

Post Issuance Compliance

May 17, 2018

Presented by:

Fred Marienthal



KUTAKROCK

kutakrock.com

Continuing Responsibilities

- ❖ The fun doesn't stop when the bonds are issued. Issuers have continuing responsibilities and obligations imposed both by the documents that control the bond issue and the regulatory authorities that monitor the industry, primarily the Internal Revenue Service ("IRS") and the Securities Exchange Commission ("SEC").

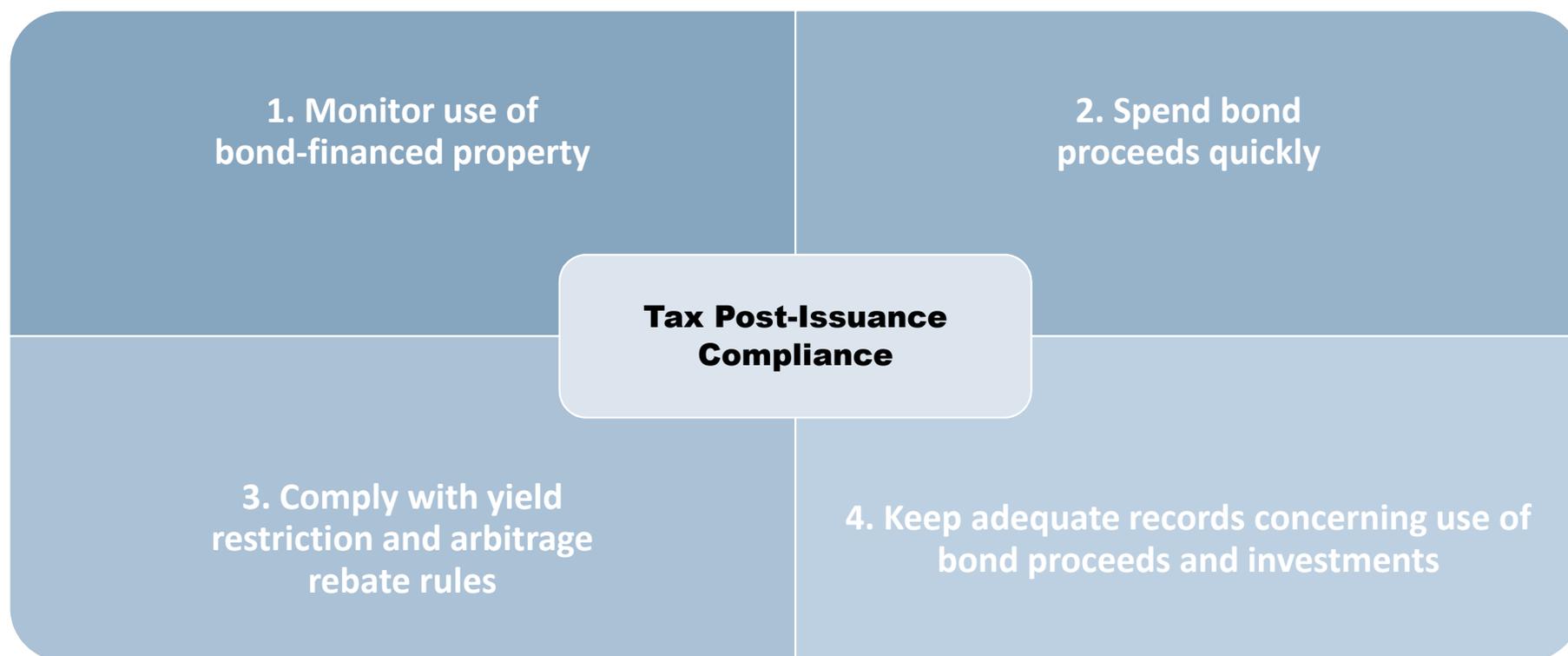
Three primary categories of post issuance requirements:

- Tax Matters
- Securities Matters (Disclosure)
- Additional Contractual Obligations

Post-Issuance Tax Matters

- ✓ What are the basic post-issuance tax rules?
- ✓ What has changed?
- ✓ How does this impact you?
- ✓ What else is the IRS up to?

