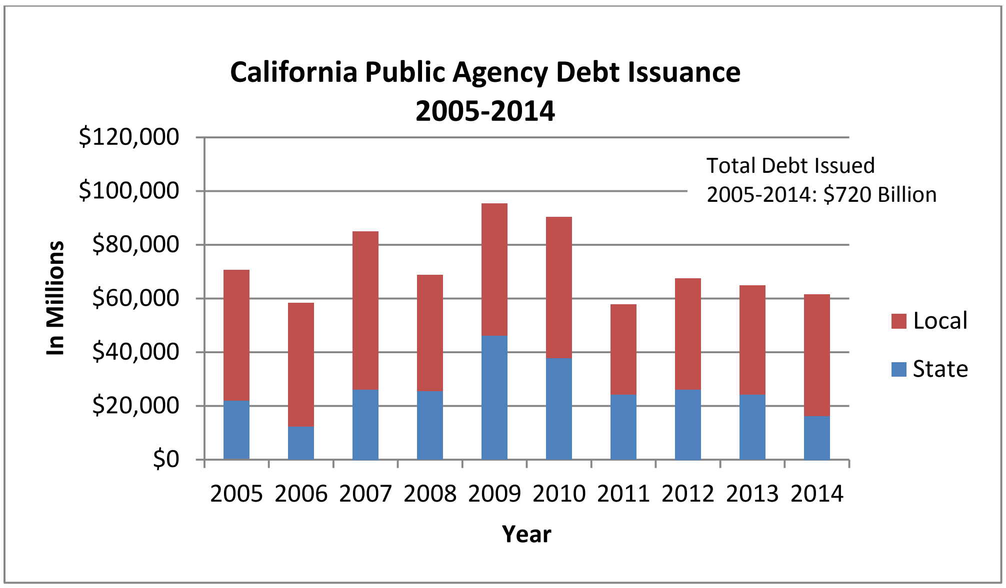
TASK FORCE ON BOND ACCOUNTABILITY
STAFF BACKGROUND REPORT

Submitted to Task Force Members
April 8, 2015

I. OVERVIEW OF CALIFORNIA'S MUNICIPAL DEBT MARKET

Over the last 10 years, public agencies in California have issued over $700 billion of municipal bonds to fund public projects and services, making California the largest issuer of tax-exempt debt in the nation. Total California debt issuance, including state and local agencies, normally ranges between $50-70 billion annually (Figure 1).

