Chapter 1

OVERVIEW OF A DEBT FINANCING

ROLES AND RESPONSIBILITIES OF PRINCIPAL PARTICIPANTS

ISSUER

Types of Issuers. The tax-exempt status of municipal issuers distinguishes them from other issuers of debt. A municipal debt issuer can be any entity authorized by the Internal Revenue Service (IRS) to issue tax-exempt securities. IRS code subtitle 18, part III, section 103(a) states that "interest on the obligations of a State, a Territory, or a possession of the United States, or any political jurisdiction of any of the foregoing, or of the District of Columbia" is exempt from tax. IRS code defines tax-exempt municipal issuers in a variety of ways, but the main types of municipal issuers are states, counties, cities, and school districts. In addition to these typical government units, there is a category of entities classified as "special districts." A special district is a limited-purpose government unit with legal authority to tax. California has a myriad of special districts authorized to levy tax assessments. Special districts range from fire and flood districts to financing districts. These special districts are identified, along with the authorizing statute, in Appendix D – Legal References – Table D-1-2 of this Primer.

In some instances the issuer may be controlled by another governmental entity, usually called a statutory authority or agency. These authorities or agencies act as a "conduit" for issuing tax-exempt debt. For example, redevelopment agencies, housing authorities, joint powers authorities, and industrial development authorities may be formed by cities and counties, and the city council or board of supervisors may sit as the governing body of the agency or authority. Similarly, nonprofit corporations have been created by governmental entities to issue bonds on behalf of the governmental entities to accomplish financings that may not be specifically authorized for governmental entities. These governmental entities borrow as a tax-exempt issuer and then pass through the funding and the liability to a private entity borrower. The private entity borrower is obligated to make the debt payments associated with the bonds or notes though a legal agreement. The issuer uses a trustee to transact between the bondholders and the private entity. Other sections of this Primer will clearly distinguish between the issuer and any entity that controls the issuer, but in this more general discussion, the two will be treated as "the issuer."

Legal Authorization. Issuers are authorized by state law to borrow money, i.e. issue bonds for many different specific purposes, and in some cases for their "general corporate purposes." For the most part, these purposes are limited to those that in one respect or another
benefit the public welfare—so-called public purposes. In the case of chartered cities, debt may be issued for purposes that constitute “municipal affairs.” (See Chapter 4, State Constitutional Limitations – The 1879 Constitution – Charter Cities and “Home Rule” for a discussion of the municipal affairs doctrine.) Within these statutory and constitutional guidelines, an issuer determines its own capital improvement program (including the parameters of any lending program), determines the resources that it has available for the payment of capital expenditures (including the repayment of any debt), and is in ultimate control of the process of issuing bonds as a part of that capital improvement program. In addition, in certain limited circumstances, an issuer may determine to issue debt to finance noncapital items. Chapter 6, Types of Financing Obligations contains a discussion of the constitutional and statutory authorization for a variety of different types of debt financing programs.

Issuer's Responsibilities. One of the first decisions to be made by an issuer is the selection of the initial members of its debt financing team, including bond counsel (and perhaps disclosure counsel) and either a financial advisor or underwriter, or both. Team members may be selected on the basis of a request for proposals, long-standing relationship with the issuer, reputation, or recommendation by others (see Using a Request for Proposals to Select Financing Team Members in this chapter).

The nature of the financing team members may depend upon several factors including:

- The type of debt being issued
- Procedural requirements for that type of debt
- The level of in-house sophistication of the issuer

For example, in a situation in which bonds are to be sold at competitive (or “public”) sale (the opening of bids from prospective underwriters at a time and place specified in a published notice of sale), an issuer will typically hire a financial advisor. On the other hand, in cases in which bonds are to be sold in a negotiated (or “private”) sale, an issuer will customarily select an underwriter or an underwriting team and also may select a financial advisor (see sections in this chapter on Financial Advisor and Underwriter/Placement Agent/Purchaser).

Having selected a team, an issuer then works with the team to issue debt to finance the capital improvement or working capital program. Subject to legal constraints and considering the recommendations of the team members, an issuer retains ultimate control and responsibility of the overall financing plan and the details of the financing structure. The issuer's staff must consider itself responsible for reviewing all aspects of the financing plan, including all documents that determine or describe aspects of the financing. The issuer's staff (including its general counsel) is in the best position to be aware of the impact of the financing on other areas of the issuer's finances and operations.
In addition, the issuer will be involved in any legal action that may arise with respect to issuance of the bonds. In circumstances where there may be legal uncertainty about some aspect of a proposed bond transaction, the issuer may pursue a validation action to obtain judicial approval before the bonds are issued. If a bond transaction is controversial and gives rise to a reverse validation action, the issuer will find itself a party to that litigation. Furthermore, after the bonds are issued, the issuer will be ultimately responsible for long-term management and troubleshooting. Such issues may include:

- Supervising, investing, and administering the expenditure of bond proceeds
- Collecting, or monitoring the collection of, revenues
- Use of revenues to pay operating expenses and debt service
- Compliance with all undertakings, covenants, and agreements
- Management of any enterprise funded by the debt
- Filing of any required reports with various governmental regulators, a bond insurer or other credit enhancement provider, if any, and credit rating agencies
- Addressing any problem that may arise with respect to the bonds, such as a shortfall in revenues, a tax audit, or a regulatory issue
- Preparing, reviewing, and filing Annual Reports and Listed Event Notices under SEC Rule 15c2-12

The degree to which members of the issuer's debt financing team are capable of looking out for the issuer's long-term interests, or are motivated to do so, will vary, depending on the relationship that each team member has with the issuer. Ultimately, the issuer must bear responsibility for its own interests. For this reason, the issuer must be an active participant in the debt financing process and not leave it all to the consultants. Even if the issuer selects its consultants with an eye toward providing services that cannot be provided in-house, the issuer must be prepared to examine the consultant’s work and ask the questions necessary to assure that the end result is appropriate given the issuer's objectives.

