

FASBO/FSFOA

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**Post-Issuance Compliance Fundamental Concepts:
Arbitrage, Continuing Disclosure,
and Private Use Requirements**

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Arbitrage Rebate & Yield Restriction Requirements

- Governed by Section 148(f) of the Internal Revenue Code
- Tax-Exemption a federal subsidy
- System Abused
 - Investing at higher rates than borrowing rates creates a “moral hazard.”
 - Incentive to issue bonds for the sole purpose of arbitraging the difference between tax-exempt and taxable rates. Drives Tax-Exempt rates upward.
- Laws and Regulations were established to discourage issuers from:
 - *Issuing more bonds than needed*
 - *Issuing bonds sooner than needed*
 - *Leaving bonds outstanding longer than needed*

Arbitrage Rebate Overview



- Rebate and Yield Reduction payments are required to be paid no later than 60 days after each 5th “Bond Year” and 60 days after the final redemption date.
 - Rebate versus Yield Restriction
 - Temporary period for yield restricted amounts
 - Most common is 3 years for construction/project funds
 - May owe yield reduction payment while rebate is negative
 - Replacement proceeds
 - » Sinking fund

Arbitrage Rebate Overview



- Necessary Information
 - Documents
 - Official Statement
 - Tax Certificate (aka: Arbitrage, No-Arbitrage, and Non-Arbitrage Certificates)
 - IRS Form 8038(G)
 - Verification Report (Refunding Issues)
 - Reimbursement Agreement (Variable Rate Issues)
 - Investment Records
 - Trust Bond Statements
 - Internal Records

Arbitrage Rebate Overview



- **What are the Federal (IRS) Requirements in order to preserve tax-exempt status?**
 - Document compliance (why you don't owe)
 - Make timely payments if / when they are due
 - Retain records to support your tax position – if you don't, IRS can draw their own conclusions
 - A good plan will address these requirements

Arbitrage Rebate Overview



- **Create a summary grid of data / dates to track**
 - Issuances per calendar year
 - Early redemptions
 - Rebate start date of each issue
 - Yield restriction start date of each issue
 - Rebate or yield reduction filing dates / payments
 - Allowable yields

Arbitrage Rebate Overview



- **Exemptions**

- Small Issuer (still subject to yield restriction rules)
 - 3 year temporary period
- Spending Exceptions
 - Spend quickly, demonstrate needed bond proceeds
- Bona Fide Debt Service Fund
 - Proper matching of inflows and outflows
 - No excess carryover
 - Excess is yield restricted
 - Limits ability to earn positive arbitrage

Arbitrage Rebate Overview



- **IRS Recent Activity**

- Elimination of advance refundings end of 2017
 - Advance = more than 90 days to call date of refunded bonds
- Elimination of special tax-advantaged bonds like Qualified School Construction Bonds
- Keep reducing the federal subsidy amount of existing tax-advantaged bonds
- Audit program
 - 20 agents down from 80
 - 577 audits closed in 2018
 - Random and targeted (excess COI, change in use, jail bonds)

Continuing Municipal Disclosure Overview



- Rule 15c2-12 was originally enacted in 1989
 - Prevents a dealer from underwriting an issue of municipal bonds unless the underwriter has been able to “obtain and review a preliminary official statement that the issuer of such securities or an ‘obligated person’ deems final as of its date”
- Rule 15c2-12 amended in 1994 to include continuing disclosure
 - Underwriter must reasonably determine that the issuer or an obligor has entered into a binding commitment to provide continuing disclosure
 - » Annual Reports
 - » Listed Events
- Rule applies directly to underwriters (broker/dealers)
- Rule Indirectly applies to issuers/obligated persons



- **Annual Reports**

- Audited Financial Statements
- Financial information and operating data as specified in the continuing disclosure agreement; essentially updates key financial and operating data contained in the original offering document which is available from the issuer or the obligor's records
- Filing required annually by a fixed date specified in the continuing disclosure agreement
- If audit not ready by reporting date, can file unaudited financial statements and file audit as soon as ready
- If don't file any part of annual report on time, must file a separate notice of failure to file