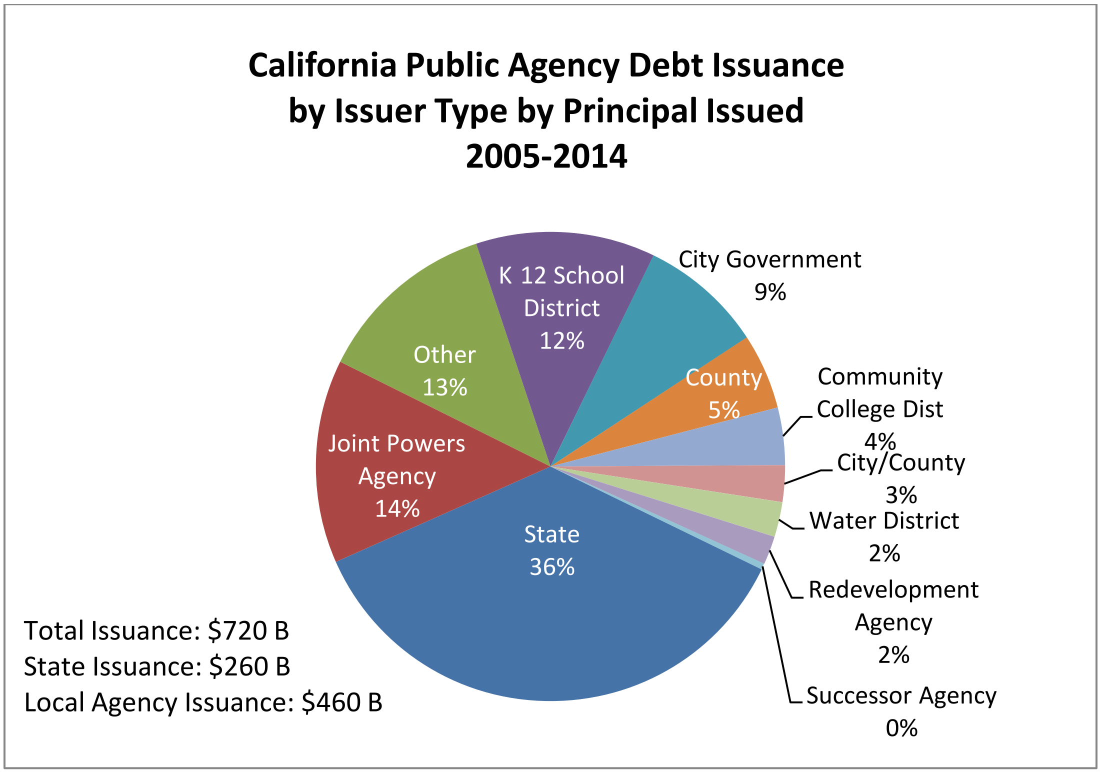
Figure 1



Source: CDIAC's Debt Issuance Database

In 2014, 720 separate California public agencies issued debt, including the State, cities, counties, school and special districts (Figure 2).

Figure 2[1]

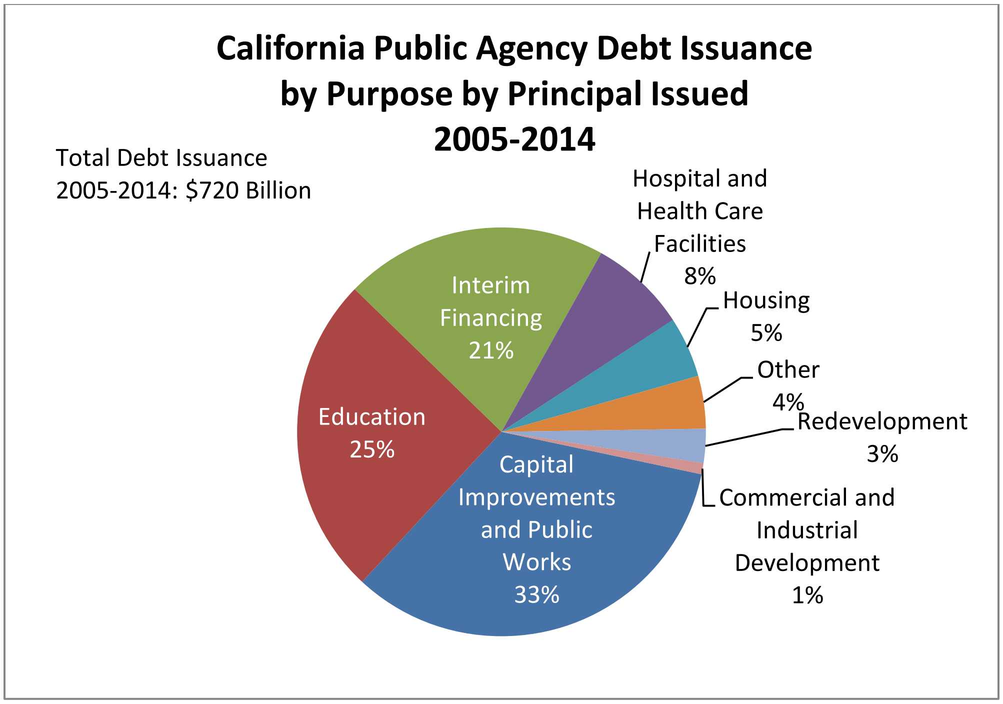


Source: CDIAC's Debt Issuance Database

California public agencies issue debt in a variety of forms, including both long-term and short-term debt, tax-exempt and taxable debt, as well as debt issued for the purpose of refunding existing indebtedness (Figure 3).

