a decade to observe some of the worst problems in the municipal industry and witness the efforts taken by leaders in state and local government, the professional communities that support them, and various regulatory bodies to address many of the complex compliance issues facing issuers of tax-advantaged debt in the market today.

TEB's work on the yield-burning schemes of the 1990s was our first large scale exposure to the documented practice by some transaction participants of exposing their clients to the loss of tax exemption on their bonds and in many cases increasing the negative arbitrage on the transaction to the detriment of the state or local government or other entity that issued the bonds (Issuer). Today, we see the results of a multi-year investigation into bid rigging practices by bond transaction participants including individuals working for some of the largest banks in the world.

In addition to these two much discussed break downs in the municipal industry TEB has observed a wide range of compliance issues and a number of catastrophic debt meltdowns within the industry.

The municipal market has seen many types of fraud and other criminal activity, such as pay to play, contractor fraud, and securities law violations. In many cases, the fraud and corruption can result in the bond transaction violating federal tax law. In all cases, fraud and corruption can greatly increase the cost of borrowing. This report is intended to examine potentially problematic situations seen during the varied phases of a bond transaction and provide some considerations an Issuer may use to avoid substantial problems.

Members of the TEB Compliance Practice Research Team include Isabel Guerra, a Senior Tax Law Specialist with TEB's Compliance and Program Management staff and Carl Scott, who is the Technical Advisor TEB Field Operations. Prior to her appointment as a tax law specialist in TEB Ms. Guerra practiced extensively in the municipal industry in a variety of roles including: bond counsel, underwriter's counsel, issuer's counsel, and counsel for a bond insurance firm. Mr. Scott has been with TEB since 2001 serving in TEB's Field Operations as a group manager and revenue agent.

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Executive Summary

This initial product "*Avoiding Troubled Tax-Advantaged Bonds*" from the TEB Compliance Practice Research Team identifies a number of considerations for Issuers of municipal bonds and is the first step toward producing public resource products to assist Issuers in avoiding troubled transactions. It is not our intention for this effort to become a clearing house for a number of "Best Practices" guides that currently exist in the industry, but rather a starting point from which to develop tools to facilitate Issuer adoption of practices and procedures that work for their individual needs to avoid abusive or questionable transactions.

The report observes that each bond transaction is accomplished through a process consisting of related phases, each with various considerations of which an Issuer should be aware.

I - Transaction Development Phase

The quality of the professionals engaged by an Issuer for a bond transaction is one of the most important aspects of a successful transaction. Issuers who actively evaluate both the qualifications and performance of transaction participants are more likely to get the quality of service they expect. This requires the Issuer to be familiar with the roles of transaction participants, research and identify participants that will provide quality services to the Issuer, identify participants that may have competing interests, be aware of potential conflicts of interest, and set forth in appropriate documentation clear statements about the Issuer's expectations of the participants in the transaction.

Whether analyzing someone else's idea for a transaction; considering a transaction that is new or unique; evaluating the roles of transaction participants and the potential for conflicts of interest; or even dealing with the withdrawal of a transaction participant; maintaining established policies and procedures provide an Issuer the tools necessary to maintain federal tax compliance throughout the life of a tax-advantaged bond and reduce their exposure to financial loss.

II - Transaction Execution Phase

During the execution phase of a transaction Issuers want to avoid unpleasant surprises. This requires that Issuers: (1) evaluate whether a transaction meets the goals established during the development phase; (2) determine that transaction participants are ready to close prior to the closing date; (3) follow clear procedures to monitor comparable sales and evaluate the actual price received for their bonds; (4) develop and monitor investment policies to maximize return on investments.

III – Post-Issuance Phase

The failure of Issuers to meet their post issuance transaction responsibilities, as required by federal tax law and transaction documentation, result in the majority of violations identified by TEB.

Issuers should clearly establish who is responsible for: (1) accounting for how bond proceeds are used; (2) determining the bonds are not arbitrage bonds; and (3) monitoring continuing compliance with all transaction requirements. Written procedures are extremely helpful and training for responsible officers and employees is essential.

The information provided in greater detail in this report and the attached appendices may be useful in formulating policies customized to the needs of Issuers who want to avoid troubled tax-advantaged bonds.

Avoiding Troubled Tax-Advantaged Bonds

Phase I – Transaction Development

1. - The Issuer and Federal Tax Law

State or local governments or other entities that issue tax-advantaged bonds (Issuer) must comply with various federal tax laws and regulations before bond counsel or special tax counsel can conclude that interest on the bonds is excluded from gross income or the bonds are eligible for certain federal tax credits. After the issue date of bonds, responsibility for continued compliance is generally left to the Issuer.

IF:

An Issuer's bonds are not in compliance with federal tax law during the lifecycle of the bond transaction

An Issuer often relies on the certification of other transaction participants with respect to some aspects of each transaction. Examples include the issue price of the bonds, the fair market value of investments, and the yield on a swap. When these certifications are not accurate, the federal tax compliance of the bonds may be jeopardized. In addition, there may be a question as to whether the Issuer is in fact getting the best deal possible from its transaction participants.

TEB has evaluated many cases where participants in bond transactions have attempted to profit from a transaction illegally. Sometimes these actions have adverse tax implications and sometimes the result is simply that the Issuer pays more or receives less than they should have if the transaction were based on fair market value.

THEN:

The federal tax advantage is jeopardized and the Issuer can be exposed to significant financial losses due to non compliance and lack of adequate transaction structuring

Adopting processes or engaging in activities that improve tax compliance not only give the Issuer a measure of confidence but, may lead to instances in which the Issuer is armed with the knowledge to better evaluate the ideas proposed by its transaction participants and thus avoid tax compliance issues in the future as well as get the best deal possible.

2. - The Original Idea

We've all experienced it; an offer comes in the mail for a new credit card or a great deal on refinancing your home. Unsolicited offers are not limited to the mailbox and amazing as it may seem, these unsolicited deals are not always the value they purport to be.

IF:

The transaction was not originally the Issuer's idea

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Based on its investigations of abusive transactions, TEB believes that many abusive transactions are developed before the Issuer's need for financing has actually been determined. Abusive transactions come in many shapes and sizes and range from poor business practices to corrupt marketing plans. The following are examples of proposed transactions that could become problematic for an Issuer:

> A promoter is on a nationwide search for Issuers willing to do a transaction. Cost of issuance is being paid by the project, and in the event of non-origination the guarantees will cover other costs;
> A real estate developer proposes a new project that needs tax-exempt financing to make it viable; and
> An underwriter contacts the Issuer with an "opportunity" to refund a transaction or restructure an existing defeasance or refunding escrow fund.

Unfortunately, many legitimate transactions happen in much the same way the not so legitimate ones do, so it is often difficult to tell the difference. Increased vigilance and refusal to participate in a prepackaged transaction verses a transaction that is crafted for the Issuer's specific needs and objectives will go a long way to help eliminate abusive practices.

THEN:

The Issuer should analyze a proposed transaction to recognize and mitigate risks

If the transaction was not the Issuer's idea, the risks involved increase substantially. There is no magic formula to identify when the transaction being proposed will turn out to be an abusive arbitrage device, a project that unjustly enriches the developer and other "team" members, or simply business development for a promoter's firm.

During the subsequent discussion we will attempt to highlight certain realities facing Issuers of tax-advantaged bonds and the considerations they may use to assist them in spotting and solving problematic issues that arise during a transaction.

3. - The Role of Transaction Professionals

One of the most important features of any successful bond transaction is the quality of the professionals hired for the transaction. The municipal bond industry has seen a number of high profile cases where elected officials, governmental staff, bankers, and various transaction advisors have plead guilty or been convicted of some type of criminal activity related to municipal bonds. Scholars have studied how corruption affects the issuance of municipal bonds, estimating the "corruption penalty" to range from 6.6 to 10.4 basis points; nearly the same effect of a credit rating two notches lower.[1]

Several abusive transaction structures identified by the IRS have established a pre-packaged core team on the transaction including the underwriter, financial advisor, credit

[1] Alexander W. Butler, Larry Fauver, and Sandra Mortal, "Corruption, Political Connections, and Municipal Finance", The Society for Financial Studies, v22 n7 (2009): 2875

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enhancer, bond counsel or special tax counsel, and other transaction professionals. These "teams" frequently contained transaction participants with multiple roles, undefined roles, conflicts of interest, and self-established fees in a kind of take it or leave it package.

IF:

The Issuer is not sure who transaction participants are and what they are doing

The Issuer should be able to identify the key professionals in their financing team and understand the following:

The role(s) each professional plays in the transaction;
Any conflicts of interest;
Professional qualifications; and
Who hired the professional for the transaction?

There are many media reports of underwriters, advisors, and brokers being selected for a role in a bond transaction after having made inappropriate direct or indirect payments to public officials, their campaigns, or those who advise them. A clear understanding of the role and service to be provided by a transaction participant can help the Issuer steer clear of those who wish to participate in a transaction due to inappropriate business practices rather than as a result of an evaluation of their professional capacity.

The good news is that most professionals in the municipal bond community are highly qualified and exhibit the highest degree of professional standards, support their professional societies and organizations, and take their role in financing America's infrastucture as seriously and with as much dedication as anyone could ask for.

THEN:

The Issuer should identify who is truly working in its interests

While almost all municipal bond transaction professionals perform their role in a professional manner, the simple fact is that there is just too much money related to fees and services in the nearly $3.7 trillion dollar municipal market for some transaction participants to avoid the temptations presented. We have seen professionals at major banks overprice Treasury securities sold for refunding escrows[2] and we are currently reading about various transaction professionals pleading guilty to numerous felony charges for conspiring to cheat Issuers on investment contracts[3] related to bond transactions.

The first step to avoid hiring professionals, who are not true advocates of the Issuer, is for the Issuer to understand the role of each professional in the bond transaction. (A summary

[2] Over 3,500 individual bond transactions were identified in settlements of yield burning cases from the 1990s.
[3] Criminal charges were filed against 1 corporation and 19 individuals with the corporation and 13 individual pleading guilty and 3 convictions received along with nearly $800 million in fines, penalties, and restitution in on-going bid-rigging investigations.