**Workouts.** The issuer needs to be aware of its responsibilities in the event that a problem arises with respect to the bonds, such as a shortfall in revenues needed to repay the bonds, a tax audit that reveals irregularities, or an investigation by a regulatory agency. The issuer is the participant most likely to be called upon to provide information and coordinate a workout strategy. Because of this, throughout the debt financing process the issuer should remain alert to potential problems, as prompt remedial efforts may avoid a larger problem later on.
Issuers should be aware that there can be substantial costs involved in dealing with a troubled bond transaction. Such costs could include legal fees and litigation expenses, appraisal fees, and the cost of hiring financial advisors and other consultants. In addition, significant staff time can be spent on these matters. Finally, political fallout can result if a transaction goes bad in a way that reflects poorly on elected officials. Although a thorough discussion of defaults and workout situations is beyond the scope of this Primer, issuers are encouraged to be aware of the potential for such events and structure their debt issues prudently so as to avoid problems.

**BOND COUNSEL**

**Bond Counsel Opinion.** Bond counsel is the attorney or firm of attorneys that gives the legal opinion delivered with the bonds confirming that the bonds are valid and binding obligations of the issuer and, customarily, that interest on the bonds is exempt from federal and state income taxes. In relatively rare cases, bonds designed to be taxable for federal income tax purposes are issued. In these cases, the tax opinion may be nonexistent, or may run only to exemption for state income tax purposes.

**Source of Need for Bond Counsel.** Historically, the requirement for the bond counsel’s legal opinion began in the second half of the 19th century when a number of issuers of railroad bonds disclaimed liability on their bonds on the basis of their own errors made in the process of issuing the bonds. Buyers of bonds began to require that an independent lawyer or law firm render an opinion that the bonds were validly issued and binding. The issuer of that legal opinion, the bond counsel, was (and is) required by market standards to be nationally recognized for expertise in municipal finance.

**Independence of Bond Counsel.** Originally, bond counsel rendered their legal opinion very late in the process, sometimes even after the bonds had been issued. Over time, however, to minimize the risk of a negative opinion, bond counsel was hired earlier and earlier in the issuing process. One result of this earlier engagement of bond counsel has been a shift in their role and independence. Originally, bond counsel was required to be “independent” of the issuer and sometimes was actually hired by the bond buyers (a practice occasionally seen even today).

The bond counsel final opinion thus meets a much more rigorous standard than is customary for most legal opinions. Under certain circumstances, where the law on a point is not entirely free from doubt, counsel may render an opinion to the effect that, if the matter were properly briefed and argued to a court of competent jurisdiction, the court “should” or “would” hold as described in the opinion. This is the standard against which many non-bond legal opinions are measured. It requires the reader to understand and appreciate the limitations of the authorities cited in the opinion and to understand that counsel is making some assumptions about the way a court would interpret these authorities if presented with the facts described in the opinion. While these “should” or “would hold” opinions may be used in a municipal finance transaction
to address collateral matters from time to time, it would not generally be possible to successfully issue and sell bonds, the validity or tax exemption of which was covered only by an opinion couched in such terms.

**Responsibilities of Bond Counsel.** Originally, the bond opinion covered only the concept that the bonds were legal, valid, and binding, and were issued in accordance with the law. In the last 30 to 40 years the statement that interest on the bonds is exempt from federal and state income taxes has become a very crucial part of the bond opinion. The legal work that goes into many bond issues is dominated by tax issues, in part because of the constant change in the tax laws relating to tax-exempt bonds. The bond opinion also may cover the validity of one or more of the legal documents under which revenues are made available to pay the bonds, such as a lease or loan agreement.

**Disclosure.** The bond opinion does not make financial recommendations or represent a financial judgment as to the acceptability of the bond for the investor. The bond opinion is not intended to be a disclosure document as it does not, in and of itself, represent a judgment that the disclosure available with respect to the bond is adequate under federal or state securities laws. However, as part of its expanding role, bond counsel sometimes agrees to a separate component of responsibility for advising the issuer concerning compliance with federal and state securities laws in the course of the debt issuance process. This is often stated as a separate item in the issuer's agreement with bond counsel for legal services or is stated to be the primary responsibility of some other lawyer (e.g. disclosure counsel) participating in the transaction.

**Legal Team.** The legal team for a bond issue sold on a negotiated basis generally will include bond counsel, issuer’s counsel, underwriter's counsel and/or disclosure counsel, counsel for the company or other nongovernmental borrower, if any, and trustee's counsel. Bond counsel's role in these cases will customarily be as special counsel to the issuer for the financing and not as counsel to the investor. In a negotiated sale, the interests of the investor are indirectly represented by the underwriter and underwriter’s counsel.

A listing of bond counsels utilized by the State Treasurer’s Office are available on its website at [www.treasurer.ca.gov/bonds](http://www.treasurer.ca.gov/bonds).

**Bond Counsel May NOT be Underwriter’s Counsel.** Historically, when an issue was to be sold on a negotiated basis and was too small to afford several attorneys, with the consent of the issuer and the underwriter, bond counsel occasionally also acted as underwriter’s counsel. In 1985, Section 53593 was added to the Government Code. This new code section prohibited bond counsel (in the case of a bond issue) from also being counsel to the underwriter or other initial purchaser of the bonds. Bond counsel may render opinions to the underwriter or purchaser, but only as bond counsel and not as counsel to the underwriter or purchaser. As described later in this chapter in **Underwriter’s Counsel**, a recent development is the increasing use of disclosure counsel, or counsel to the issuer with respect to disclosure
and bond sale matters. This type of relationship is not prohibited by Government Code Section 53593.

In the case of bonds sold at competitive sale, no underwriter or underwriter’s counsel is involved in the transaction until the financial structure has been determined, the proceedings are basically final, and the bonds are offered at the sale. In that situation, bond counsel and the financial advisor work with the issuer to design a bond issue that will be acceptable to investors. The format of these transactions is usually standard.