[1] The category of "Other" includes the following issuer types: Drainage District, Sanitation, Flood Control District, Cemetery District, Water and Power Agency, Airport District, Special District, Parking Authority, Miscellaneous, Municipal Improvement District, Sewer District, Air Pollution Control, Quality Management District, Health Care District, Resource Conservation District, Housing Finance Agency, Industrial Development Authority, Sanitation District, Public Utility District, Flood Control, Water Conservation District, Fire Protection District, Co Board of Education, Park & Recreation District, Housing Authority, Transit District,

Figure 3



Source: CDIAC's Debt Issuance Database

II. Snapshot of the Bond Issuance Process?

The procedural steps by which California public agencies issue debt vary widely depending on the type debt. For example, some types of debt, in particular general obligation bonds, require voter approval while other forms of debt such as leases or revenue bonds may be approved by simple resolution of the governing body of the issuer. Conduit bonds and some other types of debt may require action by an official body other than the issuer. [2] Virtually all types of public debt, however, adhere to the following steps: [3]

1. Determine that a project or program to be financed is necessary or desirable;
2. Select the financing team;
3. Structure the financing;
4. Obtain formal approval by the governing body of the issuer and, if applicable, conduit borrower;
5. Execute and deliver the financing documents to bond counsel;

[2] Key Debt Issuance Terms are provided in Appendix A to this staff report.

[3] *The California Debt Issuance Primer* provides a Checklist of Steps in a Debt Financing that describes in more detail the general steps public agencies follow to issue bonds (see Chapter2).

6. Receive an opinion on the validity of the debt issuance and whether the interest received by bondholders is exempt of income taxes from bond counsel;
7. Once the bonds are delivered to the underwriter the underwriter transfers funds to the issuer or to a trustee.

Proceeds from the sale of bonds are generally deposited into an account to be used by the issuer for specific public purposes. The arrangement between the controlling bond documents, the rules governing disbursements and payments, and the roles of responsible parties differ greatly among public agencies depending on the type of bonds, the uses of the proceeds, and the administrative practices of the public agency. In general the issuer assumes the following post-issuance responsibilities:

1. Administering any assessments or special taxes securing the issue;
2. Collecting, or monitoring the collection of Pledged Revenues;
3. Supervising, investing, and administering the expenditure of bond proceeds;
4. Administering any construction or acquisition programs;
5. Responding to investor inquiries;
6. Complying with ongoing covenants including continuing disclosure undertakings and tax compliance (arbitrage rebate); and
7. Dealing with any workout-related issues.

To meet these responsibilities, most public agencies adopt internal controls that enable the necessary tracking, monitoring, and reporting associated with the management of bond proceeds.

III. INTERNAL CONTROLS[4]

An Elected Official's Guide: Internal Control, published by the Government Finance Officers Association, recognizes that public agencies, as guardians of public funds, have a fiduciary responsibility to ensure that public funds are used legally and for their intended purposes.[5]

The American Institute of Certified Public Accountants (AICPA) defines internal control as:

> A process affected by those charged with governance, management, and other personnel that is designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over safeguarding of assets against unauthorized acquisition, use or

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[4] *California Local Agencies Internal Control Guidelines 2015*, published by the California State Controller's Office was the source of information for this section.
[5] *An Elected Official's Guide: Internal Control*, Government Finance Officers Association, 2015, pg. 7.

disposition may include controls relating to financial reporting and operations objectives. [6]

The application of internal control by public agencies should achieve three basic objectives:

- To operate effectively and efficiently and to safeguard their assets (Operational);
- To provide reliable information to those who need it (Reporting); and
- To comply with all applicable constraints, as required by policies, procedures, and statutes, etc. (Compliance).[7]

A governing body, which is responsible for overseeing management, is ultimately responsible for ensuring that management achieves all three basic objectives of internal control.[8] Managers, in turn, must be able to provide a reasonable assurance to the governing body that each objective is being achieved.[9] Achieving a reasonable assurance requires a comprehensive framework that provides for:

- A favorable control environment;
- Ongoing risk assessment;
- The design, implementation, and maintenance of effective control activities;
- Effective information and communication; and
- Ongoing monitoring of the effectiveness of internal control.

According to the GFOA, a system of internal controls is nothing more (or less) than the combination of people, policies, and procedures that managers rely upon to be able to provide a positive response to each of the following questions:[10]

- How do you know that the entity is operating effectively and efficiently and is safeguarding its assets?
- How do you know that financial statements and other reports can be relied upon?
- How do you know that the entity is complying with applicable laws, regulations, and policies?