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of the roles of the basic transaction professionals is included in Appendix A, *Summary of Roles of Transaction Professionals.*)

The next step for an Issuer is to understand the nature of the various, and sometimes complex, relationships between parties created in a bond transaction. The Issuer must understand what parties owe the Issuer fiduciary duties and are there to protect the Issuer's interests and which parties are on the other side of the transaction and are only required to deal with the Issuer in a fair manner. Bond counsel, financial advisors, and trustees are parties that generally act in a fiduciary capacity for the Issuer as evidenced by a transaction's structure and the engagement letters involved. Underwriters, underwriter's counsel, and investment providers are only required to deal with the Issuer in a fair manner. These parties do not have a direct contractual obligation to protect the interests of the Issuer with respect to the legal and financial elements of the transaction[4].

While attorneys have professional standards to deal with potential conflicts[5], it is important to understand that competing interests exist in many bond transactions. For example, the attorney may also be treating another transaction participant as their client. This does not necessarily indicate a problem, but should be a consideration when evaluating a proposal from someone else's attorney. The same is true of other transaction professionals whose primary function is to represent their own interests or the interests of another party to the transaction.

Understanding the role of transaction professionals is important. However, the Issuer's specific needs and objectives should be the driving force behind any criteria that may be used to select transaction participants. Considerations an Issuer may find useful in the selection process of various members of the transaction team that the Issuer will hire have been compiled and attached as Appendix B, *Considerations for Selection and Evaluation of Transaction Professionals,* hereto. While by no means a definitive list, these considerations identified may help an Issuer in developing their own guidelines for the selection of transaction professionals.

Working with trusted professionals can greatly reduce the potential for problem transactions, but establishing trust is generally a long-term process. Some Issuers have established a formal process to evaluate the performance of the transaction professionals working on each transaction using a grading system comprised of many of the considerations identified in Appendix B, *Considerations for Selection and Evaluation of Transaction Professionals.* In addition to documenting performance for future Issuer

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[4] See MSRB Rule G-17, which was recently revised to require disclosures by underwriters regarding their lack of fiduciary duty to the Issuer of bonds. This rule change was made in response to a mandate established by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

[5] The National Association of Bond Lawyers (NABL) addressed the usual function and responsibility of the role of bond counsel and the interplay with the Model Rules of Professional Conduct adopted by the American Bar Association in 1983 in its own publication, *The Function and Professional Responsibilities of Bond Counsel,* (2011, Third Edition). Attorneys practicing in municipal finance can serve in many different capacities (i.e., bond counsel, underwriter's counsel, borrower's counsel, etc.), and the NABL guidance helps to define the attorney-client relationship. At its core, the guidelines address the role of an attorney as an advocate for its client and the related ethical considerations associated with that special status. The guidelines recommend that the attorney clearly identify the client in an engagement letter, and if the attorney is representing more than one client in the transaction, that fact should be clearly disclosed to all clients in a single engagement letter.

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consideration, such an evaluation process can also improve the level of service provided where the professional knows their actions will be evaluated and could impact client relations for future transactions.

While price for service is always a consideration, most observers agree that Issuers should have some flexibility in hiring key transaction professionals. Many Issuers' procurement regulations exempt some professional services from a "lowest bid" requirement.

IF:

The Issuer identifies a potential or actual conflict of interest

Taking the time to identify those areas where conflicts may exist during the transaction development stage can help an Issuer avoid these issues later in the transaction. Below are examples of situations where conflicts may be present:

- Providers of investments to any related party involved in the transaction (This would include underwriters providing escrow securities, forward float contracts, etc., and the guarantee provider whose related company also provides the guaranteed investment contract (GIC));
- Any party with multiple roles in the transaction;
- Any valuation specialist identified by a contractor or developer;
- Any valuation specialist working on a contingency fee;
- Any parties involved in the transaction whose role is unique or not clear; and
- Any role duplicating the services provided by another transaction participant.

The more difficult situations to identify are those where the relation is more subtle in nature; one in which one party has an "understanding" with other parties that result in reciprocating rewards to the parties. For example, awards being passed around from deal to deal with the parties agreeing to establish the façade of an arms-length transaction. These relationships often involve some type of kick-back, either direct cash payments or some type of quid-pro-quo arrangement.

Many states have recently enacted pay to play laws in the wake of scandal after scandal. Some of these laws restrict vendors and contractors who make political contributions while others place restrictions on contracting officials. These laws in many cases are helpful, but don't eliminate the risk that fees, products, and services are not priced at market.

Perhaps the easiest way for an Issuer to avoid problems is to deal with trusted professionals. For example: your independent financial advisor(s) and bond counsel(s) that you have established a long-term professional/client relationship with, who are familiar with your entity's debt management policies and goals, who regularly avoid any potential conflicts, whose fees are reasonable within the market, who describe their services in a formal engagement letter, and who consistently provide exceptional service.

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THEN:

The Issuer should obtain information from parties with actual or potential conflicts which addresses Issuer's concerns and helps the Issuer evaluate the impact of the actual or potential conflict

There is a market for most financial products; however, many of these markets are small and not well defined in the municipal industry, unlike a major commodity or stock exchange. To match willing buyers with willing sellers the municipal industry uses a variety of brokers. Underwriters, who find willing buyers for bonds; swap advisors, who find willing buyers for risk; and GIC brokers who find willing buyers for the time value of money are some examples. When things work as they should, these agents evaluate "market conditions" for an Issuer to obtain the best price for their product (i.e., debt, risk, or investment). When thing don't work as they should, we see mispricing of products and services.

Three things that all Issuers can do to reduce the risk of mispricing in their transaction:

Be aware of potential conflicts of interests;
Be an active price shopper; and
Evaluate the information used by agents.

Issuers should also use their Request for Proposal (RFPs) as a tool not only to assist them in the evaluation of a professional's qualifications, but, to gather information of the professional's history in the industry. It is important to ask the professional to disclose any recent situations that called into question the professional's integrity or services such as those related to criminal conduct, civil enforcement, paying penalties, consent decrees with the SEC, or adverse federal tax actions.

IF:

A transaction professional withdraws from the transaction

The withdrawal of a professional from a transaction should trigger heightened scrutiny of the transaction by the Issuer particularly if the withdrawal occurs after the professional has expended significant time on the transaction. For example, the withdrawal of counsel (bond, underwriter's, or special counsel)near the end of the transaction may indicate that the counsel believes that the transaction in its present form will not meet the requirements necessary for the counsel to give the opinion required to successfully close the transaction. Withdrawal of other transaction professionals (financial advisors, underwriters, or trustees) may signal unusual or volatile market conditions that could have an adverse impact on the transaction.

THEN:

The Issuer should carefully evaluate any reason for withdrawal of transaction professional and selection of a replacement

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Generally, good reasons why a professional withdraws from a bond transaction are self-evident while the bad reasons may not be so clear. If the reason is not clear, extreme caution should be exercised in proceeding with the transaction. If the Issuer continues with the transaction, it should be actively engaged in the selection of any replacement and make sure the withdrawal of the professional in question was not related to the soundness of the Issuer's proposed transaction.

4. – Complexity of the Transaction

The structural and financial decisions that provide the foundation for an Issuer's proposed transaction have an enormous impact on the complexity of the transaction.

IF:

The project or objective of a proposed transaction is not clearly defined

One of the basic elements of a successful transaction is a clear plan to achieve the goals identified. Whether the building of a structure or the funding of services, undefined plans, disagreement in scope, and conflicting priorities usually have a negative impact on transaction execution. Some problems experienced by Issuers in this area include:

Staff does not have the capacity to properly evaluate project needs;
Project is substantially larger than members of the Issuer's working group have experienced;
Non-project costs are being financed directly or indirectly by the proposed transaction; and
The project plan cannot accommodate reasonable delays, change orders, cost overruns, contractor performance assurance, and proper analysis of important projections.

Lack of clarity and definition of the financing goals, especially in the early stages of a transaction, can easily place the transaction in jeopardy at a later date. An Issuer should continually be alert for situations where objectives are not clear or circumstances have changed and immediately implement a resolution strategy with their transaction team.

THEN:

The Issuer should use internal and external expertise to define the scope of the project or the objectives of the transaction

The determinations related to a project or transaction objective should come from the Issuer as they seek to identify how these needs and objectives will be achieved. At times this may be difficult due to the nature of the project and/or the resources at the Issuer's disposal. The Issuer needs either in-house staff with appropriate expertise or outside resources to be able to properly assess all the different elements of the transaction. Important questions related to a transaction which should be addressed from day one include:

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Is the project and all of its elements within the Issuer's legal authority?
Are the size and scope of the project appropriate for the public benefit?
What are the project milestones and what is the timing for delivery of these?
Are the project objectives in line with the Issuer's budgetary constraints?
Have the risks associated with the project been identified and have risk mitigation strategies been considered?
What is the current market climate and how will this affect the transaction?
What is the overall effect of the project on the Issuer's current financial situation?

Providing in-house staff with training in the related subject matter or new technology might be a solution to help the Issuer answer some of these questions. However, there are times in-house training will require a longer learning curve than appropriate given the transaction timing needs. In such cases, outside resources become necessary for the Issuer to acquire the needed expertise and establish the building blocks necessary to reach their objective. Choosing outside resources to help define a project can become as important as choosing your transaction professionals. Some of the considerations mentioned in chapter 3, *The Role of Transactions Professionals,* may be helpful for an Issuer to consider in these circumstances as well.

IF:

The proposed transaction is "new" to the Issuer

Whether an Issuer is in the market frequently or infrequently, a transaction that is "new" to the Issuer requires careful consideration. In such a case, Issuers who are novices as well as those who are old pros have to educate themselves.

As a general rule, simple or "plain vanilla" deals that are common and have relatively few "moving parts", as compared to more complex transactions, may be the preferred type of transaction for many Issuers. In such a deal, the Issuer will generally be better able to understand the obligation they are committing to as well as the various costs and risk associated with the transaction. However, there are many valid reasons an Issuer might have for using a more complex financing structure. The Issuer may face certain legal obstacles, want to balance the risk diversity of their debt portfolio, or achieve short-term variable rates during construction while locking in long-term financing at current fixed rates.

THEN:

The Issuer should understand any "new" approach and its consequences to the Issuer

Issuers using "new" features in a transaction should be able to understand the new feature, make sure it achieves the Issuer's objectives and consider the collateral consequences of such "new" feature. For example: if an Issuer is not familiar with derivatives or a new twist on the way the Issuer has done derivative deals is being urged by members of the transaction team, there is homework to be done. There are many types of risk associated with derivatives. The most obvious risk is the price risk based on changes in interest rates. An Issuer may be willing to accept the price risk associated with

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a swap transaction, but many do not consider the presence of additional risks such as default risk, collateral risk, liquidity risk, legal risk, settlement risk, operations risk, and systemic risk which may be present in a derivative contract.

