Government Finance Officers Association

DEBT 101, Volume II – Responsibilities After Bond Issuance

Introduction: What to Do After a Bond Has Been Issued

Bonds issued by State and local governments are generally subject to ongoing monitoring and reporting with respect to federal disclosure requirements, as well as compliance with federal tax requirements.

Issuers of municipal bonds need to comply with the requirements of Securities and Exchange Commission (SEC) Rule 15c2-12 with respect to continuing disclosure. Such activities include annual reporting as described in the continuing disclosure undertaking prepared at the time of issue, as well as disclosure of certain material events as outlined in the rule.

Tax-advantaged bonds (tax-exempt, tax credit and direct pay) are bonds that receive preferential tax treatment. These bonds are subject to applicable federal tax requirements both at the time of issuance and for as long as the bonds remain outstanding. Failure to comply with these requirements can jeopardize the preferential tax status of those bonds.

Ensuring that these federal tax requirements are met normally will occur at the time of closing on the bonds. There are other requirements, however, that require ongoing monitoring after the bonds are issued. Such post issuance activities will generally fall into two categories: (1) qualified use of bond proceeds and bond-financed property; and (2) arbitrage yield restriction and rebate.

This document will highlight key topic areas that Issuers need to be familiar with. A companion document entitled Debt 101, Volume I discusses steps prior to bond issuance and the bond issuance process itself.

Continuing Disclosure

Governments that issue bonds generally have an obligation to meet specific continuing disclosure requirements that are identified specifically in a continuing disclosure agreement (CDA's, also called continuing disclosure certificates or undertakings). These are entered into at the time of bond issuance pursuant to SEC Rule 15c2-12 (Rule). Obligations that have a maturity of 270 days or less are exempt from these requirements, while other short-term issues with a maturity of 18 months or less are subject to lesser requirements.

When bonds are issued, the Issuer covenants via the CDA to provide certain annual financial information as identified in the CDA, and to notify the public of certain material events as described in the Rule. Such information is required to be submitted electronically either by the Issuer or by their agent via the Municipal Securities Rulemaking Board's (MSRB) Electronic Municipal Market Access (EMMA) portal. In

addition to filing through EMMA, an Issuer may also choose to post its annual financial information or other reports on its web site.

Typically, a series of bonds will require its own CDA. While a separate CDA will generally be required with the issuance of each series of bonds, the information that is required to be disclosed is generally quite similar for each issue. In the offering document for those bonds, Issuers will be required to state whether or not they are in compliance with all previous continuing disclosure obligations.

Issuers may choose to provide information beyond that required by the Rule and identified in its CDA on a voluntary basis. Such information may also be posted on EMMA. Issuers should be aware that they should disseminate such information to the market as a whole and not provide any one individual or group with any information that is not readily available to the public as a whole. Issuers should also develop a continuing disclosure policy or procedure as further described below.

Issuers should review the following GFOA best practices for further information on meeting their continuing disclosure responsibilities:

- GFOA Best Practice: Understanding Your Continuing Disclosure Responsibilities
- GFOA Best Practice: Using Technology for Disclosure

Tax Compliance

When tax-advantaged bonds are issued, an Issuer needs to ensure they have the appropriate procedures in place to comply with all the federal tax rules applicable to those bonds from the date of issuance through their final maturity.

Federal tax rules applicable to tax-advantaged bonds generally include the following major areas:

- *Expenditure of Proceeds:* At the time of sale, the Issuer must expect to expend bond proceeds promptly, and, in some cases, by time-specific deadlines set forth in the Internal Revenue Code and Treasury Regulations. Furthermore, bond proceeds may only be spent for purposes permitted based upon the type of bonds issued.
- *Use of Financed Assets:* Internal Revenue Code and Treasury Regulations limit how an Issuer may use assets financed with the proceeds of tax-advantaged bonds. For example, for governmental purpose bonds, there are detailed rules that limit both direct and indirect use of bond-financed assets by private entities.
- *Investment of Proceeds:* Tax rules generally require that, except during certain temporary periods, the proceeds of tax-advantaged bonds may not be invested at a yield materially higher than the yield on the bonds. Any permitted investment income above the yield on the bonds is rebated to the federal government.

- *Recordkeeping:* The Issuer needs to retain sufficient records to support the continuing tax-advantaged status of its bonds, and to prove compliance with the rules for expenditure of proceeds, use of the financed assets, and investment of proceeds.

The National Association of Bond Lawyers and GFOA have collaborated on a useful and detailed document “Considerations for Developing Post-Issuance Compliance Policies,” that Issuers are encouraged to consult for much more detail on tax compliance requirements. That document may be found at:

- Developing and Implementing Procedures for Post-Issuance Compliance for Issuers of Governmental Bonds
- GFOA/NABL Post Issuance Compliance Checklist

Developing a Policy and Establishing a Compliance Program

It is recommended that Issuers establish written policies and procedures to comply with post-issuance and ongoing requirements. The policy should identify a single individual with primary responsibility for monitoring and complying with the program. While multiple individuals (or external service providers) may help with performing compliance tasks, assigning a single point of responsibility can help prevent inconsistency and unintentional omissions. It is also helpful to create a checklist or inventory of requirements, including when the tasks are performed and by whom.