The Four Most Important Tax Rules



Rules 1 and 2: Monitor Use and Spend Quickly

❖ Monitor use of bond-financed property

- Don't allow (too much) private business use
- Avoid unrelated use of bond-financed property
- Be careful before entering into management or service contracts – they may be treated as giving rise to private business use
(qualified management contract rules)
- Other circumstances giving rise to private business use

❖ Spend bond proceeds quickly

- Generally, spend bond proceeds within three years
- Reimbursement rules
- Talk with counsel before spending bond proceeds on facilities not identified in the tax documents

Rule 3, Part 1: Yield Restriction

- ❖ Don't earn too much on investment of "proceeds"
 - This is called "yield limitation" in the tax documents
 - Rule: "Proceeds of an issue cannot be invested at above the yield on the bonds, except (a) during temporary periods, or (b) as part of a reasonably required reserve, or (c) as part of a minor portion."
 - Project funds qualify for temporary period exception if:
 - ✓ 85% of proceeds expected to be spent in 3 years
 - ✓ Within 6 months, have binding obligation to spend 5%
 - ✓ Diligently spend proceeds

Rule 3, Part 2: Rebate Requirement

- ❖ Pay (arbitrage) earnings to the federal government
 - This is called “rebate requirement” in the tax document
 - Rule: Arbitrage earnings (earnings in excess of the bond yield) must generally be paid to (“rebated”) to the U.S. Treasury.
 - Complete rebate computation every five years and at retirement
 - No need to pay rebate if “spending exceptions” are met:
 - ✓ 6-month spending exception
 - ✓ 18-month spending exception
 - ✓ 2-year spending exception for construction issues
- ❖ Yield Reduction Payments

Rule 4: Keep Records

- ❖ Keep the following records regarding the bonds:
 - Records of rebate payments
 - Records of rebate calculations
 - Records concerning investment of proceeds
 - Records concerning property financed with bond proceeds
 - Records concerning use of bond-financed property
- ❖ Maintain records for at least 3 years after the later of retirement of (1) the original bonds or (2) any bonds issued to refinance the original bonds
- ❖ Post-issuance compliance policies must address recordkeeping

Form 8038 and Tax Post-Issuance Compliance

Two boxes on IRS Form 8038!

Part VII Miscellaneous

37 Name of governmental unit(s) approving issue (see the instructions) ▶

38 Check the box if you have designated any issue under section 265(b)(3)(B)(i)(III) ▶

39 Check the box if you have elected to pay a penalty in lieu of arbitrage rebate ▶

40a Check the box if you have identified a hedge and enter the following information ▶

b Name of hedge provider _____

c Type of hedge ▶ _____

d Term of hedge ▶ _____

41 Check the box if the hedge is superintegrated ▶

42a Enter the amount of gross proceeds invested or to be invested in a guaranteed investment contract (GIC) ▶ _____

b Enter the final maturity date of the GIC ▶ / /

c Enter the name of the GIC provider ▶ _____

43 Check the box if the issuer has established written procedures to ensure that all nonqualified bonds of this issue are remediated in accordance with the requirements under the Code and Regulations (see instructions) ▶

44 Check the box if the issuer has established written procedures to monitor the requirements of section 148 ▶

45a Enter the amount of reimbursement if some portion of the proceeds was used to reimburse expenditures ▶ _____

b Enter the date the official intent was adopted ▶ / /

46 Check the box if the issue is comprised of qualified redevelopment, qualified small issue, or exempt facilities bonds and provide name and EIN of the primary private user ▶

Name ▶ _____ EIN _____

- 1. "Do you have post-issuance compliance policies?"
- 2. "Do you have remedial action procedures?"

Compliance Policies

- ❖ Implement policies to ensure and prove compliance
 - IRS will ask about compliance policies in an audit
- A. Designate a responsible person or team
 - ✓ May be internal or external responsibility or combination
 - ✓ Centralized responsibility
- B. Establish system to monitor investment of proceeds and schedule periodic review and rebate calculations
 - ✓ Involve bond counsel before bidding investment contracts
- C. Establish system to monitor expenditure of proceeds

Compliance Policies (cont'd)

D. Establish system to monitor use of financed projects

- ✓ Consider how to maintain communications with persons not involved in bond financing
- ✓ Ensure management contracts are reviewed by bond counsel prior to executing

E. Keep records with respect to expenditures and investment of bond proceeds until at least 3 years after the retirement of the original bonds and any bonds that refinance the original bonds

Compliance Policies (cont'd)

F. Staff training and ongoing education

- ✓ Be wary of isolating all key information in one person
- ✓ Include post issuance compliance duties in job descriptions and organizational charts
- ✓ Know what the bond and tax documents say
- ✓ Talk to bond counsel – we are happy to help!