In the event things do not go as planned, the Issuer must be prepared to assess their options and proceed in a manner that is in their best interests. For example: issues relating to whether the Issuer will be forced to terminate the swap contract, pay substantial fees, or reset the rates agreed to under the swap are of utmost importance. Additionally, the Issuer must also be aware of the effect of indirect or collateral issues such as the effect on the Issuer of another swap party's credit rating downgrade.

Complexity is at times a necessity but, when there is a simple way and a more complex way to accomplish the same goal from a transactional perspective, an Issuer should question what is to be gained and balance that with the cost and risk associated with the use of the more complex or "new" structure. Identifying risk and comparing complex transactions with simpler alternative financing structures should be standard operating procedure for all Issuers using "new" features in their transactions.

5. – Debt Management Considerations

Most Issuers, whether large or small, devote a large part of their efforts to the proper allocation of financial resources to achieve their public purposes. These public purposes usually require significant investments which may be provided through the issuance of bonds, (i.e., incurring debt by the Issuer). Therefore, it is of great importance for Issuers to engage in sound debt management practices in order to maximize their financial resources and facilitate access to the capital markets for their funding needs.

IF:

The Issuer does not have a formal debt management policy

One helpful tool used by many Issuers to evaluate their bond transactions is a formal debt management policy. A debt management policy establishes the ground rules for the Issuer's overall debt portfolio management that are imposed on the Issuer by state law, regulation, or, in many cases, the Issuer itself. The analysis of a proposed debt transaction within the framework of a debt management policy can provide guidance to the Issuer of the impact of the proposed transaction on the Issuer's operating budget. In addition to transaction assessment, the framework provided by a debt management policy allows an Issuer to allocate its resources in an orderly and consistent manner to make the proposed transactions a reality.

THEN:

The Issuer should adopt a formal debt management policy that allows for organized and prudent fiscal decision making

In order to adopt a debt management policy that provides the Issuer with a sound method for informed and consistent decision making, the policy has to be tailor made for the

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Issuer. The following are examples of items an Issuer may consider helpful as they perform a self assessment to develop a debt management policy that is right for them:

A description of debt limit either defined by law or Issuer's experiences;
A description of debt authorization process to assure legal requirements and help establish timelines;
A description of debt administration such as the specific person(s) responsible, reports to be produced, and interfacing with rating agencies;
A description of requirements to ensure the credit review is properly accomplished;
A description of review process for market access (competitive vs negotiated) and financial instruments that may be used (i.e., swaps, variable rate debt); and
A description of record keeping and recording process to meet applicable federal tax law or other requirements that may apply.

Examples of debt management policies are abundant in public policy text books and on the internet. While these may provide an Issuer with good ideas to start with, adoption of a boilerplate policy will not ensure prudent fiscal management and proper execution of transactions. All Issuers want their debt management policies to work for them and this requires a legal and financial self-assessment.

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Phase II – Transaction Execution

6. – Issuer Involvement

As most coaches will tell you, execution is required to win games regardless of the quality of the player talent or the game plan. During the transaction development phase participants are often busy with their respective duties and communication with the Issuer can be limited to performing administrative tasks and obtaining the information required for preparing documents necessary to close the transaction.

IF:

The Issuer wants to avoid snags which could negatively impact the closing when it issues tax-advantaged bonds

There are many moving parts in any bond transaction and the Issuer's goal should be to eliminate surprises on the closing day. Transactions have many different pieces coming together at the last minute and by being actively involved in the execution of the transaction, an Issuer can identify and resolve potential issues that may have an adverse impact on the successful closing of the transaction.

THEN:

The Issuer should develop policies and procedures to become an active participant in the structuring and execution of the transaction to avoid issues that could negatively impact their tax-advantaged bond closing

A lot of work must go into successfully closing a transaction and, because of constant market fluctuation, time sensitivity is an important factor. Deciding to pull the plug on a transaction because an issue has not been resolved often carries negative costly consequences and substantial resistance in most cases. Issuers should avoid making last minute decisions. The pressure by transaction participants to close the transaction under uncertain circumstances can be intense.

By being involved in the transaction during the period leading up to closing, an Issuer can determine:

If the debt structure is what the Issuer needs and understands it to be;
Whether the Issuer agrees with the changes that have occurred to the transaction since the initial planning began;
Whether the financing objectives of the Issuer are clear and are being achieved;
Whether the Issuer understands the responsibilities it is about to undertake;
Whether the documents are clear and have been customized to the Issuer's transaction rather than generic documents that do not address Issuer's specified needs;
Whether all transaction participants will be ready for closing; and
Whether the market is still within an acceptable range to accomplish the financing goals established by the Issuer.

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One important aspect of the Issuer's involvement in the transaction prior to closing is monitoring the pricing of the bonds. If the Issuer does not have the capacity to watch the market, this is an area where the services of a Financial Advisor or the transaction's underwriter can be helpful. Many Issuers monitor the pricing scale of their bonds before pricing and market activity of their bonds for a period following issuance. By reviewing the pricing scale Issuers can better respond to unusual changes as the date for pricing approaches. Issuer involvement can also identify unusual pricing circumstances, such as pricing bonds well in advance of their issuance.

One option available to Issuers would be to require the underwriter to provide actual data on the sale of bonds following their issuance. By comparing the actual first sales of bonds with the issue price certified by the underwriter the Issuer can identify the effectiveness of the marketing effort and establish that broker/dealer markups were not made in addition to the underwriter discount agreed to in the bond purchase agreement.

In addition to the Issuer's in-house professionals and/or their Financial Advisor, the Municipal Securities Rulemaking Board (MSRB) Electronic Municipal Market (EMMA) web site can provide Issuers with an additional tool to help evaluate whether their bonds were sold at the designated price, how quickly the bonds were sold, and whether there were any unusual fluctuations or market activity immediately following the issuance. These observations are useful in evaluating the success of the financing structure used, the retail allotment strategy, and the performance of transaction participants.

7. – The Bond Pricing Process

By the time a transaction gets to the pricing stage, most structural elements are already in place, such as the par amount of the bonds and the general interest rate structure. Every dollar the bonds are inadequately priced represents a dollar not available for the public purpose of the bond transaction.

IF:

The Issuer does not monitor the market for its bonds

Issuer involvement in the pricing phase of a transaction is critical and just as important as their involvement in the structuring of the transaction as previously discussed in chapter 6, *Issuer Involvement.*

There are three common methods for selling municipal bonds available to Issuers: (1) competitive sales; (2) negotiated sales; and (3) private placement. We will not discuss bank loans, program loans, lease transactions, or other similar obligations in this report. However, much of the information in this report may be of help to the Issuer by providing them with a framework with which to analyze other financing vehicles not discussed herein.

Competitive Sale:

In a competitive sale, the entire bond issue is sold to the bidder that offers the Issuer the lowest true interest cost for the transaction. The winning bidder, usually an investment

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bank, will purchase all bonds for a stated price and then sell the bonds to customers through its own network or through a group of broker/dealers. Compensation for the winning bidder is based on the spread between the price paid the Issuer for the bonds and the price the bonds were sold to investors.

The mechanics of the competitive sale require bids to be submitted to the Issuer on a date and time specified in a notice of sale that appears in printed media of wide publication. The notice of sale is also disseminated electronically to a huge audience. The bids may be sealed bids which will be compiled in an open forum and read at a time and place designated by the Issuer[6] or the bids may be received via online bidding programs. Bids must strictly adhere to the terms and conditions of the notice of sale and any conditional or qualified bids are discarded. The winning bid with the lowest true interest cost for the Issuer will be identified and generally bond counsel or the financial advisor will verify the computations provided for the winning and cover bid.[7]

The use of online bidding programs or electronic platforms to accept bids on competitive deals is the norm although the traditional "sealed bid opened in public" is still in use in many jurisdictions. While it can be argued that opening bids by hand may lead to circumstances in which the Issuer is not getting the best deal possible, this is highly unlikely given this is a very open process which the Issuer is involved in and the Issuer has someone verifying the numerical results of the bidding. Electronic bidding for competitive bond sales has provided the industry with cost and time saving in transaction processing, reduction of human error, the ability to see information in real time, and use of data for a variety of purposes (comparison, reporting, historical analysis). When electronic bidding is used it becomes virtually impossible to tamper with or influence the bidding process as all the bidding information is available to all parties in real time. The automation of competitive sales does have costs and may not be available for all Issuers. However, it is an example of technology that can lower costs, increase transparency, provide information for various uses and reduce human error.

Negotiated Sale:

In a negotiated sale a single investment banking firm (underwriter sometimes also referred to as manager) or syndicate of firms (co-managers) is selected by the Issuer to purchase the bonds at a price based on the marketing efforts of the underwriter and any co-managers (collectively, participating underwriters). The participating underwriters often contact large institutional customers and other investors to determine the interest in the bonds and the price at which the bonds could be sold. Unlike a competitive sale, in a negotiated sale the participating underwriters have been awarded the transaction before final structuring and are not competing against other purchasers to deliver the Issuer the best bid possible on a date certain. Because of this lack of competition among possible purchasers for the bonds, the negotiated method of sale may not promote the appearance of an open and fair bond pricing process. In a negotiated bond sale the underwriter selection process is subject to allegations of favoritism related to politics or "pay to play"

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[6] The processing of competitive bids varies among Issuers. Some Issuers may have statutory or internal requirements which require the bids to be processed in an open forum such as a board meeting or a group meeting in which various transaction participant are in attendance.

[7] Cover bid or cover refers to the difference between the winning bid and the next best bid in a competitive sale.

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antics. To avoid these situations, it is imperative that the Issuer adopt procedures, engage in processes, and educate itself to guard against even the most remote appearance of impropriety. Despite the intuitive appeal of a competitive sale, there are instances that may require an Issuer to pursue a negotiated sale such as:

- The Issuer is new to the municipal debt market;
- The Issuer is not able to secure a certain credit rating;
- The transaction is complex or has innovative features not standard in the current market;
- The transaction is too large or too small to be easily sold and requires sales effort on the part of the underwriter(s); and
- The market is volatile and the Issuer needs the flexibility of a negotiated sale to enter the market when it is most beneficial to the Issuer.

