



## BEST PRACTICE

### **Payment of the Expense Component of Underwriters' Discount (1996 and 2010) (DEBT)**

**Background.** When using the negotiated method of sale for tax-exempt or taxable bonds, the compensation paid to underwriters consists of four components: takedown, management fee, underwriting risk, and expenses. The expense component includes only those costs incurred by the underwriter on behalf of the issuer for such expenses as travel, costs of underwriters' counsel, printing and mailing, and closing costs. Issuers should demand itemized expense accounting and pay close attention to the types and amounts of such expenses in order to avoid paying excessive or inappropriate expenses in their bond issues.

**Recommendation.** The Government Finance Officers Association (GFOA) recommends that state and local government issuers clearly communicate to the senior managing underwriter the expenses they view as legitimate and their expectations regarding payment of expenses by members of the underwriting syndicate. Issuers need to be sure that the expense component represents charges for items that are necessary to complete the financing, since paying for nonessential expenses reduces the amount of proceeds for capital projects or other governmental activities. Moreover, permitting the underwriter to charge members of the underwriting syndicate for expenses, without the knowledge of the issuer, by reducing the takedown or management fee, may compromise issuer goals, such as rewarding sales or other efforts by members of the syndicate.

To ensure that expenses are reasonable and explicitly identified, issuers should consider the following actions:

1. Require firms proposing to serve as senior managing underwriter to present in their proposal an itemized list of expenses that they expect to incur and how they will be paid, either by the issuer or by members of the underwriting syndicate. Underwriters should be required to explain and justify any expense component that is not clearly understood by the issuer.
2. Convey clearly to the firm selected as senior managing underwriter the expenses that the issuer regards as legitimate and those that the issuer does not view as reasonable. Among the expenses that may be regarded as legitimate are:
  - reasonable costs of underwriters' counsel;
  - travel to and from the issuer's offices;
  - data service fees for transmitting information on interest rates, takedowns, and priority of orders;
  - interest/day loan costs;
  - charges for communication, including the rating agency presentation, mailing, printing, and telephone expenses; and
  - CUSIP fees.

Expenses that the issuer may want to deny include commuting costs to and from work by the underwriters' staff, computer-run charges, and undocumented clearing charges.

Additionally, either directly or indirectly, issuers are not be responsible for and should not pay fees due to the Securities Industry and Financial Markets Association (SIFMA) or the Municipal Securities Rulemaking Board (MSRB) out of bond proceeds. These include the SIFMA Municipal Assessment fee, which the underwriter is responsible for paying to SIFMA and is equal to 2 cents of every thousand dollars of bonds issued, and the MSRB Underwriting and Transaction Assessment fee, which the underwriter is responsible for paying to MSRB and is equal to 3 cents of every thousand dollars of bonds issued.\*

3. Pay particular attention to fees for underwriters' counsel, as this generally is one of the most significant expense components paid by the issuer. Issuers should consider setting a cap on fees paid to underwriters' counsel.
4. At the time of bond pricing the senior managing underwriter should explicitly document all expenses incurred on behalf of the issuer in a negotiated sale, as well as any expenses charged to members of the underwriting syndicate. The senior managing underwriter should explain any expenses not included in the original proposal.

## **References**

- *Debt Issuance and Management: A Guide for Smaller Governments*, James C. Joseph, GFOA, 1994.
- GFOA Best Practice, *Selecting Underwriters for a Negotiated Bond Sale*, 2008.
- GFOA Best Practice, *Issuer's Role in Selecting Underwriter's Counsel*, 2009.
- GFOA Best Practice, *Pricing Bonds in a Negotiated Sale*, 2009.
- *Understanding the Underwriting "Spread,"* Issue Brief No. 2, California Debt Advisory Commission, March 1993.

Approved by the GFOA's Executive Board, March 5, 2010.

\*MSRB Rule A-13(e), "Prohibition on Charging Fees Required Under this Rule to Issuers. No broker, dealer or municipal securities dealer shall charge or otherwise pass through the fee required under this rule to an issuer of municipal securities."