Whether the bonds are sold at negotiated or competitive sale, bond counsel is customarily responsible for preparation and review of the legal proceedings for the issuance of the bonds, including election proceedings if an election is required, resolutions of the governing body of the issuer authorizing the issuance of the bonds and otherwise relating to the bond issue, and the documents under which the bonds will be issued and secured. In the case of certain types of lending programs, bond counsel also may prepare loan agreements, origination and servicing agreements, lease agreements, deeds of trust, and other similar documents relating to the sources of revenues with which the issuer will pay debt service on the bonds.

Finally, bond counsel may address a wide variety of legal issues relating to the financing. In circumstances where there may be legal uncertainty about some aspect of a proposed bond transaction, bond counsel may pursue a validation action to obtain judicial approval before the bonds are issued. If a bond transaction is controversial and gives rise to a reverse validation action, bond counsel will likely be asked to represent the issuer in the litigation or to assist the issuer’s general counsel or outside litigation counsel.

Bond counsel is not ordinarily general counsel to the issuer. However, in some cases (especially where the issuer’s general counsel is hired on a contract basis rather than as a regular employee), if the issuer’s counsel has the requisite expertise, he or she may serve as bond counsel as well. When the issuer’s regular counsel also serves as bond counsel, special attention should be paid to conflicts of interest, particularly where a contingent fee for the bond counsel services is involved.

If the issuer’s regular counsel is not bond counsel, the issuer’s counsel (e.g. the City Attorney) will nevertheless play an important role, typically with respect to conforming the procedures and documents to the special needs of the issuer. In addition, issuer’s counsel will often be required to render an opinion with respect to the issue. This opinion is typically limited to the organization and existence of the issuer, the due approval, execution and delivery of documents, the absence of litigation, and other related matters.

Because of the complexities of bond financing, there are several roles that bond counsel may play. It is very important that a clear relationship between the issuer and bond counsel be established early in the transaction and that the issuer establish who bond counsel represents and the purposes for which bond counsel is engaged.
Bond counsel may be compensated in a variety of ways, including an hourly rate proportional to the size of the issue (customarily on a sliding scale representing a smaller percentage of larger issues), a fixed dollar amount, and others. Bond counsel's fee may be payable whether or not the bonds are issued or it may be contingent upon issuance of the bonds. In addition, even if the fee is contingent, bond counsel may be reimbursed for out-of-pocket expenses, whether the bonds are issued or not.

**Workouts.** Bond counsel is often called upon to resolve any problem that arises after the bonds are issued. Problems may include:

- A shortfall in revenues needed to repay the bonds
- Irregularities revealed by a tax audit
- Regulatory concerns such as a disclosure issue

Where the problem is serious, such as a payment or significant covenant default, the issuer may wish to hire new counsel to provide a fresh perspective.

**FINANCIAL ADVISOR**

**Scope of the Financial Advisory Relationship.** A financial advisor is a professional consultant retained (customarily by the issuer) to advise and assist the issuer in formulating and/or executing a debt financing plan to accomplish the public purposes chosen by the issuer. A financial advisor may be a consulting firm, an investment banking firm, or a commercial bank. Some financial advisors identify themselves as “independent financial advisors,” being entities that do not engage in underwriting or trading of municipal securities.

In some cases, issuers have retained financial advisors for the sole purpose of assessing bond market conditions at the time of sale of the bonds to determine the appropriateness of the interest rate and other terms of the underwriter’s offer to buy the bonds. A financial advisor also may be retained to perform a broad variety of functions for the issuer, including surveying the issuer's existing debt structure and capital financing program and designing and assisting in the execution of a total financing plan for the issuer.

The role of or necessity for the financial advisor may depend upon the financial sophistication of the issuer and its staff, the workload capacity of the issuer’s staff, and the division of labor among the staff and other participants in the debt financing. For example, in the case of a negotiated sale of bonds, the underwriter is often selected by the issuer early in the process and may be the issuer’s principal advisor as to the best manner of accomplishing the issuer's ultimate financial objectives. In such cases, the issuer may not select any financial advisor or the role of the financial advisor may be limited to assessing the appropriateness of the underwriter’s recommendations. In other cases, a financial advisor may be selected initially, regardless of the method of sale, and play a key role in assisting the issuer.
Issuers should be aware that if they hire and rely on the advice of an underwriter or a financial advisor, that advice is subject to the biases inherent in the position of these participants. The only true objectivity is that of the informed staff of the issuer who are committed to the established goals and policies of their organization.

**Traditional Services of a Financial Advisor.** As an example, in a public facilities capital improvement program to be financed by general obligation or revenue bonds required to be sold at competitive sale, the financial advisor will customarily do each of the following:

- Review the financial feasibility of the capital projects
- Assess the available sources of revenue
- Recommend a financing structure (including the nature of the security for the bonds, excess revenue coverage requirements, debt service reserve account requirements, facilities insurance requirements, liability insurance requirements, and the need for credit enhancement)
- Recommend a maturity schedule, redemption terms, and other terms of the notice of sale
- Prepare on the issuer’s behalf an Official Statement, for distribution to potential underwriters and investors, describing the issuer, the bonds, the security for repayment of the bonds, and any other matters that would be material to an investor
- Be the primary spokesperson on behalf of the issuer with the credit rating agencies
- Recommend the timing of sale of the bonds
- Arrange for and direct the mailing of the Official Statement and the official notice of sale to potential underwriters and investors
- Contact and answer the questions of potential underwriters and investors
- Analyze bids received at the competitive sale
- Recommend whether to accept or reject such bids
- Assist bond counsel in organizing the closing (i.e. the delivery of the bonds in return for payment for the bonds)
- Recommend appropriate investments for the proceeds of the bonds

Other possible responsibilities include recommending, when the options are available, competitive sale, negotiated sale, or a private placement of the bonds and, in the case of a negotiated sale or private placement, negotiating bond terms on behalf of the issuer.
**Specialty Advisory Services – The Swap Advisor.** An interest rate swap is a contractual arrangement between two parties, often referred to as “counterparties.” The counterparties agree to exchange interest payments based on a defined principal amount, for a fixed period of time. Interest rate swaps have become a popular, yet complicated tool for municipal issuers to manage interest rate risks and cash flow.