Remedial Action Procedures

- ❖ Know what your remedial action options are
 - ✓ Remedial actions are actions that can be taken to fix excessive private business use (resulting from, e.g., sale of financed facilities)
 - ✓ Examples of remedial actions include redemption or defeasance of bonds, use proceeds of sale for good uses

IRS Bond Examination/Audit Program

- Each year the IRS initiates hundreds of audits of tax-advantaged bonds
- Audits of two general types – random (i.e., chosen by IRS statistical sampling) and targeted (e.g., chosen by whistleblowers; bad press; or due to SEC inquiry)
- By far most audit are random where IRS chooses market segments to review (e.g., random reviews of hospitals, school deals, refundings, airport deals)
- IRS can do cursory review by letter audit or formal review by opening a case audit

IRS Bond Examination/Audit Program (cont'd)

- ❖ IRS can close with:
 - (1) No change to tax exemption or tax-advantages;
 - (2) Cash payment; bond redemption of non-qualified amount of bonds and Closing Agreement; or
 - (3) Adverse conclusion which can be appealed to IRS Appellate Group; or, rarely, to court
- ❖ An audit can take from 6 months to 6 years or longer to close
- ❖ Don't try to do a formal case audit without counsel

IRS Voluntary Closing Agreement Program

- ✓ Process initiated by the issuer to cure compliance errors discovered by the issuer
- ✓ Issuer may present facts anonymously to test if IRS will enter into an agreement to protect tax-exemption (Closing Agreement)
- ✓ If so, IRS settles on a named basis problems for cash payment, redemption of non-qualified amount of bonds and a Closing Agreement
- ✓ Many common “problems” have set payment and redemption formulas
- ✓ Program continues to improve but still takes from 2 to 6 months to finish

What do we mean by “continuing disclosure”?

Following the issuance of municipal securities, providing to the market financial and operating data concerning the issuer or other “obligated person” (person obligated to support the payment of the bonds) on a periodic (generally annual) basis and, in addition, reporting to the market the occurrence of specified material events relating to the issuer, obligated person or the municipal securities.

Questions for consideration:

- What type of information?
- Provided by whom, to whom?
- When?
- What if you don't?

Why?

The Municipal Securities Regulatory Framework

- ❖ The Tower Amendment; limited jurisdiction over municipal securities
- ❖ Indirect regulation through Rule 15c2-12, imposing requirements on the underwriter of municipal securities
 - 1975 – mandatory registration of brokers /dealers; MSRB created
 - 1989 – underwriters required to obtain and review “deemed final” official statement before offering or purchasing municipal securities
 - 1994 – continuing disclosure agreements with issuer and obligated persons required
 - 2008 – EMMA established; small issuer exemption changed
 - 2010 – amendments to continuing disclosure requirements affecting certain exemptions and reporting requirements
 - 2014 – SEC MCDC Initiative

Rule 15c-2-12

Generally prohibits any underwriter from purchasing or selling municipal securities unless the issuer or other obligated person has committed to provide annual updates about its financial condition and operating data of the type included in the official statement, as well as disclosure of certain specified material events.

Key Issuer or Obligated Person Requirements Resulting from 15c2-12

- ❖ Provision of annual financial and operating information
- ❖ Provision of audit when available
- ❖ Notice of material events
- ❖ Exemptions
 - Limited offerings in denominations of \$100,000 or more (though note some voluntary continuing disclosure undertakings)
 - Recent change eliminating exemptions for variable rate demand obligations
- ❖ Filings to be made with EMMA
- ❖ Obligation documented in Continuing Disclosure Agreement/Undertaking

Changes to Event Notice Requirements

- Notice to be provided not in excess of 10 business days after occurrence of event
- Materiality standard eliminated in several cases
- New events added

Notice Events

- (1) Principal and interest payment delinquencies;
- (2) Non-payment related defaults, if material;
- (3) Unscheduled draws on debt service reserves reflecting financial difficulties;
- (4) Unscheduled draws on credit enhancements reflecting financial difficulties;
- (5) Substitution of credit or liquidity providers, or their failure to perform;
- (6) Adverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the security, or other material events affecting the tax status of the security;

Notice Event (cont.)

