

Municipal bonds need vigilant post-issuance monitoring

The author, a Portland attorney, recommends that municipalities designate officers and monitor facilities financed by bonds for their continued compliance.

By E. William Stockmeyer

After a municipality issues tax-exempt bonds, municipal finance officials must remain vigilant regarding post-issuance compliance with applicable tax and securities laws. This can be challenging. The laws are often complex and arcane, and the professionals who guided the financing to closing are no longer at your elbow. In addition, municipalities are responsible for post-issuance compliance as long as bonds remain outstanding, which can be for decades. As a result, compliance can lapse due to turnover of municipal employees and lack of institutional memory. This article will give a broad overview of how to monitor and comply with IRS and SEC regulations.

When municipalities issue tax-exempt bonds, the U.S. Treasury experiences a net loss of tax revenue from interest earned by bondholders. Consequently, the IRS is keenly interested in regulating conduct of municipalities that issue tax-exempt bonds, including their conduct after the bonds are issued.

Some municipalities sell their bonds through underwriters who resell the bonds on the public market. We will refer to these publicly traded bonds as "securities." With the aim of preventing "fraudulent, deceptive,

or manipulative" practices in connection with the trading of securities, the Securities and Exchange Commission (SEC) directly regulates underwriters and indirectly regulates municipal issuers. For example, the SEC generally requires an underwriter to ensure that a municipal issuer of securities agrees to make ongoing public disclosures to update the market regarding the municipality's financial and operating condition and other information that may affect the value of the securities. These disclosure obligations persist for the life of the securities.

Post-issuance noncompliance with IRS regulations can have significant negative consequences. A bond may lose its tax-exempt status retroactive to the issue date of the bond. Among other things, noncompliance may cause the IRS to assess financial penalties and expose the municipality to significant liability to bondholders. For securities, post-issuance noncompliance consequences include SEC enforcement actions, which may result in federal securities law liability and penalties, lower bond ratings, and higher costs of capital.

Identify compliance officer

In Maine, municipal bonds and securities generally can remain outstanding for up to 30 years. As a result, it is critical to create institutional knowledge about post-issuance compliance. To this end, the municipal governing body should adopt a compliance policy, or periodically review and update, as needed, its current policy. A compliance policy is generally broader than the written procedures that may accompany a specific bond issue. A policy will typically outline the general duties of post-issuance compliance

for bonds and securities, including the areas discussed in this article, and provide broad guidance for fulfilling these duties.

Perhaps most importantly, a policy will designate at least one employee or official who will be responsible for compliance (a "compliance officer"). It is advisable not only to identify the compliance officer(s), but to assign compliance responsibility to one or more specific positions and include compliance as part of those job descriptions. A municipality should also provide the compliance officer(s) with appropriate training and support as needed.

To understand a municipality's specific post-issuance compliance obligations, the compliance officer should compile documentation, typically a closing binder or transcript, for each of the municipality's outstanding bonds. If a transcript is missing, the lender or bond counsel may have copies.

A transcript should inform whether the bond was issued on a tax-exempt basis (subject to tax compliance) and/or whether the bond was a publicly marketed security (subject to SEC compliance). A transcript for a tax-exempt bond should contain a Tax Certificate and/or an Arbitrage and Use of Proceeds Certificate, in which the municipality typically (i) certifies as to expectations at the time the bond was issued and (ii) covenants to comply with tax regulations. A bond transcript may also include written procedures that outline the elements of post-issuance compliance for that bond. A transcript for securities should include a "continuing disclosure agreement" that details the municipality's ongoing SEC compliance obligations.

E. William Stockmeyer is an attorney who heads the Public Finance subgroup at Drummond Woodsum in Portland and has represented clients on a wide range of financial and business matters, including bond issuance, budgetary matters, enabling and other legislation, school funding, school reorganization, construction contracts, public bidding and procurement, real estate, and board conflicts of interest. He attended Cornell Law School and also earned undergraduate and Master's degrees at Cornell. He was admitted into the Maine Bar in 1986. Reach him via email at: bstockmeyer@dwmlaw.com.

Maintain records

Maintaining tax and securities compliance is difficult without adequate records. The closing transcript contains certifications and expectations as to the use of bond proceeds at the time the bond was issued. While a bond remains outstanding, the municipality should keep records, including those related to (i) the municipality's required reporting of the tax-exempt financing to the IRS (generally, Form 8038-G is filed at or shortly after issuance); (ii) expenditures of bond proceeds; (iii) investment earnings on bond proceeds; (iv) progress and completion of the bond-financed facility; (v) use of the facility, especially any nongovernmental uses; and (vi) sources of payment of debt service, including all income from private uses of the facility. All records should generally be kept for the life of the bond plus three years.

Two important concepts

Generally speaking, understanding two basic tax concepts will go a long way toward staying in compliance with the tax laws after issuing tax-exempt bonds. The two concepts are compliance with (1) arbitrage restrictions; and (2) private business use and payment restrictions.

Tax Concept 1: Monitor compliance with arbitrage restrictions on investment earnings

"Arbitrage" occurs when a municipality invests bond proceeds at

a materially higher rate of interest than that which the bond yields for bondholders. (The bond "yield" is reported on the IRS Form 8038-G.) The IRS generally restricts a municipality's ability to earn and keep arbitrage earnings. Compliance with these arbitrage restrictions has many components, but in our experience there are two matters that compliance officers must be especially vigilant to monitor, and where action may be required to stay in compliance.