The swap advisor provides a review and analysis of swap alternatives and can assist in the procurement of the swap, including conducting a competitive bid. The advisor provides ongoing monitoring of swap market conditions, advice about rates and structure, and participates in reviewing the closing documentation. The swap advisor also can assist in the development of a swap policy and ongoing monitoring and swap valuation. Issuers should consider the need to obtain a “fair market certificate” from their swap advisor in regard to pricing, and to fully discuss how such certification will be defined.

**Workouts.** In the event that any problem arises with respect to the repayment of the bonds, such as a shortfall in revenues, a financial advisor typically gets involved in the efforts to resolve the problem. Issuers facing repayment and other problems sometimes turn to the financial advisor who assisted with the original transaction, or bring in a new financial advisor to provide a new perspective. Some financial advisors have acquired substantial expertise in restructuring bond transactions, negotiating with bondholders and trustees, and carrying out other necessary or appropriate workout steps.

**Conflicts of Interest.** The relationship between the issuer and the financial advisor should be one of confidence and trust, and is in the nature of a fiduciary relationship. The law emphasizes this by prohibiting certain actions that might create a conflict of interest. Section 53591 of the Government Code prohibits a financial advisor, with respect to an issue of bonds, from acquiring the bonds from the issuer as principal, either alone or as a participant in a syndicate or other similar account unless the issue is sold by the issuer at competitive public sale and the issuer has, prior to the bid, expressly consented in writing. Section 53592 of the Government Code requires each financial advisory relationship to be evidenced by a written document executed prior to or promptly after the inception of the relationship, or promptly after the creation or selection of the issuer if the issuer does not exist or has not been determined at the time the relationship commences. The document must describe the basis of compensation for the services to be rendered. With certain limited exceptions, the compensation must be on a basis other than a percentage of the amount of the bonds to be issued. Section 1090 of the Government Code also regulates conflict of interest. The full text of these Government Code sections is set out in Appendix D – Legal References.

Rule G-23 of the Municipal Securities Rulemaking Board (MSRB) contains requirements that are similar to, although not quite as stringent as, the requirements of Government Code Sections 53591 and 53592 relating to financial advisory relationships. Rule G-23 includes an express additional requirement that prior to purchasing from an issuer bonds with respect to
which a financial advisor has provided advisory services, the financial advisor must terminate its financial advisory relationship with the issuer with respect to that issue.

Neither state law nor the MSRB rules prohibit a financial advisor from purchasing bonds in the secondary market, either for the financial advisor's own trading account or for the account of customers, except to the extent that such purchase is made to contravene the purpose and intent of the above-described requirements.

As these rules emphasize, the financial advisor's professional duty is to the issuer, and the advisor must advance the financial interests of the issuer on the issuer's chosen course.

A listing of financial advisors utilized by the State Treasurer's Office is available on its website at www.treasurer.ca.gov/bonds.

UNDERWRITER/PLACEMENT AGENT/PURCHASER

Underwriter vs. Placement Agent. An underwriter purchases bonds from an issuer with the intent to resell the bonds to investors. A placement agent acts as agent for the issuer in selling bonds to a private placement purchaser, and, as such, does not purchase the bonds. The responsibilities and functions of the underwriter will depend primarily on whether the bonds are to be sold at competitive sale or at negotiated sale.

Services in a Negotiated Sale. In the case of a negotiated sale, the issuer will customarily select the underwriter (or the underwriting team) early in the process and the underwriter may perform many of the services described above for financial advisors. If the issuer has not retained a separate financial advisor, the underwriter may assist the issuer in determining what is to be financed, the method of financing, and the financing structure. The underwriting firm performing these functions is often called the “managing underwriter” or, where there is more than one member of the initial underwriting team, the “lead managing underwriter” or “senior managing underwriter.” In such cases the underwriter will usually hire its own counsel and the underwriter and underwriter’s counsel will take the lead in coordinating preparation of the Official Statement for the bonds. Alternatively, as discussed above, the issuer may elect to retain disclosure counsel for the purpose of preparing the Official Statement and related sale documents. However, regardless of who takes on the primary drafting responsibility, the issuer remains responsible for full disclosure in the Official Statement.

After the design of the financing and the preparation of the Official Statement, the underwriter in a negotiated sale does the following:

- Mails the Official Statement to potential bond buyers and underwriting syndicate members
- Assesses bond market conditions to recommend timing and pricing of the bond sale
• Forms an underwriting syndicate in the case of large issues

• Obtains agreement from the underwriting syndicate to the interest rates and terms of sale for the bonds

• Signs a bond purchase agreement on behalf of itself or the underwriting syndicate, as the case may be

• Ensures that appropriate continuing disclosure undertakings are entered into by the issuer to show compliance with SEC Rule 15c2-12

As an alternative to forming a syndicate, an underwriter may form a selling group. When a syndicate is formed, each syndicate member has, through the Agreement Among Underwriters and as part of the bond purchase agreement, a direct obligation to the issuer to buy the bonds. A selling group member has no such obligation to buy the bonds, and in these cases only the managing underwriter has a direct obligation to the issuer to buy the bonds. A selling group member receives only the bonds the managing underwriter agrees to sell to it (in response to its order for such bonds).

An issuer selling bonds at negotiated sale has the flexibility of advancing or delaying the sale date to respond to market conditions in an effort to obtain the best possible financing terms. In the case of complex or unusual debt financings, the negotiated sale process also permits direct input from the buyer of the bonds as to the desirability of various financing structures or features. Finally, in a negotiated sale, the underwriting syndicate can do a substantial amount of preselling of bonds, thus lowering the underwriting risk and, presumably, lowering the need for compensation for taking underwriting risk.