Pursuant to California Government Code section 12422.5, the State Controller (SCO) has developed *Internal Control Guidelines for California's Local Agencies* (Guidelines) for use by

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[6] *Internal Control – Integrated Framework*, Committee of Sponsoring Organizations of the Treadway Commission, 2013.
[7] *An Elected Official's Guide: Internal Control*, Government Finance Officers Association, 2015, pg. 9.
[8] *An Elected Official's Guide: Internal Control*, Government Finance Officers Association, 2015, pg. 9.
[9] It is important to emphasize that the goal is to provide a reasonable assurance because a system of internal controls that is capable of producing an absolute assurance of meeting these objectives is not likely to be cost effective.
[10] *An Elected Official's Guide: Internal Control*, Government Finance Officers Association, 2015, pg. 9.

local public agencies. The Guidelines are intended to assist local agencies in establishing a system of internal control to safeguard assets and prevent and detect financial errors and fraud

IV. Common Bond Management Practices

A. Pre-Bond Authorization (Prior to Voter/Board Approval)

Careful planning and thorough preparation is a critical factor in successful bond management. Preparation typically begins long before the authorization of the bonds and may include:

- Development of a capital improvement plan (CIP);
- Establishment and consideration of debt management, investment and disbursement policies to guide the issuer's financing and management of bond funds;
- Careful review of federal, state and local laws;
- Constant attention and supervision of the debt financing and a commitment to provide resources to efficiently and effectively manage Bond funds after issuance;
- Advance preparation and education of the governing body of the issuer and, if appropriate, the community at large; and
- A comprehensive plan to allow for the accurate and timely flow of information to current and prospective investors, members of the governing body and the public.

The public agency may develop and submit a CIP to the governing body for approval prior to issuing debt. A CIP identifies projects to be funded, funding sources, and project expenditures over the planning horizon and serves as a guide that assists the public agency to:

- Establish priorities in order to balance capital needs with all available funding;
- Match projects with appropriate funding alternatives;
- Ensure the debt-financed projects do not exceed legally or statutorily permitted levels of debt issuance; and
- Plan for debt issuance to meet expenditure requirements.

Along with a CIP, a public agency may have adopted a debt management policy that, in general, reflects the scope of activities that the issuer is likely to fund by issuing bonds. The debt management policy can be used to reflect community goals and expectations concerning the use of debt financing. Debt policies are also formally submitted to and adopted by the governing body. A debt management policy enables the public agency to:

- Establish parameters for issuing and managing debt;
- Provide guidance to decision makers so as not to exceed the debt affordability standards;[11]

[11] An Issuer may also consider adopting debt affordability standards in order to help them evaluate when, why, and how much debt should be issued. These standards can lead to a debt affordability plan that keeps debt levels within acceptable ranges. A debt affordability plan will typically include a set of target ratios for debt, which might

- Direct staff on objectives to be achieved both pre- and post-issuance;
- Promote objectivity in decision-making and limits the role of political influence; and
- Facilitate the process by considering and making important policy decisions in advance of an actual debt issuance.

B. Voter Approval/Authorization of Issuance

Issuers of municipal bonds are legally authorized by state law to borrow money for different purposes and in some cases for their "general corporate purposes."[12] 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." The legally required procedural steps vary widely among the different types of public debt financing.[13] Depending on the type of bond authorized, the issuer may have to satisfy additional legal requirements prior to issuing the authorized bonds.

The legal authority for the issuance of public debt can be visualized as a three-legged stool, including:

- The state law that authorizes the issuance of bonds;
- The federal and state securities laws that govern the eligibility of the bonds for "tax-exempt" status; and
- The federal and state securities law that govern disclosure, sale, and trading of bonds.

As these legal requirements are in a constant state of change, issuers must monitor and review them on a regular basis and in consultation with bond counsel, the local agency's general counsel, and other legal professionals.

C. Typical Bond Issuance Process (Structuring, Sale and Closing)

The issuer is the key figure and major focus throughout the debt issuance process. As mentioned earlier, one of the first decisions to be made by an issuer is the selection of the initial members of its debt financing team, including, but not limited to, bond and tax counsel, disclosure counsel, financial advisor, underwriting firms, and trustee. Team members may be selected on the basis of a competitive procurement process, long-standing relationship with the issuer, reputation, or recommendation by others.[14]

Having selected a debt financing team, an issuer then works closely with the team members during the structuring and sale phase of the debt issuance process to finance its capital improvement or working capital program. Subject to legal constraints and considering the

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be based upon assessed valuation of property, revenues, population, system users, or other factors relevant to specific types of issues.