The selection of underwriters by an Issuer in a negotiated deal begins with interviews and detailed discussions with potential underwriters the Issuer is considering for the transaction. Several considerations an Issuer may find helpful to select an underwriter were covered in chapter 3, *The Role of Transaction Professionals.* Issuer involvement in all stages of a transaction is of paramount importance and one of the recurring themes found during the research phase of this report. Continually changing circumstances in the municipal market require an Issuer to remain actively involved in the transaction process to secure the best price for its transaction and uphold its public purpose. Much has been written about the pitfalls of negotiated transactions and how an Issuer might overcome them. Each Issuer is different and faces different challenges which require the Issuer to tailor the wealth of information available to fit their specific needs. Appendix C, *Considerations for Bond Pricing,* is an attempt to distill the wisdom found in various industry sources to considerations an Issuer may find helpful to develop or refine their involvement in the bond pricing process.

Private Placement:

A private placement is a special type of negotiated sale in which the Issuer sells bonds directly to an investor which is typically a bank. The Issuer will either prepare a solicitation and circulate it to a limited group of banks or contact a specific bank. Generally, the Issuer will specify the preferred terms of the loan it wishes to receive and the bank responds with conditions and terms it deems necessary. Private placements are generally small, shorter term transactions with streamlined documentation. They typically tend to have lower issuing costs and may bear a slightly higher interest rate. However, for certain Issuers this method of financing may have an overall lower effective borrowing cost. A good way for an Issuer to assure they are getting the best deal when using this method of financing is to use some the considerations suggested in chapter 3, *The Role of Transaction Professionals,* in order to select their transaction team and the various considerations suggested throughout this report in order to evaluate their specific transaction.

THEN:

The Issuer should establish clear procedures to monitor comparable sales and evaluate the actual price received for their bonds

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There have been many studies and much written about the "best method of sale" for Issuers of tax-advantaged bonds. Competitive sales are frequently the method of choice because competition drives the cost of the issue to the lowest possible level. However, this may not be the best choice for every transaction an Issuer engages in. An Issuer has to carefully consider the costs and benefits of each method of sale on a transaction by transaction basis. In the flurry of activity facing an Issuer when trying to issue bonds, it could be very helpful for the Issuers to establish procedures which enable the Issuer to analyze the best method of sale in an orderly and consistent manner. Such analysis could include consideration of the following:

Evaluation of the method of sale in light of financial, market, transaction specific and Issuer related conditions;
Evaluation of particular risks associated with each method of sale; and
Understanding and ability to explain rationale for method of sale selected.

There is no substitute for Issuer involvement in the process that determines the amount of money to be received upon the closing of a transaction. Small differences in the price of bonds or costs associated with their issuance can have a huge impact on funds available for an Issuer's public purpose.

8. – Investment Arrangements

Perhaps no other area in the life cycle of a bond transaction has seen more abuse than that of the investment of bond proceeds. Transaction participants are so focused on managing the legal and market requirements necessary to obtain funds for the Issuer's purpose that the investment of these funds may not receive the attention it should.

IF:

The Issuer does not have a specific investment plan for proceeds of the transaction

If an Issuer does not have specific investment plans for their proceeds, someone else involved in the transaction may have their own plans. As we discussed in chapter 5, *Debt Management Considerations*, a debt management policy is an essential tool for the financial well being of any Issuer. Included in this debt management policy should be a plan for investment of the Issuer's funds. An Issuer will usually have funds that require investment for different purposes and are subject to different restrictions. In the case of funds related to tax-advantaged bond transactions, federal income tax and state law requirements restrict the types of investments and returns allowable to an Issuer.

THEN:

The Issuer should develop investment policies that comply with applicable legal requirements to maximize return on investments and minimize the cost of financing

Just because an Issuer does not profit from arbitrage earnings itself does not mean that a violation has not occurred. During the yield-burning epidemic of the 1990s many escrow

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securities providers were earning arbitrage by artificially marking up the securities sold to an Issuer. The IRS rulings related to these cases stated that an Issuer cannot "give away" the arbitrage profit and viewed the transaction as if the Issuer earned additional investment earnings and then gave it away to the investment provider, in many cases creating a yield restriction violation.

The arbitrage regulations are quite extensive and can be overwhelming, but it is important to remember that, at their worst, the requirements for rebate and yield reduction payments only take that portion of investment earnings that exceed the bond yield. It is easy to understand that the basic goal of the arbitrage rules is to prevent an Issuer from making a profit from the investment of unspent bond proceeds while waiting to use those proceeds for their intended public purposes.

By not focusing on the proper management of investment income, many Issuers can become unknowingly involved in an abusive transaction. Common themes seen in abusive transactions include:

- Not using State and Local Government Series securities (SLGS) when appropriate[8];
- Using guaranteed investment contract (GIC) bid sheets with terms that are unclear and not standard market practice; and
- Bidding agents in collusion with bidders.

While being alert to the potential for conflicts of interest that can occur in a transaction is essential, as we discussed in chapter 3, *The Role of Transaction Professionals*, proper management of investment earnings by an Issuer in pursuit of their public purpose objectives is perhaps the best defense against most abusive transactions.

Issuers who develop investment policies will generally have plans for their investments and develop tools to evaluate the quality of investment performance in conjunction with their overall debt management policies and objectives. In addition to providing guidance on the types and diversification of the Issuer's investments, such a policy can also provide guidance on evaluating investment performance and alert the Issuer to potential issues such as:

- Escrow investment yields that are within a few thousandths of a percent of the bond yield without using zero coupon SLGS[9];
- Wide differences in GIC bids or bidders failing to respond to GIC bid request[10];
- Not seeing individual yields on securities purchased; and
- Anomalies with the bid dates and times (i.e., winning bidder regularly bids last, dates bids are received are spread out longer than is customary, or information about time and date of bids is not available).

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[8] Currently, SLGS rates are based on the U.S. Treasury securities prior daily average less one basis point. The SLGS rates provide a good comparison for non-SLGS investments.

[9] In many abusive transactions participants burned the yield to meet a yield restriction of 1/1,000th of 1 percent. Yield on an investment portfolio that matches the bond yield to three or four decimal places is statistically improbable without using zero coupon SLGS and has long been a red flag for IRS examiners (i.e., bond yield of 4.0365% and investment yield of 4.03647%).

[10] There is an active market for guaranteed investment contracts.

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The Issuer's attention to investing proceeds is an important aspect of managing a transaction. The more involved the Issuer is in the selection and evaluation of investments, the less room there is for others to attempt to acquire investments that are in their own interests rather than in the interests of the Issuer's transaction and public purpose.

9. – Evaluation of Investments and Derivatives

In addition to the investment of proceeds previously discussed in chapter 8, *Investment Arrangements*, the use of collateral financial contracts such as investment contracts (including GICs) or derivative contracts (including swaps) is another area of the municipal market that is currently under much scrutiny due to many publicized abuses. Mispricing an investment contract or swap can result in a large amount of bond proceeds being diverted from the Issuer's public purposes and possibly lead to a violation of federal tax law jeopardizing the tax status of the bonds. In addition, Issuers have sometimes misunderstood or have been misinformed of their obligations and risks under these types of contracts which have also been at the heart of some abusive or questionable situations.

IF:

The Issuer wants to maximize the economic benefits of the investment contract it enters into while protecting the tax-advantaged status of its bonds

Investment contracts offer the Issuer a guaranteed interest rate on a specific amount of money for the term of the contract. Issuers use investment contracts for various transaction funds such as construction funds. As a general matter, the evaluation of investment contracts, similar to the evaluation of any investment, involves consideration of the following by the Issuer:

Does this investment meet the legal, contractual, or investment policy requirements imposed on the Issuer for the bonds?
Does this investment contract maximize return given the liquidity requirements for the specified proceeds invested?
Does this investment have a market history or is market information available for its evaluation?

The availability of market history or market information for investments in established markets, while helpful, does not necessarily guarantee that all established market investments are free from abusive practices as compared to non-established market investments. In established markets where the market price of investments is easily determined, mispricing of investments occurs when certain information is not made available to, or reviewed by, the Issuer. For example, an Issuer who does not require identification of the price of specific securities purchased and compare the price paid against available market information could easily fail to identify a mispriced investment. Many of the escrows involved in the yield-burning deals of the 1990s did not identify the yield for each security purchased, which allowed the escrow provider to price longer term securities to yield less than securities with a shorter maturity.

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In non-established markets where the pricing of a security may be difficult, Treasury regulations provide methods to establish fair market value of investments.[11] Treasury regulations state that except as otherwise provided, an investment that is not of a type traded on an established securities market is rebuttably presumed to be acquired or disposed of for a price that is not equal to its fair market value. The exceptions provided include:

For United States Treasuries; fair market value is the price purchased directly from the United States Treasury;
For certificates of deposit; fair market value is the price purchased if not less than reasonably comparable direct obligations of the United States, and the highest yield published or posted by the provider to be currently available from the provider on reasonably comparable certificates of deposit; and
For guaranteed investment contracts and investments purchased for yield restricted defeasance escrows; fair market value is the price purchased if a bona fide solicitation is made and certain bidding requirements are met.

To establish the purchase price of a guaranteed investment contract or an investment for a yield restricted defeasance escrow as its fair market value, the Issuer must make a bona fide solicitation that complies with the requirements set forth in Treasury regulations providing guidance on the matter.

These are practical rules the Issuer should follow to ensure competitive bids are being received and the investment yield is maximized. These rules provided in Treasury regulations are a minimum standard for determining the presumption of fair market value. The Issuer should establish its own process to be followed for bidding investments as a part of its investment strategy.

THEN:

The Issuer should establish investment policies and procedures that maximize the return on investment of bond proceeds and minimize the opportunity for mispricing investments

On-going bid rigging investigations have revealed that the practice of manipulating the bidding process for investments of municipal bond proceeds is a reality. The competitive bidding process is supposed to provide an Issuer with a fair market price for investments of bond proceeds; however, the bidding process may be manipulated. This is especially true in instances where the Issuer has not been given information on the bidding process. Instances of manipulation that lead to situations which increase the cost of the investment to the Issuer are not simple and straight forward. For example, the pool of potential bidders could be manipulated by including unnecessary complex terms or structural components in the bidding requirements which diminishes the possible pool of bidders and reduces the benefits of a competitive process to the Issuer.