It is critical that once a policy and/or program are defined, Issuers closely follow the requirements and document their compliance. Documented proof of intentional compliance can be a very effective defense against any potential regulatory investigation. It is also important that a compliance program consider the process for dealing with non-compliance in the event this is discovered. Generally, Issuers should take actions to get back into compliance as soon as possible.

Further detail on post-issuance compliance is available at the following resources:

- GFOA Best Practice: Debt Management Policy
- GFOA/NABL Post Issuance Compliance Checklist

Investment of Bond Proceeds

Upon the issuance of bonds by a State or local government, the bond proceeds are usually deposited in various funds. These funds may be construction funds, debt service funds, debt service reserve funds, an escrow fund, etc. The deposited proceeds are usually invested until they are needed.

There are a number of considerations the governments should consider when making decisions to invest such proceeds. Examples of these considerations include the anticipated drawdown schedule of the proceeds, federal and State regulations governing the types of investments permitted for the investments, the arbitrage yield, the State or local government’s investment policy, and requirements from rating agencies.

The anticipated use and drawdown of the invested proceeds, such as projected expenditures for capital projects or use for coverage of debt service, will be a major consideration in the investment of the proceeds. Those responsible for making investment decisions should coordinate closely with departments and staff that will be drawing down proceeds, depending upon the purpose of the bonds issued. This may involve coordinating with the staff responsible for engineering and construction for bonds issued for capital projects, or with cash management and treasury staff responsible for making debt service payments for bonds issued for refunding purposes.

A written investment policy is the single most important element in a public funds investment program. The investment policy should describe the most prudent objectives for a sound policy, including safety, liquidity, and yield. It should indicate the type of instruments eligible for purchase by a government entity, the investment process, and the management of a portfolio. Adherence to the investment policy signals to rating agencies, the capital markets and the public that a government agency is well managed and is earning interest income suitable to its situation and economic and regulatory environment. The GFOA has developed a Best Practice titled *Creating an Investment Policy* available for reference.

In 2014, the SEC Municipal Advisors (MA) Rule took effect. The MA Rule has implications that may impact the investment of bond proceeds, as it limits the kinds of communications brokers may have with Issuers. Specifically, brokers may be considered Municipal Advisors if they provide advice on investments of bond proceeds to governments. Brokers are prohibited from providing advice to governments unless the brokers become Municipal Advisors in accordance with the MA Rule, including following requirements to register with the SEC and the MSRB, or meet one of the exemptions to the MA Rule.

One result of the MA Rule is that certain brokers are sending letters to State and local governments asking them to indicate that none of the funds they are investing on behalf of the government are bond proceeds. They do this because bond proceeds now have certain requirements under the MA Rule within which the brokers may out of compliance. The investment of bond proceeds is now treated differently in some respects, and is subject to different requirements, than investment of other funds, in accordance with the MA Rule.

The GFOA has issued an *Alert on the MA Rule and Issuers*, and this Alert details the multiple exemptions permitted. It is recommended that Issuers become familiar with the MA Rule and its definitions, requirements and exemptions. A link to the Alert is provided below.

As with the investment of other governmental funds, there are risks inherent in investing bond proceeds. These include credit risk (safety), the risk of investing in instruments that may degrade in credit quality or default; market risk (liquidity), the risk of selling an investment prior to maturity at less than book value; and opportunity risk (yield/return), the risk of investing long term and having interest rates rise, or investing short term and having interest rates fall while needing to reinvest the bond proceeds. Issuers should develop and adhere to investment policies and activities that minimize these risks. The GFOA has a Best Practice on the *Investment of Bond Proceeds*.

Issuers should become acquainted with federal tax law as it applies to arbitrage restrictions, and maintain adequate records to comply with arbitrage reporting and rebate requirements. Arbitrage is the ability to obtain tax-exempt bond proceeds and invest the funds in higher yielding taxable securities, resulting in a profit. In short, arbitrage occurs when interest earned on invested proceeds exceeds the interest rate of the interest repayment, or debt service, of the proceeds. Investments should be considered in light of the yields permitted to comply with federal arbitrage requirements. Procedures should be established to monitor any arbitrage rebate liabilities and reserve liabilities for future remittance to the IRS.

- Alert on the MA Rule and Issuers
- GFOA Best Practice: Creating an Investment Policy
- GFOA Best Practice: Investment of Bond Proceeds

Payment of Debt Service

Issuers of government debt have a fiduciary responsibility to manage their funds in a manner that assures timely and accurate payment of debt service principal and interest. Failure to make a debt service payment generally results in a default, a requirement to post a Material Events Notice on the MSRB EMMA system, and can have major negative consequences. If a debt service payment is missed, Issuers should take immediate action to remedy the situation.