[12] *California Debt Issuance Primer*, California Debt and Investment Advisory Commission, 2006, pg 2-3.

[13] *California Debt Issuance Primer*, California Debt and Investment Advisory Commission, 2006, pg 37.

[14] *California Debt Issuance Primer*, California Debt and Investment Advisory Commission, 2006, pg. 3.

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, including the management of the financing schedule, development, review and approval of bond documents (i.e. Indenture, Preliminary and Final Official Statement, Bond Purchase Agreement, Tax Certificate, Continuing Disclosure Agreement and other related legal documents) and review and approval of underwriting policies, issuer representations and certifications.

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. Key considerations of the issuer that should be addressed prior to the sale of bonds include, amount to be issued, type of debt to be issued, structural features of the bonds, method of sale of debt and compliance with disclosure requirements. The issuer's management and staff are also responsible for seeking approval from its governing body prior to the sale of bonds. All members of the governing body should be provided with an appropriate scope of details regarding the proposed bond issuance so that each member has a thorough understanding of the bond issuance that they are asked to approve.

D. Post-Issuance (Management of Bond Funds)

Upon the closing of a bond financing transaction, the issuer assumes responsibility for the long-term management of bond proceeds, including:

- Supervising, investing, and administering the expenditure of bonds proceeds;
- Collecting, or monitoring the collection of Pledged Revenues;
- Use of revenues to pay administrative expenses and debt service;
- Compliance with all undertakings, bond covenants, and agreements;
- Management of any enterprise funded by the bonds;
- Filing of any required reports with various government regulators, 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 Pledged Revenue, a tax audit, or a regulatory issue; and
- Preparing, reviewing, and filing Annual Reports and Listed Event Notices pursuant to Securities and Exchange Commission rules.

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, many issuers remain an active participant in the issuance of debt and long-term management of their bonds. Even if the issuer selects its consultants with an eye toward providing services that cannot be provided in-house, many issuers continue to examine the consultant's work and ask the questions necessary to assure themselves that the end result is meets their objectives.

E. Custody and Control of Bond Funds

At bond closing and depending on the type of bonds issued as well as the needs and capabilities of the issuer, the bond proceeds as well as the pledged revenues collected for the repayment of the bonds and other permitted uses may either be deposited with a trustee that is a Public Control Agency (i.e. funds are held within the local government's Treasury) or with a commercial bank or corporate trust company (i.e. funds are held outside of the local government's Treasury). In either scenario, Bondholders are comforted by the involvement of a fiduciary acting on their behalf and holding funds and accounts relating to the bond issue. The terms under which the trustee safeguards and administers the use of the proceeds is set forth in an Indenture of Trust, Resolution or other legal agreements. A trustee may perform one or more of the following duties:

- As trustee—establishing and holding the funds and accounts relating to the bond issue, determining that the conditions for disbursement of bond proceeds and Pledged Revenue 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; and
- As trustee—protecting the interests of Bondholders by monitoring compliance with covenants and acting on behalf of Bondholders in the event of default.

In performance of its 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 Indenture of Trust, Resolution or other legal agreement.

Appendix A
Key Debt Terms

Issuer. The tax-exempt status of the municipal issuer 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 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 the authority to tax and includes, among others, water districts, sanitation districts, and community facilities districts.

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, including the management of the financing schedule, development, review and approval of bond documents (i.e. Indenture, Preliminary and Final Official Statement, Bond Purchase Agreement, Tax Certificate, Continuing Disclosure Agreement and other related legal documents) and review and approval of underwriting policies, issuer representations and certifications.

Bond Documents. The following are some of the key documents that dictate not only how bond funds are to be distributed post issuance but identify the public agencies annual reporting requirements to the market.

Bond/Trust Indenture. The bond/trust indenture is a contract between a trustee, usually a bank, the bondholders, and the issuer. The bond/trust indenture is the most important of the bond documents and includes the form of the bonds. It establishes the security, interest rate, maturity, bondholder rights and remedies in case of a default. The issuer and the trustee each are bound by the terms of the bond/trust indenture. The issuer promises to pay principal and interest on the bonds. The trustee holds all funds under the bond/trust indenture; pays principal and interest to bondholders; and acts for the bondholders in the event of a default.