[11] Treasury Regulation section 1.148-5(d)

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There is no single process or formula to solve mispricing issues. However, requiring a bidding agent or party involved in the bidding of an investment to follow a specified bidding process and fully disclosing the information gathered in that process to the Issuer in a timely fashion is one way to reduce abusive and questionable business practices which are adverse to the Issuer's interests. Appendix D, *Considerations for Bidding Investments*, provides some considerations Issuers may wish to include in their bidding process.

The Issuer faces different issues when evaluating swaps. However, the fundamental principal is the same; the greater the Issuer involvement and its demand to be properly informed, the less likely it will be for the Issuer to enter into a swap that is contrary to its transaction objectives. Derivative contracts have been used by Issuers as a debt management tool that may lower overall interest costs within federal tax law constraints.

Since their first use in the municipal market, the growth of derivatives in the municipal market had been dramatic. Some of the attraction to these products may have faded since 2008 when many contract participants realized that they had not fully considered all the risks involved in their particular derivative contracts. Much has been written about the problems with financial derivatives and there are a number of proposals for reforming various aspects of the market for these products. Even if future reforms help establish transparency in pricing derivatives, Issuers purchasing swaps, options, and other derivatives need to establish a process of determining the rate they are paying is fair market value and the risks they are taking as well as the collateral consequences of those risks are well understood.

IF:

The Issuer does not fully understand the derivative contract it is entering into

Treasury regulations section 1.148-4(h) provides that payments made or received by an Issuer under a qualified hedge, which include many interest rate risk derivative products, may be taken into account for purposes of determining the yield of an issue. By including such payments the Issuer is allowed to compute its bond yield as if the fixed or variable rate acquired through the swap or other derivative contract was the rate for the bonds. Concerned with the potential for arbitrage (when a hedge contract is overpriced, the excessive payments could be recovered through higher allowable investment yields) the regulations provide that generally, qualified hedges do not include payments for off-market swaps.

Much like guaranteed investment contracts; derivatives do not have an established market. Unlike GICs, however, derivative contracts are not competitively bid but rather priced by the broker, who is often a major financial institution and may be a counterparty to the transaction. Most derivative providers have their own proprietary models for valuing the various risks included in a given contract. These models generally break the various components of risk into distinct elements that can be evaluated in response to the current yield curves of various securities and financial products. How these elements are weighted and the adjustments included become important in developing pricing.

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The lack of transparency of fees and prices in derivative contracts provide an environment for abusive and questionable practices. Issuers should consider establishing a policy of receiving bids for derivatives to ensure a fair market price. Complex derivative products may not be easily bid, but there are steps Issuers should consider in evaluating the pricing of these products including:

Compare bids received for derivatives- Request all fees and expenses paid or to be paid in connection with the contract be separately disclosed and request information on how the potential swap provider is pricing the swap;
Compare terms on derivatives- Are prospective derivative bidders accepting the Issuer's terms or imposing their own; and
Check for conflicts- Request disclosure of any financial arrangements and relationships between parties involved in the derivative contract and Issuer's transaction.

THEN:

Issuer should establish a plan to ensure any derivatives used are not overpriced, are in their best interests, and do not otherwise jeopardize the federal tax status of the bonds and lead to adverse financial consequences

Absent traditional exchange markets or a competitive bidding process to establish the fair market value of derivative products, an Issuer must rely on its staff or other transaction professionals to ensure these complex transactions are properly priced. An Issuer should establish procedures to determine whether the derivative contracts into which it enters are priced at fair market value so the contract meets the qualified hedge rules.

As with mispriced bonds and mispriced investments, mispriced and poorly understood derivatives can divert a substantial amount of proceeds from the public purposes of an Issuer and jeopardize the federal tax status of the bonds.

10. – Closing the Transaction

After all the planning, meetings, and endless conference calls, the day has arrived to close on the bonds. For the Issuer who has been actively involved throughout the transaction, the closing process should not be a burden but a reward for a job well done.

IF:

The Issuer discovers its transaction participants are not ready for closing

Once the bonds have been priced, if all the parties to the transaction have done their job, everything should be practically complete in the transaction except for obtaining signatures on documents and minor administrative tasks. If an Issuer has not been involved in the planning, evaluation, and execution of the transaction, it could turn out to be a much different closing day. At closing an Issuer's options to change, amend, or delay the transaction are very limited. You either proceed or delay based on how significant the problems encountered turn out to be and what the delay will cost. A lot of work has gone into the transaction by this point and not closing is not an easy decision for the Issuer or any transaction participant.

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Even if the Issuer has been actively involved all aspects of the transaction and all the parties to the transaction have done their jobs properly, unforeseen events could threaten to jeopardize the closing day. In these cases, if all parties are prepared and have done what they are supposed to, it will be easier and more likely for the transaction team to come up with a solution that solves the unforeseen problem in a manner acceptable to all involved parties.

THEN:

The Issuer should conduct a pre-closing check to be ready for closing well before the closing date and use the actual closing process to plan post closing compliance

Issuers who have been active participants in their transaction and are prepared for closing often use the closing event as an opportunity to learn about their post closing transaction responsibilities and establish a plan for meeting their obligations under the terms of the transaction documents. Many Issuers will take advantage of the closing event, especially if transaction participants are present, and use this as an opportunity to have bond counsel and other transaction professionals discuss the contractual and legal requirements imposed upon the Issuer so the Issuer can plan for future compliance.

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Phase III – Post-Issuance

11. – Establishing Responsibilities

All Issuers, whether their transactions are simple or complex, will have post-issuance responsibilities that are required by their transaction documentation. Nevertheless, based on responses to written questionnaires, TEB has found that written procedures for post-issuance compliance are not widely utilized within the municipal industry.

IF:

The Issuer has not clearly designated who is responsible for what aspect of post-issuance compliance

Some respondents to TEB's questionnaires indicated they had no written procedures, while others identified the tax certificate as their written procedures for post-issuance compliance. Written procedures for post-issuance compliance are not currently required by any body of law, but a written procedure that survives the closing of the bond transaction will enable the Issuer to better deal with what comes next in the life of the transaction.

Many Issuers have implemented excellent examples of post-issuance compliance procedures that document persons/positions within the entity responsible for compliance for each aspect of the Issuer's responsibilities under the bond transaction. In many cases, these duties are written into the position description to clearly establish the responsibilities delegated. Some Issuers have specific procedures for record maintenance and communication procedures between individuals responsible for various tasks. Other Issuers provided their staff with guidance on the allocation of bond proceeds to capital project expenditures, along with a description of the additional requirements for allocations to reimbursed expenditures. Potential types of private business use were identified by Issuers and the specific responsibility for monitoring leases, management and service contracts, and other potential private business use situations was specifically assigned to staff members or procedures were in place to hire outside expertise to deal with these situations.

THEN:

The Issuer should clearly identify the individual(s) responsible for each aspect of post-issuance compliance

Finally, in addition to providing the Issuer with an orderly process to administer and comply with various responsibilities required to maintain post-issuance compliance, another benefit of written procedures for post-issuance compliance is the ability to establish "institutional knowledge" within the organization that will survive staff or administration changes. Appendix E, *Considerations for Post-Issuance Compliance,* provides some considerations an Issuer might find useful in the development of post-issuance compliance procedures.

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12. – Accounting for Proceeds

Perhaps one of the most overlooked aspects of post-issuance compliance is accounting for proceeds allocated to expenditures related to the bond transaction.

IF:

The Issuer does not know what was financed with transaction proceeds

Proceeds of a bond transaction are used or "allocated to" various expenditures that will achieve the Issuer's objectives. During examinations, Issuers often indicate that the Official Statement (OS) sets forth the allocation of proceeds to expenditures for the project. Unfortunately, the expectation of the use of proceeds contained in the OS may not be quite the same as the actual allocation of proceeds to expenditures for land, building, and equipment that were acquired after the date the bond transaction closes.

The allocation of gross proceeds to expenditures is the process by which the use of proceeds is determined for purposes of certain use tests and arbitrage computations required by federal income tax law. An Issuer may use any reasonable, consistently applied accounting method to account for gross proceeds, investments, and expenditures of an issue. If an Issuer fails to maintain books and records sufficient to establish the accounting and allocation method for a transaction, specific tracing is applied.

THEN:

The Issuer should account for its allocation of transaction proceeds in its books and records in a consistent manner

Being required to specifically trace bond proceeds from a project fund or similar fund in which sale proceeds were deposited may have adverse consequences if private business use or other non-qualified use is present for a portion of the facility financed and that portion of the facility was intended to have been financed with equity or taxable bond proceeds. Failure to document official intent related to expenditures for which the Issuer plans to be reimbursed from tax-exempt bond proceeds could also impact an Issuer's allocation in a manner that has negative consequences for federal income tax purposes.

Failure to clearly identify the use to which bond proceeds were allocated makes post-issuance compliance extremely difficult for any Issuer. Leasing of space, sale of assets and entering into management contracts after the bond transaction closes, are among the many events that can impact the federal tax status of bonds so it is extremely important to know which facilities are tax-exempt bond financed, and for each such facility, which bond issue provided the proceeds allocated to that facility. Also, it is important to identify the use of bond proceeds for non-capital expenditures (i.e., salaries and other working capital expenditures) because special rules apply for federal income tax purposes.

Many Issuers do not have a clear process to determine the extent of private business use, non-governmental use, or the portion of net proceeds used to acquire qualified facilities at the date the facilities acquired were placed in service. In such cases, it may come as an

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unpleasant surprise to an Issuer during an examination that their use of proceeds never met the legal requirements for their bond transaction.

13. – Monitoring Arbitrage

Perhaps the single most complex post-issuance compliance area for an Issuer is that of arbitrage rebate and yield reduction. The general concept that an Issuer should neither lose money nor profit from investing proceeds of their tax-advantaged bonds requires understanding a significant number of definitions, rules, exceptions, exceptions to the exceptions, safe harbors, and extensive anti-abuse provisions. Arbitrage compliance must be monitored over the life of the transaction.

IF:

The Issuer does not have a process to monitor arbitrage related issues after the closing date

Although the Issuer may not be earning arbitrage today that does not mean that their bond yield and investment circumstances will not change or be affected by market conditions that impact arbitrage and yield restrictions in the future. A failure to pay rebate or a yield reduction payment could result in the loss of federal tax exemption for otherwise qualified bonds. Penalties imposed in lieu of the loss of federal tax exemption are either 50% or 100% of the rebate payment that was due based on the type of bond issue. In either case, a failure to comply with the arbitrage requirements carries significant negative consequences for an Issuer.