It is recommended that Issuers review GFOA's Best Practice *Settlement Procedures for Debt Service Payments*. Major recommendations of this Best Practice include:

- Establishing procedures and appropriate contractual terms for making debt service payments
- Use of electronic funds transfers to ensure timely payments and to ensure full utilization of funds until the due date.

In addition to the recommendations from the Best Practice, Issuers should consider the following items when designing procedures and policies for making debt service payments:

- Issuers should have a debt service schedule for each bond issue containing all principal and interest payment dates and amounts
- Issuers should be aware of any "flow of funds" requirements contained in a bond indenture. Some bond issues may require monthly or other periodic transfers of funds before actual payment dates (i.e. 1/12th of principal payment each month)
- Issuers with variable rate debt should understand and monitor changing debt service requirements

Refunding Analysis

It is common that – prior to maturity of the debt – an Issuer will have the opportunity to refinance the remaining debt at lower interest rates (called a "refunding"). Municipal debt is typically issued with a call or redemption feature. The call feature must be specific and include what bonds can be called, at what

time, and for what price, giving flexibility to the Issuer. The date is usually approximately 10 years after the original issue date, but can vary based upon the specific terms agreed to at the original point of debt issuance and the length of the bonds. Refunding debt at or after the call date is called a "current refunding." Debt can also be refunded prior to the call date via an "advance refunding", though there are typically additional cost requirements and tax compliance issues associated with an advance refunding prior to the call date.

Refunding of debt requires essentially the same process and effort as a "new money" issue, and often there is only one opportunity to refund debt for significant interest savings. Therefore, an Issuer should have a policy or guidelines that set a minimum savings baseline under which a refunding would be pursued. For example, many Issuers require a minimum of 3% or 5% savings (and/or a minimum dollar amount of savings) in order for a refunding to proceed. Setting an appropriate savings minimum avoids inefficient use of time exploring inefficient refundings, and can prevent refunding too early and missing greater savings by waiting until a later date.

Typically, the final maturity in a refunding remains unchanged, and the other terms of the refunding often closely match the original debt issue. The proceeds of the refunding are generally placed into an escrow until the call date (or next payment date) occurs, at which point the original bonds are paid off from money in the escrow. It is important that an Issuer work with service providers to create an escrow that earns as much as possible (i.e. an efficient escrow) without exceeding maximums allowed under federal regulations.

- GFOA Best Practice: Analyzing and Issuing Refunding Bonds

Other Requirements

Issuers should be aware that in addition to continuing disclosure and tax compliance requirements, there are often other legal documents, laws and regulations, policies, contractual requirements, and/or relationships that must be monitored. Some of the most common of these are included in this section.

Bond Indentures/Bond Ordinance/Bond Resolution. Many bond issues have an ordinance and/or resolution that authorize and set many of the terms of the bond issue. Also, some bonds may have a bond indenture, which is a legal contract between the Issuer and bond holders. These documents can contain a variety of requirements that may include:

i. Notice requirements
ii. Reporting requirements
iii. Coverage ratio or revenue covenants
iv. Additional bonds tests
v. Permitted investments
vi. Debt service payment requirements
vii. Debt service reserve fund requirements
viii. Bond insurance or surety bond requirements
ix. Required accounts/segregation of funds

x. Requirements related to a trustee or paying agent
xi. Restrictions on the use of bond proceeds
xii. Redemption provisions

State/Local Law Requirements*.* Issuers should work with Bond Counsel and/or legal counsel to determine if there are any ongoing requirements related to State or local law that must be monitored. These may include items such as notice requirements, public protest procedures, legal debt limits, or limitations on revenue used to pay debt service.

Policy Requirements*.* Issuers may have debt or other financial policies that must be monitored to ensure compliance. Common policy items that relate to debt issuance are debt limits, use of debt, debt ratios, and investment policies.

Rating Agencies. Issuers should be familiar with the GFOA best practice *Using Credit Rating Agencies*. Issuers (often with assistance from their Municipal Advisor) are responsible for managing the relationship with rating agencies after issuance. This can involve keeping the rating agencies informed of material events and responding to ongoing requests for information.

Investor Relations*.* Issuers should be familiar with the GFOA best practice *Maintaining an Investor Relations Program*. An effective investor relations program that responds to the informational needs of investors may lead to lower future borrowing costs for Issuers.

Financing Team Relationships*.* Issuers should manage the ongoing relationships with the various members of the financing team, which may include a Municipal Advisor, Bond Counsel, disclosure counsel, trustee banks, and/or paying agents. Issuers should continuously evaluate services provided, ensure compliance with contracts, and periodically conduct selection processes as needed.

- GFOA Best Practice: Analyzing and Issuing Refunding Bonds
- GFOA Best Practice: Using Credit Rating Agencies
- GFOA Best Practice: Maintaining an Investor Relations Program