Official Statement. The Official Statement (OS) contains the final terms of the bonds. Under federal securities laws, the issuer is obligated to disclose in this document all information that a “reasonable investor” would consider important in deciding whether to purchase a bond. A Preliminarily Official Statement (POS), complete except for interest rates and maturities, is used to market and pre-sell the bonds.

Purchase Contract. This is the agreement between the issuer and the underwriter in which the issuer agrees to sell the bonds to the underwriter, and the underwriter agrees to purchase the bonds from the issuer at a specified purchase price, typically principal plus accrued interest from the date of the bonds to the date of closing. The purchase contract sets forth the terms and conditions under which the underwriter will purchase the bonds. These provisions include provisions for various documents and opinions to be provided by parties to the financing at the closing, including any expected bond rating. This contract is known as a Bond Purchase Agreement (BPA).

Credit Enhancement Agreement. In many financings, there may be a credit enhancement agreement that a third party insures or guarantees either the bonds or the issuer's mortgage repayment obligation. Often there are two documents, the guaranty or insurance agreement, which runs to the trustee, and the agreement of the issuer to repay the insurer/guarantor.

Disclosure Agreement. Another common document is the disclosure agreement, in which the issuer, or the borrower in a conduit financing, agrees to provide ongoing disclosure as required by Securities and Exchange Commission Rule 15c2-12.

Bond Proceeds. Public agencies issue Bonds to borrow money (bond proceeds) primarily from investors (Bondholders) in the tax-exempt capital market to finance the new construction of buildings and public facilities for their respective capital improvement programs, including but not limited to school facilities, police and fire stations, infrastructure, multi-family housing, health care facilities and many others. Additionally, bond proceeds may be used to pay costs of issuance and other permitted expenses of a bond financing transaction and to establish a reserve fund, if applicable. Bond proceeds are deposited in funds and accounts and held in trust primarily by a third-party custodian (trustee) that is a commercial bank or corporate trust company (i.e. held outside of the local government's Treasury) or Public Control Agency (i.e. held within the local government's Treasury). If bond proceeds are not held by a trustee, the available amounts must be maintained in a restricted fund or account.

Cost of Issuance. Borrowing costs money, in addition to the interest on the amount borrowed. Additional costs include expenses for bond counsel Services, Publishing Bond Documentation, Determining Credit Ratings, trustee/paying agent services, financial advisor consulting fees, and underwriter commission.

Financing Team. The coordinated efforts of a specialized group of professionals all working in concert is required to successfully issue debt.

Bond Counsel. Bond counsel is the attorney, firm of attorneys, or group of firms that give the legal opinion delivered with the bonds confirming that the bonds are valid and binding obligations of the issuer and that interest on the bonds is exempt from federal and state income taxes.

Disclosure Counsel. Disclosure counsel is the attorney or law firm retained by the issuer to provide advice on issuer disclosure obligations and to prepare the official statement and continuing disclosure agreement.

Financial Advisor. A financial advisor is a professional consultant retained to advise and assist the issuer in formulating and/or executing a debt-financing plan to accomplish the public purposes chosen by 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. A financial advisor may be a consulting firm, an investment banking firm or a commercial bank.

Underwriter. An underwriter is a firm, or group of firms, that purchases bonds directly from a bond issuer and resells them to investors. Underwriters are intermediaries between issuers and investors. Underwriters fill the void in the marketplace by purchasing whole bond issues and then reselling them, ideally for a profit, to investors. The responsibilities and functions of the underwriter will depend primarily on whether the bonds are to be sold at competitive bid or at negotiated sale.

Underwriter's Counsel. Underwriter's counsel is customarily selected by the underwriter to represent the underwriter and its interests in a negotiated sale. Normally, no underwriter's counsel is retained in a competitive sale. Underwriter's counsel will customarily review, from the underwriter's perspective the documents prepared by bond counsel, and will negotiate matters relating to those documents on behalf of the underwriter.