THEN:

Issuer should establish a process to ensure its bonds are not arbitrage bonds during the life of the transaction

Most Issuers hire an arbitrage rebate specialty company[12] to provide computational and advisory services. Often rebate specialists are bought into the transaction near the closing date to assist in developing the rebate aspects of the Issuer's investment strategy. This often includes establishing plans to take advantage of rebate exceptions during the construction period. Many Issuers engage rebate specialist to prepare rebate reports[13] on an annual basis citing the value of this information in managing their investment of bond proceeds and meeting their post-issuance compliance requirements. For organizations exempt under section 501(c)(3) of the Internal Revenue Code (Code), good rebate reports are helpful in meeting the reporting requirements for Schedule K of Form 990. Additionally, annually monitoring rebate will often allow Issuers to uncover and correct problems that can be resolved by filing a late or amended Form 8038T or requesting an agreement through the Voluntary Closing Agreement Program (VCAP) from TEB.

[12] Rebate specialist firms range from small independent offices of one or two specialists to larger groups of specialists that may be a part of a law or accounting firm.

[13] A rebate report generally computes bond yield and analyzes investment activity to compute arbitrage rebate, yield reduction payments, and yield restriction compliance.

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Arbitrage computations are based on information from many sources in the transaction. At closing the Issuer should clearly establish responsibility of in-house and outside transaction participants for gathering, organizing and analyzing information relevant to the rebate computation over the term of the bonds. Training programs related to various aspects of compliance might be helpful to assist Issuer personnel dealing with compliance matters. (See chapter 15, *Education and Training*, for additional information on training resources). In conduit borrower situations, the Issuer and the conduit borrower should agree on a clearly defined process for arbitrage compliance so in the future, both parties are relying upon a clearly agreed upon process, not assumptions as to who might be doing what.

14. – Establishing Continued Compliance

It is not sufficient for an Issuer to have their bonds qualified for exempt interest or tax credits at the date of issue, or even when the facilities are placed in service. There are additional requirements the Issuer must continue to meet over the life of the transaction to ensure such tax-advantaged status is maintained.

IF:

The Issuer does not periodically assess if continuing compliance requirements are met

Just as planning was essential to formulate and structure the transaction, planning is also an essential component of continuing compliance. A successful compliance program will include proper planning and the consideration of elements relevant to the Issuer's particular transaction such as:

Establishing roles and responsibilities for compliance duties;
Determining and accounting for the use of proceeds;
Monitoring arbitrage, private business use, significant modifications; and
Adequately documenting compliance efforts and information over the entire life of the transaction.

A rebate report generally computes bond yield and analyzes investment activity to compute arbitrage rebate, yield reduction payments, and yield restriction compliance.

THEN:

The Issuer should establish a means of ensuring continuing compliance for all transaction requirements

The best post-issuance compliance process for an Issuer will come from an examination of their compliance needs and resources available to fulfill those needs. Appendix E, *Considerations for Post-Issuance Compliance*, contains information helpful for Issuers when developing their own compliance program[14].

[14] When submitting a VCAP request to TEB, the Issuer must include with the request an affirmative or negative statement as to whether it has adopted comprehensive written procedures intended to promote

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15. – Education and Training

The responsibilities faced by an Issuer of tax-advantaged bonds require the Issuer's attention to detail throughout a transaction's life cycle. As we have previously discussed in chapter 11, *Establishing Responsibilities*, it is a prudent practice to establish written procedures that assign tasks and responsibilities related to post-issuance compliance to the officers and personnel of the Issuer dealing with such matters. Assigning responsibilities to a designated person while an important step, is only part of the equation. Persons entrusted with these tasks may often need additional knowledge to be able to carry out the responsibilities assigned to them.

IF:

The Issuer does not provide its officers and personnel with training and education related to tax-advantaged bond transactions

The proper training and education of the Issuer's officers and personnel entrusted with carrying out the various responsibilities related to a transaction is a dynamic process as the Issuer is facing constant fluctuating situations. In addition to changes within the Issuer related to their internal management and financial health, the world outside the Issuer is constantly presenting new legal and financial challenges as well.

THEN:

The Issuer should develop specific training required to meet the responsibilities assigned to its officers and other personnel with respect to tax-advantaged bond transactions

Issuers have several avenues available to gain knowledge and keep up with current changes in the municipal industry. During a transaction, bond counsel and the rest of the transaction professionals can provide a wealth of information and sound advice useful to the Issuer beyond the immediate transaction they are working on. TEB offers specialized information and services to the municipal finance community including education and outreach programs. Information on these programs as well as information related to federal tax law, tax forms, revenue procedures, TEB publications[15] and emerging issues in

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post-issuance compliance with, and to prevent violations of, the provisions of the Code related to tax-advantaged bonds. The Issuer must also include a detailed description of the portion of such comprehensive procedures which relate to the violation which is the subject of the TEB VCAP request. The description of such written procedures should identify the authorized person(s) that adopted the procedures, the officer(s) with responsibility for monitoring compliance, the frequency of compliance check activities, the nature of the compliance check activities undertaken, and the date such procedures were originally adopted and subsequently updated (if applicable). The extent to which an Issuer has appropriate written compliance procedures will be an equitable factor that will receive consideration in determining appropriate resolution terms with respect to VCAP requests.

[15] These publications include IRS Publication 4077, *Tax-Exempt Bonds for 501(c)(3) Charitable Organizations*, IRS Publication 4078, *Tax-Exempt Private Activity Bonds*, IRS Publication 4079, *Tax-Exempt*

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the industry is available through TEB's website at *http://www.irs.gov/bonds*. The TEB tax law training modules (available on the TEB website) have long been used by many members of the municipal industry in their training programs and TEB also hosts free webinars and conferences on a variety of federal tax law and post-issuance monitoring compliance matters on a periodic basis. The Securities and Exchange Commission and the Municipal Securities Rulemaking Board also provide educational information through their websites. Additionally, there are a number of municipal industry associations for general and specific Issuer communities and organizations for transaction professionals which provide information, training materials, and conferences opportunities useful to Issuers.

Conclusion

Abusive transactions, failed projects, and other compliance issues all contribute to increase the overall financing costs for State and local governments. Resolving these issues often ranges from payment of tax exposure on bonds determined to be taxable, to bankruptcy of the Issuer. All of these actions can consume an Issuer's time and in many cases represent significant opportunity costs. Unfortunately, a single approach is not available to protect an Issuer from these potential problems.

As we have discussed, Issuer involvement in the planning and monitoring of each phase of a transaction is an essential element of municipal finance. The decisions an Issuer makes at the beginning of a transaction with respect to participants and structure together with the internal procedures an Issuer has to evaluate a transaction and its effect on the Issuer's overall financial well being, are critical for the transaction's success.

Governmental Bonds, and IRS Publication 5005, *Your Responsibilities as a Conduit Issuer of Tax-Exempt Bonds*.

Avoiding Troubled Tax-Advantaged Bonds

Summary of Roles of Transaction Professionals **Appendix A**

Legal Team	A typical bond issue sold on a negotiated basis may require services of attorneys who are engaged for many different roles including: bond counsel, issuer's counsel, underwriter's counsel, disclosure counsel, borrower's counsel, trustee's counsel, and in some cases specialized counsel for tax and other matters. Some legal roles such as issuer's counsel are more general and are often filled by the entity's general counsel who may not have extensive experience in bond, municipal finance, tax law or securities law. Many attorneys who practice regularly in municipal finance frequently serve in different capacities; bond counsel on one transaction, underwriter's counsel on the next, disclosure counsel on the next, etc.		
Bond Counsel	**Roles**	**Hired by**	**Fees**
	Provide opinion that interest paid on bonds is tax-exempt or tax credit bonds are qualified under federal tax law Provide opinion that bonds were validly issued under state law Draft many of the documents used in the transaction May be involved in structuring transaction	Issuer	Generally contingent upon issuance based on an hourly rate or a fixed dollar amount plus out of pocket expenses
	Bond counsel involvement in municipal finance originated out of the need to provide comfort to the bond market as to the enforceability of an Issuer's obligations. In the last 30 to 40 years the opinion that interest on the bonds is exempt from federal and state income taxes has become a very crucial part of the bond opinion. Today bond counsel is generally engaged as counsel to the issuer of the bonds for a specific transaction and some states prohibit bond counsel from also serving as counsel to the underwriter in the same transaction[16]. Bond counsel drafts many of the documents utilized in the bond transaction and may be heavily involved in the structuring and closing of the financing[17], as well as in the tax analysis.		
Special Tax Counsel	**Roles**	**Hired by**	**Fees**
	Provide opinion that interest paid on bonds is tax-exempt or tax credit bonds are qualified under federal tax law Analyzes complex federal tax aspects of transaction	Issuer	Generally contingent upon issuance based on an hourly rate or a fixed dollar amount plus out of pocket expenses
	In some transactions where the tax aspects of a transaction are particularly complex, or otherwise beyond the ability of bond counsel to render an opinion, an attorney may be engaged for purposes of providing the tax opinion. Generally, another attorney will be engaged as bond counsel and will perform all other normal duties in the transaction.		