- **Listed Events Notices**

- Listed events notices must be filed “not in excess of 10 business days after the occurrence of the event”
- Necessary to have system in place to timely identify and report on any of the listed events
- Note some of the events have a materiality qualifier, others do not (they are deemed automatically material)

Continuing Municipal Disclosure Overview



- **Listed Events that require notification within ten (10) business days:**
 - (1) Principal and interest payment delinquencies
 - (2) Unscheduled draws on reserve reflecting financial difficulties
 - (3) Unscheduled draws on credit enhancement reflecting financial difficulties
 - (4) Substitution of credit or liquidity provider or failure to perform
 - (5) Adverse tax opinion, the issuance by the IRS of proposed or final determination of taxability, adverse tax opinions, or Notices of Proposed Issue (IRS Form 5701-TEB)
 - (6) Defeasances
 - (7) Rating changes
 - (8) Bankruptcy, insolvency, receivership, or similar event of an obligated person
 - (9) Tender offers



- **Listed Events that require notification within ten (10) business days, if material:**
 - (10) Nonpayment related defaults
 - (11) Modification to bondholder rights
 - (12) Bond calls
 - (13) Release, substitution or sale of property securing repayment of bonds
 - (14) Merger, consolidation, acquisition, or sale of all or substantially all of the assets of an obligated person, other than in the ordinary course of business, and the entry into or termination of an agreement to undertake such action
 - (15) Appointment of a successor trustee or change in name of a trustee

Continuing Municipal Disclosure Overview



- <https://www.sec.gov/rules/final/2018/34-83885.pdf>

- Compliance Date: February 27, 2019

- **New “Listed Events” adopted by SEC**

(16) incurrence of a "financial obligation" of the obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material

(17) default, event of acceleration, termination event, modification of terms or other similar events under a financial obligation of the obligated person, any of which reflect financial difficulties

Continuing Municipal Disclosure Overview



- **"financial obligation" defined as:**
 - (i) debt obligation;
 - (ii) derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation;
 - (iii) or a guarantee of either (i) or (ii)
 - does not include municipal securities as to which a final official statement has been provided to the MSRB consistent with the Rule (e.g. Final Official Statement)
 - does not include ordinary financial and operating liabilities incurred in the normal course of business
- Focus of amendment is on “debt, debt-like, and debt-related obligations”

Continuing Municipal Disclosure Overview



- **Examples of debt obligations and derivatives**
 - 1) Commercial Paper
 - 2) Private Placements
 - 3) Direct Purchase
 - 4) Interest Rate Swaps, Futures Contracts, Forward Contracts, Options, etc. (“entered into in connection with....”)
 - 5) Leases that operate as vehicles to borrow money

- Consult with counsel regarding other types of “financial obligations”



- **Prior to the Compliance Date:**

- create a list of “financial obligations”
- reflect terms and conditions, such as par amount, amortization, interest rate, default provision, security pledge, etc.
- discuss list with counsel to determine which financial obligations are deemed “material”
- maintain and update list accordingly for new “financial obligations” and changes to existing “financial obligations”

Be prepared to disclose

Continuing Municipal Disclosure Overview



- Prepare for implementation of the two new Listed Events.
- Note the two events will only become operative after the issuance of new, public debt and the execution of a new continuing disclosure agreement after February 27, 2019 (referred to herein as “Qualifying CDA”).
- Examine the debt and financial portfolio (starting with the audited financials) to identify all existing “financial obligations.” Make an inventory/spreadsheet. Remember this excludes public debt already subject to a CDA.
- Establish policies and procedures, and assign staff to monitor the inventory list of financial obligations so responsible person for CDA compliance is notified whenever there is a change (e.g. amendment) or adverse event (e.g. default) in any existing financial obligation.

Continuing Municipal Disclosure Overview



- Non-compliance is not an Event of Default under bond documents or continuing disclosure agreements but bondholders have right to sue for compliance with continuing disclosure obligations
- ***Must disclose such failure in future Official Statements for the period of 5 years following the failure***
- ***Can give rise to a securities law fraud case if misstatement about past compliance in an offering document***
- Including only the information specifically required under the continuing disclosure agreement may not be deemed sufficient to satisfy the anti-fraud rules and could result in securities fraud under Rule 10b-5



What records must be maintained?