**Services in a Competitive Sale.** In a competitive sale, at the time and place specified by the official notice of sale, competing underwriters deliver sealed bids to the issuer, and the issuer selects the underwriter (alone or as representative of an underwriting syndicate or selling group) offering the best terms at that time and place. Bidders are permitted to specify, within the limits specified by the notice of sale, the interest rate for each maturity of the bonds and the price (including premium or discount) at which they will buy the bonds. The notice of sale also specifies the method used to determine the best bid—either the Net Interest Cost method or the net effective interest rate method (sometimes called the True Interest Cost method). (See Appendix C – Debt Financing Terms and Concepts.) Because the underwriters in a competitive sale have not been independently involved in the design of the financing structure and only have available to them the Official Statement and other readily accessible information concerning the issuer, bonds sold at competitive sale are relatively standard in design and security. In addition, the potential investors in such bonds are relatively identifiable.

Legal requirements regarding published notice for a competitive sale may sometimes make it difficult for an issuer to remain flexible concerning the timing, terms, and amount of the sale. (See Chapter 6, Types of Financing Obligations for a discussion of requirements relating to
the process for sale for various debt obligations.) On the other hand, a properly conducted competitive sale gives an issuer reasonable comfort that on the date of sale, given the financial structure chosen, the issuer has received the best possible bid for its bonds. Issuers have begun to include a provision in the notice of sale in a competitive offering that allows the issuer to postpone the sale date for up to a limited number of days or weeks (usually on 24 hours notice by MunifactsSM wire service). This affords the issuer some flexibility to postpone a sale if the market on the sale date does not appear favorable.

Compensation – The Underwriter’s Gross Spread. In both negotiated and competitive sales, the underwriters are primarily compensated by the difference between the price they pay the issuer for the bonds and the price at which they resell the bonds to investors (the “spread”). When a managing underwriter and syndicate members determine the amount to be bid for the bonds and the expected amount of the spread, they take into account a number of factors, including:

- **Management fee**: a fee paid to the managing underwriter for handling the affairs of the syndicate, including, in the case of a negotiated sale, structuring the issue and negotiating with the issuer

- **Expenses**: any advertising and printing costs to the underwriter, fees and expenses of underwriter’s counsel, Blue Sky fees and expenses, computer expenses, travel expenses, MSRB fees, CDIAC fees, and other similar expenses

- **Takedown**: normally the largest component of the spread, similar to a commission, which represents the income derived by the selling broker or dealer from the sale of the bonds
  - If bonds are sold by a member of a syndicate, the seller is entitled to the full takedown (also called the “total takedown”)
  - If bonds are sold by a dealer which is not a member of the syndicate, such seller receives only that portion of the takedown known as the concession or dealer’s allowance, with the balance (often termed the “additional takedown”) retained by the syndicate

- **Risk**: the amount of compensation for risks incurred by the underwriter in underwriting the bond issue, relating to the difficulty of marketing the issue, bond market conditions, and the amount of bonds remaining to be resold after the execution of the bond purchase agreement. It is rare for there to be any risk component in the spread

Underwriting spreads have tended to decline in recent years due to competition, market factors, new mechanisms to limit risk (derivatives), and technology. It is difficult to state a rule of thumb for what an underwriting spread should be or what the components should be relative to each other, because of the variables, which can include the type of financing, the credit quality of the debt, the scope of services to be provided by the underwriter, and other factors. In the
process of the final pricing of the bonds, the issuer should request information from the underwriter as to the elements of the expected spread and data on comparable spreads from other recent pricings. Issuers should remember that all of the elements of a spread are negotiable. If a financial advisor is involved in the transaction, the advisor should be prepared to analyze the proposed spread and ensure that it is reasonable under all of the circumstances.

**Rules on Conflict of Interest Issues.** MSRB Rule G-37 generally prohibits underwriters that have made political contributions to elected officials of an agency from conducting any underwriting business with that agency for a period of two years after the contribution is made. In some cases, state law or local ordinances may impose similar limitations or exclusions.

The MSRB established Rule G-38 to address actual and perceived abuses associated with the awarding of municipal securities business to brokers and dealers. The rule is intended to deter and detect attempts by dealers to avoid the limitations placed on certain dealer activities. It also seeks to provide information to issuers about the relationship between dealers and the persons they have engaged to seek municipal securities business on their behalf.

Rule G-38 was adopted in 1996 and essentially requires dealers to disclose information about consultant arrangements. It defined consultants as individuals used by dealers to obtain business through direct or indirect communication with issuers, in exchange for payment. The rule specifies that this definition does not include people who did “substantive work” on bond issues, such as engineers or accountants.

In 2005, Rule G-38 was amended to bar municipal securities dealers from using anyone other than their employees or affiliated persons to solicit municipal securities business on their behalf. The rule change was adopted because of concern that an increasing number of municipal securities dealers were hiring and paying independent consultants to obtain business for them when the consultants were not subject to any of the same regulatory requirements as the dealers. The change prohibits a municipal securities dealer from making any direct or indirect payment to any person, other than an associated person of the dealer. Solicitation is defined as a direct or indirect communication with an issuer for the purpose of obtaining or retaining municipal securities business.

**Workout.** The role of the underwriter varies in workout situations. If new bonds are being issued as part of solving the problem, the original underwriter, or a new underwriter, may be closely involved with the financial advisor and bond counsel in the workout effort. Nonetheless, because many underwriters are concerned about the viability of bonds in which they are involved, they will, if requested, attempt to identify the bondholders and help to facilitate contact with them as part of the workout effort.
**UNDERWRITER’S COUNSEL AND DISCLOSURE COUNSEL**

**Underwriter's Counsel**

**Selection and Need.** Underwriter's counsel is customarily selected by the underwriter to represent the underwriter and its interests in a negotiated sale. Competitive sales generally do not require the retention of underwriter’s counsel. Underwriter’s counsel customarily review, from the underwriter’s perspective, the documents prepared by bond counsel and negotiate matters relating to those documents on behalf of the underwriter.