First, the municipality is permitted to earn arbitrage on a project fund only for a "temporary period" after the bonds are issued (typically, three years). After the applicable temporary period ends, the municipality must "yield restrict," by limiting any earnings on unexpended bond proceeds so as to not exceed the bond yield, or making "yield reduction payments" to the IRS to reduce investment earnings down to the bond yield.

Second, although an issuer may earn arbitrage during the applicable temporary period, the issuer must still rebate to the IRS all earnings in excess of the bond yield unless the issuer qualifies for a "rebate exception." In most cases, a municipality intends to apply either the "small issuer exception to rebate" or a "spend-down exception to rebate."

The compliance officer must first identify the applicable rebate exception, which is usually stated in the

Arbitrage and Use of Proceeds Certificate. The most common rebate exceptions relied upon are the "small issuer exception to rebate" and the "two-year construction spend-down exception to rebate." The compliance officer must then become familiar with the requirements of the applicable rebate exception and monitor compliance with the rebate exception or else the municipality will be required to calculate and pay rebate to the IRS. If at any time it appears the municipality will not qualify for a rebate exception, contact bond counsel to discuss how to proceed.

To use the two-year rebate exception as an example, the bond proceeds (including investment proceeds) generally must be used for construction or renovation, and the municipality must meet four spending targets to satisfy the exception: 10 percent at six months, 45 percent at one year, 75 percent at 18 months and 100 percent at two years. The compliance officer must monitor the investment earnings and project expenditures and measure whether in fact the municipality actually meets the spending targets. If any target will not be met, the compliance officer should consult with its bond counsel to determine if another spend-down exception might apply, and if not, what further action to take for arbitrage rebate compliance.

Tax Concept 2: Monitor bond-financed facility to comply with limits on



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private business use and private payments

The second post-issuance tax compliance concept is that facilities financed with tax-exempt bonds generally must be monitored to ensure that they are applied to state or local governmental uses, except for small permissible threshold amounts of private business use and private security for or payments on the bond. Long after bonds are issued, but while they are still outstanding, there are numerous arrangements that may be deemed to be a private business use and that result in private payments that may be deemed to be indirect payments of a bond. For example, these might include a sale or rental of portions of the facility, certain management contract arrangements, or even advertising use such as for naming rights. In general, the thresholds for allowable private business use and private payment are 10 percent, but in some circumstances the thresholds are reduced to 5 percent.

The compliance officer must identify the use and payment thresholds in the Arbitrage and Use of Proceeds Certificate, be alert to recognize the situations that will arise, and monitor the extent of private business uses and payments for facilities to ensure they stay below the allowable thresholds. Bond counsel should be consulted in advance whenever facilities financed with tax-exempt bonds are proposed to be used for payment by private business.

Timely disclosures on "EMMA"

At the time a municipality issues securities in a public offering, the municipality typically will have provided an "official statement" and a "continuing disclosure agreement." The official statement is an initial disclosure document that informs investors about the offered securities and provides financial and operating information of the issuer. The continuing disclosure agreement is a binding contract signed by the issuer that specifies the type of ongoing disclosures that the issuer has agreed to provide to investors for the life of the securities and the timing of these disclosures. Since 2009, these disclosures are required to be uploaded to the "Electronic Municipal Market Access" (EMMA), a website of the Mu-

nicipal Securities Rulemaking Board (MSRB), where they are available to the public.

The continuing disclosure agreement is the key to identifying ongoing SEC disclosure obligations. The compliance officer should carefully review this document to become familiar with the types of disclosures that are required and the deadlines for making those disclosures. To help ensure timely continuing disclosure filings, the compliance officer can schedule periodic email reminders through EMMA.

In general, a continuing disclosure agreement will require two types of information: (1) annual financial information, including financial information and operating data of the issuer and audited financial statements; and (2) notices of the occurrence of "material events."

The annual financial information and operating data required to be disclosed is of the type that was provided in the official statement. The continuing disclosure agreement must specify the date by which this disclosure will be provided. Typically, this is 270 days after the close of a fiscal year. If the issuer does not timely disclose annual financial information and operating data, there is a further obligation to post a "Notice of Failure to File" on EMMA.

Material events are occurrences

that a reasonable investor would consider important in making investment decisions. The SEC regulations provide a nonexclusive list of 14 materials events, including payment delinquencies, ratings changes, bankruptcy, and merger or consolidation. Issuers are required to disclose a material event within 10 business days of its occurrence. This narrow 10-day window for disclosure emphasizes the need for the compliance officer to understand these disclosure obligations and to be alert to report the occurrence of such events.

Summary

Municipalities are often unaware of their federal tax and securities compliance obligations after they have issued tax-exempt bonds. Effective compliance requires adopting or updating an effective post-issuance compliance policy, identifying compliance officers, keeping thorough records, and providing proper training. The compliance officers must understand what needs to be monitored for tax and securities law compliance purposes. They must seek out timely advice when questions or potential problems are identified. Advice is available from written post-issuance compliance procedures, from bond counsel, and from other sources, such as websites maintained by the IRS and the MSRB. ■

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