[16] In 1985 California enacted California Government Code section 53593.
[17] The American College of Bond Lawyers. "The Role and Function of Bond Counsel", Accessed April 19, 2012. http://www.bondcounsel.org/bond-law/roles-and-function

Avoiding Troubled Tax-Advantaged Bonds

Summary of Roles of Transaction Professionals **Appendix A**

	Roles	Hired by	Fees
Financial Advisor	Usually involved in structuring transaction Provides advice on market conditions and investments	Issuer	Generally contingent upon issuance based on an hourly rate or a fixed dollar amount plus out of pocket expenses
	The financial advisor (typically known in the industry as the "FA") is a professional consultant, customarily retained by the Issuer to provide advice and can play a significant role in structuring the transaction, hiring other transaction professionals, monitor pricing, and advising on the use of investments and derivatives. The necessity for engaging an FA often depends on the sophistication level of the Issuer's staff and whether the bonds are being sold on a negotiated or competitive basis. The FA may be a consulting firm, an investment bank, or a commercial bank. FAs identified as "independent financial advisors" do not engage in underwriting or trading of municipal securities. The scope of an FAs engagement may be quite broad; such as in the case of developing an overall debt structure and capital financing program for the Issuer; the role may be issue specific as in the case of a competitive sale where the FA is instrumental in most aspects of structuring the bonds; or the role may be more limited such as reviewing the financial feasibility of the capital projects or an engagement to provide recommendations on some other financial aspect of a bond transaction.		
Underwriter	**Roles**	**Hired by**	**Fees**
	Purchase bonds for resell to investors Act as agent for bond purchaser Assist in the structuring and sale of the bonds	Issuer	Generally contingent upon issuance, based on a discount from the issue price of the bonds plus out of pocket expenses
	An underwriter purchases bonds from an Issuer with the intent to resell the bonds to investors. In a negotiated sale the underwriter is usually selected early in the process and the underwriter is heavily involved in structuring the transaction. In a competitive sale, the underwriter delivers a sealed bid and the Issuer selects the underwriter offering the best terms at that time, so their role in structuring is greatly reduced. Generally, the underwriter will engage its own counsel who will prepare many of the sale documents including the Official Statement. In a private placement the placement agent, often an investment banker, acts as agent for the purchaser and as such does not purchase the bonds for resell. Underwriters may also use broker- dealers to help sell bonds the underwriter has purchased from the Issuer. Underwriters, broker-dealers, traders etc. are governed by their own set of rules set forth by the Securities Exchange Commission and the Municipal Securities Rulemaking Board.		
Underwriter's Counsel	**Roles**	**Hired by**	**Fees**
	Represent underwriter's interest in a negotiated transaction Coordinate and draft documents used in conjunction with the Official Statement (if disclosure counsel was not engaged)	Underwriter	Generally contingent upon issuance based on an hourly rate or a fixed dollar amount plus out of pocket expenses
	Underwriters regularly engage an attorney to coordinate preparation of the Official Statement with input from other financing team members and represent the underwriter's interest in a transaction. Underwriter's counsel customarily review documents prepared by others and negotiate matters relating to those documents on behalf of the underwriter. Many of the duties traditionally performed by underwriter's counsel may be performed by disclosure counsel, if engaged, for the transaction.		

Avoiding Troubled Tax-Advantaged Bonds

Summary of Roles of Transaction Professionals **Appendix A**

	Roles	Hired by	Fees
Disclosure Counsel	Provide opinion that disclosure of information meets federal and state securities law requirements Draft the Official Statement and related disclosure documents	Issuer	Generally contingent upon issuance based on an hourly rate or a fixed dollar amount plus out of pocket expenses
	Because the bond opinion is not intended to be a disclosure document (it does not address whether the disclosure available with respect to the bonds is adequate under federal or state securities laws) bond counsel or some other attorney is increasingly engaged to provide legal services in order to give an opinion that the legal requirements under securities laws relating to the transaction, have been met.		

	Roles	Hired by	Fees
Trustee	Protect interests of bondholders under the terms of the trust indenture Provide gatekeeper function and accounting for deposits, disbursements, and investment of proceeds	Issuer	Generally based on a fixed dollar amount plus out of pocket expenses with fixed yearly maintenance fee
	The trustee, or other paying agent, is generally a bank that can provide basic trust services for the Issuer throughout the transaction. Generally, the trustee holds a fiduciary responsibility to the bondholders and provides general trust administrative functions. Bond proceeds are often deposited with the trustee and the trustee operates under direct instruction from the trust indenture with respect to the distribution of proceeds, investment of proceeds, collection and payment of debt service amounts, and many other facets of a transaction. The ability of the trustee to monitor compliance with bond covenants, disbursement of proceeds, taking investment actions (i.e., rollovers), and issue notices as required, is crucial to the long term success of the transaction.		
Trustee's Counsel	Roles	Hired by	Fees
	Represent trustee's interest in the transaction	Trustee	Generally based on an hourly rate or a fixed dollar amount plus out of pocket expenses
	An attorney engaged by the trustee to represent the trustee's interest in the transaction.		
Credit Enhancement Provider	Roles	Hired by	Fees
	Provides a guarantee of the payment or liquidity for bonds	Issuer	Generally based in terms of basis points, or a percentage, of the par amount of the bonds covered by the provider
	There are a variety of credit enhancement providers that may play a role in a transaction. Credit enhancement may come in the form of bond insurance, letter of credit, line of credit, mortgage, private guarantee, or a liquidity facility. Depending on the nature of the risks involved, the credit enhancement provider may take a very active role in the structural development of the transaction because of the possibility that it can be called upon to perform on their guarantee.		

Avoiding Troubled Tax-Advantaged Bonds

Summary of Roles of Transaction Professionals **Appendix A**

	Roles	Hired by	Fees
Investment Providers	Advisors Provides investment advice to maximize return on investment of bond proceeds in construction, escrow, reserve, and other funds before proceeds are needed	Issuer	Generally based in terms of basis points, or a percentage, of the par amount of the bond proceeds invested
	Bidding Agents Structures investment arrangements and handles bidding process including solicitation and award to provider	Issuer or FA	Generally a flat fee based on the size and complexity of the investments acquired (sometimes paid by winning bidder)
	Securities/Guaranteed Investment Contract (GIC) Provider Provides investment products for the transaction	Awarded based on bid	Profit or loss is based on spread between cost of securities and sales price to Issuer or the GIC contract price and the providers cost of funds over the term of the contract
	This category includes investment advisors, bidding agents, and the dealers, brokers, banks, and other entities involved in providing investment securities or an investment contract that was acquired with bond proceeds.		
Derivative Providers	**Roles**	**Hired by**	**Fees**
	Swap Advisor Provides advice on structuring derivative transactions to adequately evaluate risk management objectives of transaction	Issuer	Generally based in terms of basis points, or a percentage, of the amount of the swap
	Swap Broker Structures derivative transaction matching Issuer with a counterparty	Issuer or FA	Generally based in terms of basis points, or a percentage, of the amount of the swap
	Swap Counterparty Assumes the risk being swapped under the terms of the contract	Swap Broker	Generally based in terms of basis points, or a percentage, of the amount of the swap
	This category includes swap advisors, brokers, and/or swap counter parties.		

Avoiding Troubled Tax-Advantaged Bonds

Considerations for Selection and Evaluation of Transaction Professionals Appendix B

	Considerations for Bond Counsel
Bond Counsel	**I. Client Service** If the Issuer has previously engaged bond counsel, have any client service deficiencies been addressed? Does bond counsel have knowledge of the Issuer's debt management policies, outstanding bond structures, existing documents, and existing legal matters that may impact the transaction? Do the individuals assigned to the transaction have experience with the financing structure and size contemplated in the transaction? Does bond counsel possess any specialized knowledge that will be required for the transaction? Has the Issuer communicated its expectations that the individuals assigned to the transaction by bond counsel be responsive, available, and accessible to the Issuer? Are bond counsel's proposals focused on balancing the needs of the Issuer against legal requirements of the transaction? Does bond counsel use an engagement letter to document the services to be provided for each transaction?
	II. Transaction Fundamentals Does bond counsel understand the administrative and financial structure of the Issuer, and the proposed transaction structure? If not, is bond counsel willing to obtain this basic understanding at their own expense? Will bond counsel participate actively in the drafting of documents and financing discussions? Who from bond counsel will do this? Has the Issuer communicated its expectations that bond counsel circulate draft documents to the transaction working group in a timely manner and that such draft documents are to be thorough and complete?
	III. Transaction Execution Does bond counsel understand what approvals must be obtained from the various governmental bodies and understand the deadlines related to this process? Has the Issuer communicated its expectations that bond counsel alert transaction participants as soon as issues/concerns are identified in order to develop an acceptable solution that keeps to deadlines in the transaction calendar?
	IV. Fees Are the bond counsel's fees competitive based on level of service to be provided and Issuer needs? What specific services and actions are included in the bond counsel fee and what does the Issuer have to pay for separately and when? If the final fee charged to Issuer is in excess of amounts quoted by bond counsel or amounts set forth in the engagement letter, what happens?

Avoiding Troubled Tax-Advantaged Bonds

Considerations for Selection and Evaluation of Transaction Professionals Appendix B

	Considerations for Financial Advisor
Financial Advisor	**I. Client Service** If the Issuer has previously engaged financial advisor, have any client service deficiencies been addressed? Does financial advisor have sufficient experience with transactions similar in size and structure to the one contemplated? Does financial advisor have knowledge of existing documents, outstanding bond structures, Issuer debt management policies, and existing market conditions? What individuals are assigned to the transaction by the financial advisor and how responsive, available, and accessible will these individuals be to the Issuer? Do financial advisor's proposals, comments and recommendations creatively and innovatively balance the needs of the Issuer against market conditions? Does the financial advisor's ability complement, strengthen, weaken, or provide unique expertise to the transaction?
	II. Transaction Financial Development Will the financial advisor advise Issuer on the merits of competitive, negotiated or private placement of debt? Will the financial advisor review and comment on the preliminary and final official statements, participate in due diligence meetings, and participate in bond document review sessions? Will the financial advisor analyze any proposals for new products as they pertain to the particular transaction/Issuer's overall debt management? Will the financial advisor assist Issuer with rating agency or investor meetings related to the transaction as may be requested by the Issuer?
	III. Marketing Function Will the financial advisor provide input on how to market the bonds to retail and institutional investors? Will the financial advisor review and comment on the marketing plans submitted by the underwriters, including review of proposed underwriter spreads and estimated cost of issuance items? Will the financial advisor provide a cost/benefit analysis of different structuring and pricing options? Will the financial advisor analyze and recommend fair pricing levels based on historical pricings and the pricing of comparable credits in the current municipal bond market? Will the financial advisor assist with investor outreach and marketing strategy?
	IV. Fees Are the financial advisor's fees competitive based on level of service to be provided and Issuer needs? What specific services and actions are included in the financial advisor's fee and what does the Issuer have to pay for separately and when? If the final fee charged to Issuer is in excess of amounts quoted by financial advisor or amounts set forth in any written agreement, what happens?