**Disclosure and Securities Laws Compliance.** Underwriter’s counsel often coordinate preparation of the Official Statement with input provided by other financing team members, including the issuer, issuer's general counsel, the underwriter, bond counsel, the financial advisor (if any), the credit enhancement provider (if any), and the nongovernmental borrower (if any). In addition, underwriter’s counsel often prepare the continuing disclosure agreement or certificate to evidence the undertakings of the issuer and other obligated persons with respect to SEC Rule 15c2-12. In so doing, underwriter’s counsel will make recommendations concerning the disclosure requirements of federal and state securities laws. Upon the issuance of the bonds, underwriter’s counsel give to the underwriters a “10b5 opinion” (named after SEC Rule 10b5) concerning compliance with the disclosure requirements of federal law.

In order to give a “10b5 opinion,” underwriter’s counsel need to conduct “due diligence” concerning the issuer, the securities, and their sources for repayment. Due diligence is the inquiry made to reveal or confirm facts about the issuer, the issue, and the security for the issue that would be material to a prudent investor in making a decision to purchase the issue. Due diligence inquiries are made by underwriters and lawyers to determine, for example, whether the issue follows the purpose and scope outlined by the enabling legislation, statutes, and resolutions of the issuer and whether all material facts have been accurately disclosed in the Official Statement. This exercise varies depending upon the type of debt being issued and the issuer involved, but typically involves review of documents including financial statements, minutes of meetings, major contracts, licenses, permits and real estate documents and other items relevant to the credit involved. Counsel will typically start this process with a request that specific documents be made available for inspection in the issuer’s offices on a particular day. After review of the documents, counsel may need to follow up with interviews or requests for additional information.

Underwriter’s counsel also advise the underwriter concerning any registration requirements of federal and state securities laws (so-called Blue-Sky Laws) for sale of the bonds in various jurisdictions.

**Compensation of Underwriter’s Counsel.** Underwriter’s counsel is customarily paid by the underwriter from the underwriting expense portion of the spread.
Disclosure Counsel

Disclosure Counsel. Disclosure counsel handles many of the tasks traditionally handled by underwriter’s counsel, except when it is clear that the disclosure counsel’s client is the issuer and not the underwriter. If underwriter’s counsel has been retained, it may be unnecessary to retain disclosure counsel.

Disclosure counsel may prepare the draft Official Statement, the Bond Purchase Contract (or, in the case of a competitive sale, the Official Notice of Sale), the Continuing Disclosure Agreement and any Blue Sky Memoranda. In addition, disclosure counsel may render a “10b5 opinion” to the underwriter for the transaction. In doing this work, the disclosure counsel is representing the issuer and not the underwriter, and all parties must be aware of this role and of the duties disclosure counsel owes to its client, the issuer. If structured in this way, disclosure counsel may be the same lawyer or firm as bond counsel on a particular transaction since the client in both cases is most likely the issuer. Occasionally where disclosure counsel is used, the underwriter also will have its own counsel, but typically that counsel’s role is limited to advising the underwriter on negotiation of the purchase contract and on regulatory compliance issues.

Compensation of Disclosure Counsel. Because disclosure counsel works for the issuer, they are paid by the issuer from the proceeds of the bonds. As with bond counsel, compensation arrangements may include hourly rates, fixed or percentage fees, or a combination of methods, and may be contingent upon issuance of the bonds or payable regardless of the success of the transaction.

Trustee/Fiscal Agent/Paying Agent/Registrar/Authenticating Agent

An issuer customarily selects one or more commercial banks or trust companies to perform one or more of several administrative duties relating to a bond issue. Historically, an issuer may have received, held, and disbursed the bond proceeds itself, and collected, held, and paid debt service on the bonds with the revenues pledged as security for the bonds. However, today, relatively few issuers have the banking capabilities and relationships necessary to perform those services themselves. In addition, investors are comforted by the involvement of a fiduciary acting on their behalf and holding the funds and accounts relating to the bond issue.

As a result, many bond resolutions and indentures appoint a trustee or fiscal agent to perform a number of duties relating to the bond issue. In performing those duties, a trustee acts in a fiduciary relationship to both the issuer and the bondholders, since both are beneficiaries of the trust established by the bond indenture. By contrast, a fiscal agent or paying agent is not a trustee, but merely acts as an agent of the issuer to perform functions necessary to comply with the requirements of the documents.

A trustee or fiscal agent may perform one or more of the following duties:
• As trustee—establishing and holding the funds and accounts relating to the bond issue, including accounts for bond proceeds and revenues, determining that the conditions for disbursement of proceeds and revenues have been met, and, in some cases, collecting revenues and executing investments

• As bond registrar—maintaining a list of the names and addresses of all registered owners of the bonds and recording transfers and exchanges of the bonds

• As authenticating agent—authenticating bonds upon initial issuance or upon transfer or exchange

• As paying agent—paying interest on the bonds by check or wire to the respective registered owners, and paying principal of the bonds to the registered owners upon surrender of the bonds at maturity or upon earlier redemption

• As trustee—protecting the interests of bondholders by monitoring compliance with covenants and acting on behalf of bondholders in the event of default

• As escrow agent—holding the investments acquired with the proceeds of an advance refunding and using payments on those investments to pay debt service on the re-funded bonds

• As dissemination agent—acting on behalf of the issuer or other obligated person to disseminate annual reports and event notices to repositories under SEC Rule 15c2-12

• In several of the above capacities—mailing required notices to bondholders

• Acting as a liaison to bondholder committees (in the event of a default or workout situation)

These functions are not necessarily always performed by the same bank or trust company and, in some instances, may be performed by more than one such entity.