Credit Rating Agencies. Debt issued by governmental entities is rated to reflect the degree of risk and probability of repayment of all interest and principal to the investor. Investors use the bond ratings to determine the level of repayment risk associated with the specific issue and determine a minimum rate of return for the risk involved. If the bonds have high ratings, they are assumed to have low risk and the investor will therefore require a lower yield. Just the opposite will occur for a lower rated (riskier) bond. There are four major investment grade ratings assigned to bonds by the rating agencies -Highest (AAA/Aaa), High (AA/Aa), Above Average (A), and Medium (BBB/ Baa). All long-term bonds rated below the fourth category are judged to be below investment grade (speculative grade) and are often referred to as "junk" bonds. Most financial institutions are prohibited from lending on any securities rated below (BBB/Baa).

Trustee. The trustee is responsible for carrying out the administrative functions that are required under the bond documents. These functions include establishing the accounts and holding the funds relating to the debt issue, authenticating the bonds, maintaining a list of holders of the bonds, paying principal and interest on the debt, and representing the interests of the bondholders in the event of default.

Investment Advisor. In many cases, issuers will wish to retain an investment advisor to assist them in investing bond proceeds. Investment advisors are professionals with experience, training, and special expertise in the area of investment management. With a few limited exceptions, investment advisors must register with the SEC or the California Department of Corporations. However, there is no required license exam or certification for investment advisors. Investment advisors receive a fee for their service. Certain investment advisors specialize in the management of local agency funds.

Long-term Debt. Long-term debt is usually defined as bonds or other obligations with maturity of 10 years or longer. Most "long-term" assets such as public buildings and major infrastructure are financed over 25 or 30 years. On the other hand, equipment, which typically has a much shorter economic useful life, is usually financed over an intermediate term of 3 to 10 years.

Short-term Debt. Short-term borrowing is generally defined as debt maturing no later than one year after the date of its issuance. The two basic reasons for borrowing short term are to smooth out cash flows due to the timing of tax receipts and to cover start-up costs for large projects until the actual final costs are known. For example, short-term operating needs are generally financed with short-term borrowing, such as a "tax and revenue anticipation note" (TRAN), while a capital asset, such as a library building, is typically financed with a debt instrument having a longer maturity.

Refunding. A substantial amount of long-term debt issuance consists of debt issued to refund other existing outstanding debt. In simple terms, new debt is issued to pay off old debt, normally to achieve cost savings associated with lower interest rates.

APPENDIX B
SOURCES OF INFORMATION

The following resources were used to compile this staff report.

RESOURCE	ORGANIZATION
An Elected Official's Guide to Internal Control (2015)	Government Finance Officers Association
California Debt Issuance Primer (2006)	California Debt and Investment Advisory Commission (CDIAC)
California Debt Issuance Primer Handbook	CDIAC
California Local Agencies Internal Control Guidelines (2015)	California State Controller

Information provided by financial institutions, government organizations, trade groups, educators, along with state and local oversight agencies is available through traditional published and electronic Internet sources. The following sources contribute significantly to the understanding of issues related to markets, credit ratings, oversight, and current trends in the industry.

ORGANIZATION	PURPOSE
Securities Industry and Financial Markets Association http://www.sifma.org/	The main trade association representing the securities industry.
The Bond Buyer http://www.bondbuyer.com/	The daily newspaper serving the municipal bond industry.
The Government Finance Officers Association (GFOA) http://www.gfoa.org/	Principal professional association of state and local finance officers in the United States.
The Municipal Securities Rulemaking Board (MSRB) http://www.msrb.org/	Makes rules and regulations, along with setting standards for all municipal securities dealers.
The Governmental Accounting Standards (GASB) Board http://www.gasb.org/	Establishes and improves standards of state and local governmental accounting and financial reporting.
Government Accountability Office http://www.gao.gov	Independent, nonpartisan agency that works for Congress. The GAO investigates how the federal government spends taxpayer dollars.

Internal Revenue Service http://www.irs.gov/	Provides information and technical assistance on tax law and requirements.
Securities and Exchange Commission http://www.sec.gov/	Oversees securities markets, including stock exchanges, broker-dealers, investment advisors, and mutual funds companies.
California Debt and Investment Advisory Commission http://www.treasurer.ca.gov/cdiac	Provides information, education, and technical assistance on debt issuance and public fund investment to local agencies.