Avoiding Troubled Tax-Advantaged Bonds

Considerations for Selection and Evaluation of Transaction Professionals Appendix B

	Considerations for Underwriter
Underwriter	**I. Client Service** If the Issuer has previously engaged underwriter, have any client service deficiencies been addressed? Does underwriter have sufficient experience with transactions similar in size and structure to the one contemplated? Does underwriter have knowledge of existing documents, outstanding bond structures, Issuer debt management policies, investor preferences, and existing market conditions? What individuals are assigned to the transaction by the underwriter and how responsive, available, and accessible will these individuals be to the Issuer? Do underwriter's proposals, comments and recommendations creatively and innovatively balance the needs of the Issuer against market conditions? How reliable is the market data provided by the underwriter? Does the underwriter's ability complement, strengthen, weaken, or provide unique expertise to the transaction?
	II. Preparation for Sale How knowledgeable and helpful are the underwriters in document preparation, preparation for transaction meetings, presentations and discussions with the rating agencies? Does underwriter adequately discuss the advantages and disadvantages of proposed structures to enable the Issuer to thoroughly consider? Will underwriters develop issue-specific marketing plans? Will pre-pricing materials be prepared which discuss among other topics important to Issuer, present market conditions and show recent issues of comparable credits prior to pricing calls?
	III. Distribution Has the Issuer communicated its expectations to the underwriter for any retail or other special offering requirements for the bonds? Does the underwriter, or members of its underwriting syndicate, have sufficient market specialization to meet the specific marketing requirements of the bonds? Will the underwriter or members of the syndicate be taking a position in the bonds? Will the underwriter provide an explanation of any substantial differences between the marketing plans and the actual sales experienced to the Issuer?
	IV. Fees Are the underwriter's fees competitive based on level of service to be provided and Issuer needs? What specific services and actions are included in the underwriter fee and what does the Issuer have to pay for separately and when? If the final fee charged to Issuer is in excess of amounts quoted by underwriter or amounts set forth in any written agreement, what happens?

Avoiding Troubled Tax-Advantaged Bonds

Considerations for Selection and Evaluation of Transaction Professionals Appendix B

	Considerations for Trustee
Trustee	**I. Client Service** If the Issuer has previously engaged trustee, have any client service deficiencies been addressed? Does trustee have sufficient experience with transactions similar in size and structure to the one contemplated? What individuals are assigned to the transaction by the trustee and how responsive, available, and accessible will these individuals be to the Issuer? How knowledgeable is trustee regarding Issuer's investment policies, debt management policies, and transaction structure? Does the trustee have official in-house procedures relating to their responsibilities? Do trustee's proposals, comments and recommendations creatively and innovatively balance the needs of the Issuer and the administrative requirements of the transaction? Does the trustee have any unique expertise which may be required for the transaction?
	II. Accounting and Reporting Have the Issuer and trustee agreed upon time frames and formats of accounting and related reports? Will reports be accurate, reconciled and easy to read? How willing and able is the trustee to make changes to reports to meet Issuer's specific needs?
	III. Fees Are trustee's fees competitive based on level of service to be provided and Issuer needs? What specific services and actions are included in the trustee's fee and what does the Issuer have to pay for separately and when? Is fee structure acceptable over long term how can fees change in future? If the final fee or future maintenance fee charged to Issuer is in excess of amounts quoted by trustee or amounts set forth in any written agreement, what happens?

Avoiding Troubled Tax-Advantaged Bonds

Considerations for Bond Pricing **Appendix C**

Selection Process	**Prior to Selection:** Evaluate underwriter qualifications and check for possible conflicts using Issuer adopted criteria and RFP process (See chapter 3, *The Role of Transaction Professionals*). If the Issuer has requirements or conditions that will impact the structure or marketing of the bonds require underwriter to provide a preliminary market evaluation during the RFP process and evaluate each prospective underwriter's ability to address Issuer requirements. Require underwriter to provide a written proposal for all underwriting services (max fees, cap on fees, expenses) and the process to be used to address any increases in costs. **Upon Selection:** Issuer should clearly communicate to the underwriter its needs with respect to: o availability of designated transaction personnel; o service expectations in general; and o pricing, marketing, and distribution of bonds. Determine documentation used for transaction such as the Bond Purchase Agreement, Agreement Among Underwriters, and the particular certifications to be given as required by transaction.
Market Reality	Upon selection the underwriter should update the Issuer on prevailing market conditions and how these affect the current transaction (i.e., current interest rates/yields, current supply, investor interest in transaction, etc.). These items might form part of a prepricing/premarketing book underwriters give to Issuer. Underwriter should clearly communicate any decision to change market strategy, pricing strategy, and the reasons for repricing, reasons for changing maturities or other structural elements of the transaction.
Cost Review	Issuer should check that costs, compensation or related goals as discussed in "Selection Process" above are on track. Issuer should check that bond pricing is on track with prepricing/premarketing book given to Issuer in "Market Reality" above If any items not on track with goals/objectives Issuer set forth in the very beginning, Issuer needs underwriter to provide explanation so Issuer can assess and modify or refocus previous goals.
Sale Activity	Issuer should communicate its distribution requirements, if any, to the Underwriter. Underwriter should provide information describing the marketing plan for the bonds including how bonds are being distributed among any underwriting syndicate members. Underwriter should identify any member of the underwriting syndicate taking a position in the bonds. If the actual distribution is not in accord with established plans, Underwriter should provide an explanation and the Issuer should ensure it is not in violation of any law or other requirement. Underwriter should provide an analysis comparing the price of the actual first sale of a substantial amount of each bond to the public with the price included for each bond in the issue price certification. An explanation reconciling any substantial differences between the two should be provided by the Underwriter.
Next Time	Issuer should develop a transaction "scorecard" to gather data to help evaluate transaction performance. Data collected could include: price; structure; fees and other costs; professionals used; satisfaction with service; and market specifics (i.e. interest rate, yield, distribution). The data should be organized to easily compare the transaction with other Issuer transactions and comparable transactions in the market. Issuer should evaluate deal as a whole: o Were costs in line with expectations? o Were market conditions favorable? and o What worked well and what did not work?

Avoiding Troubled Tax-Advantaged Bonds

Considerations for Bidding Investments **Appendix D**

Bidding Agent	Has Issuer researched bidding agent – professional reputation, experience to achieve Issuer objectives, conflicts? Has Issuer negotiated/contracted directly with bidding agent involved? Will the fee be paid by Issuer and will bidding agent provide certificate stating no other payments are being made to the bidding agent with respect to the bond transaction ? Prior to agreeing to engagement, has Issuer informed bidding agent and has bidding agent agreed to provide information on the bidding process and data collected as may be required by Issuer request (see below)?
Bidding Process	Is there a standard set of documentation used for bidding (spec sheet, settlement sheet) that clearly verifies bid specs and fee breakdown? Will Issuer review the list of the potential providers to be solicited in order to identify any concerns about their qualifications or the overall competitiveness of the pool of potential providers? Does the Issuer have detailed information of the bidding process mechanics to determine if bidding was an "open and fair" process? o What information are bidding agents giving potential providers – is this information shared with all potential providers? o Are bids time stamped when received or faxed or submitted via email to verify arrival time? o How and to whom are bids submitted– simultaneously to Issuer and bidding agent by hand, fax, email, other electronic process? Does Issuer review how many potential providers submitted a bid? Does Issuer review bids to verify compliance with the specs and required submission deadlines to see who is disqualified? Does Issuer notice that the winning bid is usually the last bid received? Was the number of non-responding providers unusually large? Is there a possible explanation related to market reality or deal structure? Are investment yields submitted by all potential providers bunched fairly close (indicating a market consensus) or was there a lack of consistency amongst potential providers?
Evaluation of Winning Bid	Does the investment yield received on the investment compare favorably with the yield curve for United States Treasury Securities (available at http://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/TextView.aspx?data=yield) For yield restricted escrows, was the yield received very close to the restricted yield? (Yields within a few thousandths of a percent are statistically improbable and may indicate yield burning is taking place.) Are the yields of any individual investments unusual (i.e., longer term yields lower than shorter term yields)? If front loaded cash payments are to be received in connection with the investment, has the transaction been evaluated to determine the impact on the overall yield? (Some view an initial cash payment received in connection with an investment contract as a very expensive loan when the actual cost of borrowing the upfront cash amount is viewed separately from the overall transaction.) Have all regulatory requirements to establish the fair market value of the investment as required by the Internal Revenue Code or the Issuer's internal investment guidelines been met and properly documented?

Avoiding Troubled Tax-Advantaged Bonds

Considerations for Post-Issuance Compliance **Appendix E**

Establishing Responsibilities	Determine the person responsible for coordinating various aspects of compliance and related reporting requirements. Provide the persons responsible for compliance with appropriate tools to carry out responsibility (training, software to track and maintain records etc.) Determine records to be maintained/produced for post-issuance compliance as required by bond transaction documents and applicable law. Establish policies for resolution of any identified violations/problems.
Documenting Important Information	Document total proceeds of the bond issue. Document project period and use of proceeds before and after such period. Establish procedures for authorizing payments, memorializing allocation of proceeds to expenditures which indicate the date of expenditure, date of official intent (for reimbursement of expenditures made prior to the date of issue), and date allocation of proceeds was made to each expenditure. Secure documentation of Issuer's expectations for use of proceeds to establish reasonable expectations that bonds are not hedge bonds. For multi-purpose issues, indicate the amount of proceeds allocated to each purpose. Identify all potential non-governmental use of facilities financed with tax-advantaged bonds through leases, management or service contracts, naming rights agreements, etc. Document the proceeds not used for governmental purposes as of the end of the project period. For qualified private activity bonds document the use of proceeds for qualified facilities when placed in service.
Monitoring Changes	Establish procedures for the periodic review for private use of the bond financed facilities. Establish policy of reviewing changes to all identified private use of facilities, leases, management contracts, service contracts, or other contracts identified as potential private use related to facilities financed with tax-advantaged bonds. Establish procedures for immediate review of any sale, exchange, or other disposition of tax-advantaged bond financed facilities and asses impact on bond transaction. Evaluate departures from planned use of proceeds to determine if project was altered or there are any changes in bond transaction that have collateral federal tax consequences.
Investment Strategy	Identify bond transaction funds and moneys to be deposited therein as well as funds from transferred proceeds, disposition proceeds, or replacement proceeds, if any, that will also become bond transaction funds. Review flow of funds in bond transaction documents to develop investment strategy to maximize yield based on the expected availability/need of proceeds in each fund. Identify applicable temporary periods, rebate and yield parameters. Regularly evaluate whether investment strategy is effective or should be modified balancing bond transaction requirements and market conditions.
Monitoring Rebate	Determine and document any exceptions from rebate that are available and establish procedures to ensure compliance with the requirements for such exceptions. Before each measurement date for rebate exceptions determine and document compliance with established procedures to ensure rebate requirements were met. Determine procedure for computation of rebate and the frequency computations shall be performed. Document elections, including establishment of first computational period. Establish procedures to ensure whether payment/refund is required in connection with rebate or yield reduction at specific periods and process applicable forms (Form 8038-T or Form 8038-R).