**Workout.** In the event that any problem arises with respect to the bonds, such as a shortfall in revenues needed to make the payments, the trustee is usually called upon to play a key role. In particular, because the trustee acts as fiduciary for the bondholders, the trustee must decide the nature, extent, and timing of information to be provided to bondholders concerning the problem. Also, the trustee generally acts as the liaison to the bondholders, particularly when a decision needs to be made about restructuring the debt or making only a partial repayment. Issuers should be aware that trustees have contractual duties to bondholders in the event of a problem and are prepared to act pursuant to the terms of the documents if and when a problem arises.
“Credit enhancement provider” and “credit provider” describe any entity that guarantees or insures in one form or another the sufficiency of revenues to pay the bonds. A credit enhancement provider may be a bank providing a letter of credit, or a bond insurer providing a bond insurance policy or, in the case of certain types of bonds to finance lending programs, the credit enhancement provider may be a savings and loan association, a mortgage insurer, a federal agency, or a private guarantor. In each case the purpose of the credit enhancement is to provide, for a fee, additional security for the bonds that improves the credit rating of the bonds and thereby lowers the borrowing costs to the issuer. In essence, the higher rating of the provider is relied on by investors rather than the underlying rating of the issuer, so that the investors will demand a lower interest rate, more than compensating for the cost of the credit enhancement. Normally, credit enhancement only makes sense where the savings from the credit enhancement exceed the cost of the credit enhancement or where the credit enhancement facilitates the sale of a bond issue that would not otherwise be possible. Normally, the credit enhancement provider is selected by the issuer with advice from the underwriter or financial advisor.

Common types of credit enhancement include:

**Bond Insurance.** Bond insurance is represented by a bond insurance policy that insures the timely payment of scheduled principal and interest on the bonds. The policy is customarily not subject to cancellation for the entire term of the bonds. The premium for bond insurance is payable at the time the bonds are issued, but also may be payable as an annual fee. Bond insurance often results in a AAA rating for the issue.

Municipal bonds are typically insured by “mono-line providers” or companies that specialize in insuring only investment grade debt securities (as opposed to companies that provide property and casualty or automobile insurance). These companies carry the highest credit ratings because of their financial strength and liquidity. Four long-established guaranty companies—Ambac, FGIC, FSA, and MBIA—control the majority of the market, along with XL Capital Assurance, CDC IXIS Financial Guaranty, ACE Guaranty Corp., and Radian Asset Assurance Inc.

Almost half of the outstanding municipal bond issues in the United States, both fixed and variable, currently have bond insurance. Bond insurance also is utilized in connection with swap and other derivative transactions.

**Letter of Credit.** A letter of credit issued by a bank will customarily provide that the trustee or fiscal agent may draw on the letter of credit when necessary to make payments of principal and/or interest on the bonds. The issuer (or, in the case of some bond issues for lending programs, the nongovernmental borrower) agrees to reimburse the bank for each such draw. Generally, the letter of credit will be irrevocable for a specified term, which may or may not be the entire term of the bonds. Ordinarily, there is both an initial fee and an annual fee for
the letter of credit. In some cases letters of credit are issued by nonbank financial institutions, such as the State Teachers’ Retirement System.

**Line of Credit.** A line of credit is a standby obligation of a bank to make payments with respect to debt service on bonds if the issuer (or borrower in a conduit financing) fails to do so. It is not as secure from a bankruptcy point of view as a letter of credit and therefore is used infrequently except as a liquidity facility (see below) where the issuer or borrower has an underlying investment grade rating.

**Mortgage Insurance.** An alternative form of credit enhancement in the case of lending programs is mortgage insurance provided by a federal or state agency or a private mortgage insurance company. Mortgage insurance insures payment of principal and interest by the borrowers in a lending program, such as a single-family or multifamily loan program.

**Private Guarantor.** Similarly, a private guarantor may guarantee payment of principal and interest on a loan agreement under which the principal borrower agrees to pay to the issuer amounts sufficient to pay principal and interest on the bonds. For example, the parent company of a corporate borrower might agree to guarantee the borrower's loan agreement payments.

**Liquidity Facility.** Finally, credit enhancement should be distinguished from the provision of liquidity. The holders of certain types of variable rate bonds have the option, after a specified notice period, to “put” the bonds (that is, to sell the bonds) back to the issuer or to another specified entity. Often, the issuer will arrange for a bank or other guarantor to provide a liquidity facility, to provide to the issuer the amounts necessary to purchase bonds which are put in this fashion and not able to be resold to another investor. A liquidity facility can take the form of a “standby bond purchase agreement” under which the bank agrees to purchase any bonds that are put by investors but cannot be remarkeated.

**Nongovernmental Borrower**

In California, various issuers are authorized to issue bonds and lend the proceeds to one or more nongovernmental borrowers to finance facilities the development of which is deemed to be a public purpose. Such facilities include, among others:

- Single-family housing
- Multifamily housing
- Student loan programs
- Hospitals and other health care facilities
- Educational facilities
- Pollution control facilities
- Solid waste facilities
- Power facilities
- Airports, seaports, and marinas
- Certain kinds of sports facilities
- Certain other types of industrial or commercial facilities

In each case, the criteria for qualification as a borrower are derived from state constitutional and statutory criteria, the issuer's own policy requirements, and, in the case of federally tax-exempt bonds, federal tax requirements. Such financings are often called conduit financings and the nongovernmental borrowers are often called conduit beneficiaries. Generally, the nongovernmental borrower and any credit enhancement provided by or on its behalf, are the only sources of revenues for repayment of the bonds.

In some cases, the nongovernmental borrower will take a very active role in designing and negotiating the terms of the bonds. In others, for example in the case of single-family lending programs, nongovernmental borrowers are not directly represented, but establish a market in which the lending program must operate. However, in all cases, the issuer is the central figure in a financing.

**INVESTORS**

A bond financing structure must meet not only the needs of the issuer, but also the needs of the investor. Target investors in a bond financing have considerable influence in determining the features and structure of the bonds.

Over five million households own municipal bonds either directly or through institutional portfolios, including mutual funds, unit investment trusts, and bank trust accounts. The investment market for municipal bonds is one of the world's largest securities markets with approximately $2 trillion worth of municipal bonds in the hands of investors. There are more than 50,000 state and local entities that issue municipal securities, and two million separate bond issues outstanding. Generally, however, investors in tax-exempt bonds have one characteristic in common—the ability to take advantage of the exemption from federal income taxes customarily applicable to interest on municipal bonds.