- Documents related to the bond transaction (entire transcript)
- Documents related to post-closing elections
 - ✓ Bond Year Selection
 - ✓ Retro-Active or Selective Application of Regulations
- Documents evidencing any investment of bond proceeds
 - ✓ Trust Bank or Investment Pool Statements
 - ✓ Internal Records (expenditure detail and allocation of pool earnings)
- Documents evidencing expenditure of bond proceeds
- Use of bond financed property by public and private sources
- Sources of payment or security for the bonds
- Arbitrage Reporting – Rebate and Yield Restriction



Private Business Use Overview – Governmental Bond Requirements

- At least 90% of the proceeds of the bond issue must be used for governmental purposes
- The 90% requirement is increased to 95% in certain circumstances. See Tax Certificate for details
- Aggregate private business use generally cannot exceed the “lesser of” 90%, 95% or \$15 million
- Costs of issuance of the bonds paid with bond proceeds are not treated as private business use



Private Business Use Overview – Governmental Bond Requirements

- Private Business Use – Use of bond financed property in a trade or business by other than a state or local government or members of the general public
- Private Business Use is generally triggered if a non-governmental party is provided a “special legal entitlement”
- Examples:
 - ✓ Lease of bond financed space to a for-profit entity
 - ✓ Certain management contracts
 - ✓ Certain sponsored research contracts



Basic Tax Analysis – Governmental Bond Financing

- Are the bond financed assets used by members of the general public?
- Does a party other than a State or Local Government agency or department have a “special legal entitlement” to use the bond financed assets?
- Use of bond financed assets by a charitable organization (e.g., a Section 501(c)(3) organization) will generally give rise to private business use
- Contracts with the federal government will generally give rise to private business use



Private Business Use Overview

- Private business use can arise under a management contract even if the bond-financed assets serve the general public
- *Example:* City and County hires an outside management company to manage and operate a public garage
 - ✓ Even though the garage serves the general public, the tax-exempt bond rules require that the nature of the agreement with outside management company be examined

Private Use Requirement Overview



Private Business Use Overview

- Contracts that may give rise to private business use include:
 - ✓ Management Contracts
 - Garage/Parking Facility Contracts
 - Concession Contracts
 - Cafeteria Contracts
 - “Out-sourcing” certain activities to third parties
 - ✓ Research Contracts
 - Federal
 - Business Sponsored
- Leases generally will give rise to private business
 - ✓ If someone is paying you rent (\$) or splitting profits (\$) from an operation in bond financed space they are not treated as a manager under the tax rules



Management Contracts

- Many so-called “management contracts” are in fact leases (even though they might be called something else)
- If operator is paying you rent, a guaranteed return or splitting net profits (\$) from an operation in bond financed space, such arrangement is treated as a lease under the tax rules
- Need to maintain the “owner” and “manager” economic relationship in the contract



Why do Some Management Contracts Give Rise to Private Business Use?

- They represent a transfer of control or economic benefit from the owner to a private party
- They provide a “special legal entitlement” to use bond financed property
- If management contract satisfies IRS “safe harbor” management contract rules – no PBU



Private Business Use Exceptions

- Incidental Contracts or Arrangements
 - ✓ Janitorial services
 - ✓ Equipment repair
 - ✓ Billing activities or similar services
 - ✓ Landscaping



Short-Term Use – 50 Day Exception

- Term of use pursuant to the contract, including renewal options, is not longer than 50 days
 - ✓ Note, focus is on total “use days” and not term of contract
- The contract is a negotiated arm’s-length arrangement and compensation is at fair market rule
- The property is not financed for a principal purpose of providing that property for use by that party

Private Use Requirement Overview



How to avoid trouble:

- Review management contracts annually
 - ✓ Adopt uniform contract if possible
 - ✓ Seek outside help as required
- Work with outside provider to assist with measuring private business use/unrelated trade or business use and Schedule K preparation

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