- (7) Modifications to rights of security holders, if material;
- (8) Bond calls, if material, and tender offers;
- (9) Defeasances;
- (10) Release, substitution, or sale of property securing repayment of the securities, if material;
- (11) Rating changes;
- (12) Bankruptcy, insolvency, receivership or similar event of the obligated person;
- (13) Merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business;
- (14) Appointment of a successor or additional trustee or the change of name of a trustee, if material.

Consequences to Issuer or Obligated Person of Failing to Comply with Continuing Disclosure Agreements

- Does not constitute an event of default under indenture or loan agreement; only remedy is action for specific performance.
- Underwriter must have reasonable basis for recommending municipal securities to investing public, including reasonable basis for believing Issuer or Obligated Person will comply with continuing disclosure undertaking
- Underwriter duty to investigate past compliance
- Duty to disclose any instance of Obligated Person's failure to comply in prior five years; potential impact on sale of new bonds
- Required representations re: past compliance
- Remedial actions may be required for Underwriter to have reasonable basis to believe future compliance by Issuer or Obligated Person

VOLUNTARY DISCLOSURES

- ✓ Possibility of Refunding
- ✓ Mergers, Affiliations, Acquisitions (at right time)
- ✓ Disclosures to Bondholders or Trustee for Particular Bond Issues
- ✓ Other non-public Indebtedness
- ✓ Other Material Events

Municipalities Continuing Disclosure Cooperation (MCDC) Initiative of SEC's Enforcement Division

- Launched on March 10, 2014; “expired” on September 10, 2014 and December 1, 2014
- Provided standardized settlement terms for violations involving continuing disclosure obligations
- Available to issuers, obligated persons and underwriters who self-reported or were already under investigation
- Purpose was allegedly to address materially inaccurate statements in municipal bond offering documents
- The initiative led to settlements with 72 issuers from 45 states and 72 underwriters representing 96% of the underwriting market. In December, 2016, the SEC announced it was finished with MCDC settlements and would turn its attentions to violators who did not report, whom the SEC considered to be at high risk for future violations.

Who is Responsible for Dissemination?

- Trustee
- Paying Agent/Registrar
- Investment Banker
- Public Entity or Obligated Persons

What will they think of next?

- ✓ Bank loan/private placement disclosure
- ✓ SEC proposed expansion of authority
- ✓ Possible minimum disclosure requirements, similar to the corporate world

OTHER CONTRACTUAL OBLIGATIONS

Review those covenants carefully!

Annual Reports & Certifications

- Evidence of Appropriation & Budget
- Certificate re: Reserves/Surplus Funds
- Certificate re: insurance coverage
- Annual audit
- Coverage, Liquidity, Days Cash On Hand and Other Financial Covenants
- Bond Reserve Requirement (may change)
- Posting of Other Data
- Certificate that legal requirements of bond documents met/no default

Periodic Reports & Certifications:

- ❖ Quarterly Financial Reports – comparative
- ❖ Insurance Consultant Review and Certification

Some Suggestions for Now...

- A. Conduct a full audit of bond and tax documents with bond counsel
- B. Document and address any issues discovered
- C. Adopt ongoing compliance policies
 - ✓ Know what the bond and tax documents say
 - ✓ Talk to bond counsel – we are happy to help!
- D. Call your bond counsel and tell us how we can help!

Emerging Best Practices:

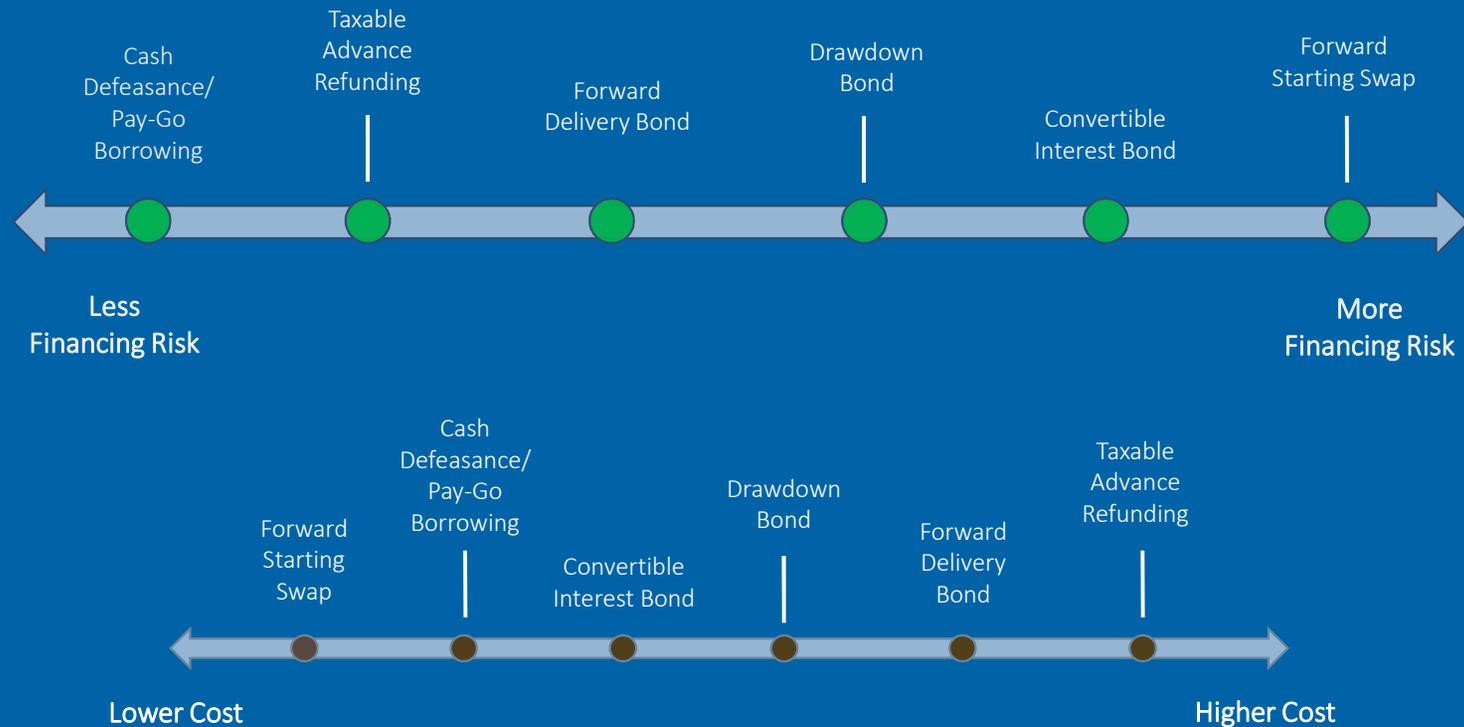
- ✓ Maintain an up-to-date and complete inventory of outstanding bonds and refunded bonds
- ✓ Bond policies and procedures integrated with organizational policies and procedures
- ✓ Job descriptions include bond responsibilities
- ✓ Internal audit includes bond compliance review periodically
- ✓ Process in place to alert responsible personnel to changes in requirements
- ✓ Periodically train personnel responsible for compliance
- ✓ Communicate regularly with bond counsel

Post-Tax Reform Debt Management

(Courtesy of North Slope Capital Advisors)

- ❖ The Tax Reform and Jobs Act signed into law on December 22, 2017 eliminated tax-exempt advance refundings of tax-exempt bonds issued after December 31, 2017.
- ❖ Tax-exempt advance refundings had long been an important debt management tool for achieving debt service savings in lower rate environments and for restructuring or reshaping annual debt service.
- ❖ Colorado higher education institutions achieved debt service savings of **over \$72 million via advance refundings in December 2017 alone.**
- ❖ The loss of tax-exempt advance refundings is giving rise to new refunding tools and structuring techniques for new money issues.

Alternative Financing Vehicles



The Next Chapter: Structuring Features for New Issues

- We expect tax-reform to precipitate more corporate style borrowing for public entities including:
 - Structures that “play” the yield curve
 - Commercial paper
 - Floating rate notes
 - Put bonds
 - Multi-modal bonds
 - Structures that incorporate additional flexibility
 - Shorter call features
 - Couponing strategies designed to drive down option-adjusted borrowing cost
 - Changing mixes of fixed and variable rate debt
 - Make whole call features
 - Adjustable sinking funds
 - Low volume sets up an issuer’s market and reduces the cost of buying additional flexibility

Contact

Fred Marienthal

Partner

Fred.Marienthal@KutakRock.com

Kutak Rock LLP

1801 California Street

Suite 3000

Denver, CO 80202

(303) 297-2400