**Retail Investors.** Retail investors typically are individuals with high net worth who achieve the tax exemption from federal and, in some cases, state income taxes. These retail investors tend to be highly sophisticated clients of the organizations involved in the underwriting and remarketing of tax-exempt issues.
**Institutional Investors.** Institutional investors, such as tax-exempt bond and money market funds, also are major players in the market for municipal securities. National municipal bond funds invest primarily in the bonds of various municipal issuers in the United States. These funds seek interest income free from federal tax. State municipal bond funds invest primarily in municipal bonds issued by a particular state. These funds seek high after-tax income for residents of individual states. Tax-exempt money market funds invest in short-term municipal securities and must have average maturities of 90 days or less. These funds seek the highest level of income—free from federal and, in some cases, state and local taxes—consistent with preservation of capital.

As of 2003, there were 527 state municipal bond funds, 251 national municipal bond funds, and 312 tax-exempt money market funds.

Both retail and institutional buyers may have slightly different investment objectives in the purchase of municipal securities. Thus it is important for the issuer and underwriter to recognize these market nuances when pricing and marketing the bond issue.

Major changes in the composition of the municipal bond market are the result, in large part, of changes in federal tax law which made tax-exempt interest less attractive to certain segments of the market. For example, banks historically constituted a large segment of the market for municipal bonds but they are now denied a federal tax deduction for the portion of interest paid on their own obligations (such as deposits) attributable to the carrying of tax-exempt bonds. Similarly, changes in federal tax law may adversely affect the attractiveness of municipal bonds to property and casualty insurance companies and to corporations and individuals with alternative minimum tax liability. Other entities such as pension funds and certain other tax-exempt entities have never been attracted to municipal bonds because of the inability to take advantage of the tax exemption (since their income is already tax-exempt). Conversely, the segment of the municipal bond market represented by bond funds and bond trusts is growing, as more and more investors take advantage of the ability to invest through mutual funds, including tax-exempt money market funds.

**Suitability.** In addition to the tax exemption, other criteria that serve as primary determinants of the suitability of a particular bond for a particular investor include the credit quality of the bond (credit rating), its term to maturity, its risk of redemption, and its potential for sale in the secondary market. It is critical that broker dealers offering bonds to investors match up the sophistication, risk tolerance, and economic situation of a potential investor with the structural features, liquidity, and credit quality of the bonds being offered. The securities laws require that broker dealers take these factors into account when offering and selling bonds. It is important for issuers to know what suitability considerations a broker dealer will use in selling the issuer’s bonds.

The relative demand by investors for bonds having different characteristics may influence the financial advisor’s or the underwriter’s recommendations concerning the structure of a
financing. For example, in a market where short-term, high credit quality bonds are in great demand, it may be advantageous for an issuer to issue variable rate put bonds rather than long-term fixed rate bonds. Or, in periods of relatively high interest rates, investors may demand that bonds not be redeemable prior to maturity (or be redeemable only after an extended period of time) to assure investors that they will have the benefit of the high interest rate and not run the risk of having to reinvest at a time when the market offers lower interest rates.

Suitability rules play a role in determining what securities a broker-dealer or underwriter may recommend to an investor. Historically the SEC has deferred to self-regulatory organizations to regulate this conduct. Under suitability rules used by the NASD (National Association of Securities Dealers), the NYSE (New York Stock Exchange), and the MSRB the members or the securities dealer must have some basis for believing that any particular security that they recommend is suitable for the customer on the basis of facts disclosed by the customer. The MSRB suitability rule (Rule G-19) is considerably more stringent than those of the NASD and the NYSE and imposes on the municipal securities dealer an affirmative duty to have knowledge or inquire about the “customer’s financial background, tax status, and investment objectives and any other similar information.”

As a result, in each financing, the issuer and its financing team members must design the financing structure to meet the needs of the issuer in the context of the investor market for the issuer’s debt. See Chapter 10, Continuing Disclosure and Investor Relations Programs for more information.

**INVESTMENT ADVISOR**

In many cases, issuers will wish to retain an investment advisor to assist them in investing bond proceeds. (See Chapter 11, Investment of Bond Proceeds for more information on the considerations that should be taken into account in determining appropriate investments.) Often the financial advisor or underwriter will act as an investment advisor with respect to the bond proceeds, but the issuer also may use a separate advisor. In some cases, the members of the issuer’s staff have substantial investment experience and will handle this task “in-house.”

**REBATE COMPLIANCE CONSULTANT**

**Arbitrage Yield Restriction.** The tax code generally prohibits municipalities from issuing tax-exempt bonds if the issuer reasonably expects to use the proceeds of such bonds, directly or indirectly, to acquire securities or obligations with a yield materially higher than the yield on such bonds, or to replace funds used to acquire such higher yielding securities or obligations. Thus, the tax code generally restricts the rate of return on investments purchased with gross proceeds to a yield that is not materially higher than the yield on the bonds.

As described in Chapter 3, General Federal Tax Requirements, exceeding the arbitrage yield restriction requires the issuer to rebate the difference to the IRS. The rebate requirement applies to most tax-exempt bond financings. Depending on the attributes of the financing,
computing the correct amount of rebate to be paid to the Internal Revenue Service (or confirming that nothing needs to be paid) can be very complicated and time-consuming. Issuers should consider and discuss with members of the financing team the most cost-effective way of satisfying the rebate requirement. Complying with the rebate requirement is a post-closing responsibility of the issuer (or possibly the nongovernmental borrower) and not the responsibility of other members of the financing team. In general, the best economic decision will be to maximize the investment earnings on the proceeds of the bond financing and engage a qualified rebate compliance consultant to perform periodic calculations. In addition, a qualified rebate compliance consultant may be able to suggest ways to avoid paying a rebate while maximizing the investment earnings on bond proceeds, subject to the issuer’s investment policies. For more information on arbitrage restrictions and rebate requirements, see CDIAC’s *California Public Fund Investment Primer, Chapter 4: Other (Non-Surplus) Fund Investment*. 