

INTRODUCTION

On May 14, 2015, staff to the California State Senate Committee on Governance and Finance (Committee) released an oversight report titled, *Misappropriated Bond Proceeds at the Association of Bay Area Governments*. The report provided a detailed description of the alleged misappropriation of bond funds and asked several questions that should be considered in any attempt to develop or recognize practices that ensure the proper management of bond funds. The Committee's staff report also acknowledged the work of the State Treasurer's Task Force on Bond Accountability (Task Force).

This staff report addresses some of the questions raised by the Committee's staff report. Response are based on testimony given by subject matter experts at Task Force meeting, information provided in the Committee's oversight report, and research conducted by the California Debt and Investment Advisory Commission.

POLICY QUESTIONS AND ANSWERS

In its report, the Committee offered policy makers the following threshold question to consider, "Does the ABAG incident reveal the existence of any broad, systemic problem with how bond proceeds are managed?" In light of this fundamental question, the Committee staff also recommended further inquiry into the following questions that may help address potential policy implications related to the ABAG incident.

Question 1: Is there a universally accepted set of "best practices" among bond issuers that is applicable to the management of bond proceeds?

Staff Response: According to expert testimony given to the Task Force, it is believed very little focus has been afforded to a universally accepted set of best practices that provides a comprehensive guide to bond issuers for managing bond proceeds after the sale of the bonds. There are, however, various guidelines to support the pre-issuance process and for managing the post-issuance obligations of issuers that focus. Pre-issuance guidelines address the development of debt policies, selection of a financing team, preparing the initial disclosure materials. Post-issuance guidelines consider the financial reporting and continuing disclosure obligations of issuers. There are also generally accepted practices with respect to internal control structures that may be applied to the disbursement of funds by a public agency.

In an effort to identify universally accepted best practices for the management of bond funds by public agencies, CDIAC staff surveyed public finance practitioners and professional consultants, reviewed publications from government agencies and professional associations¹, bond documents, policies, procedures and statutes for various bond issuances and completed case studies² of small to large public agency issuers. Consistent with expert testimony presented to the Task Force, research conducted by CDIAC did not reveal any widely accepted best practices specific to the internal management and control of bond proceeds throughout the life of bonds.

¹ Professional associations include, but are not limited to, the Municipal Securities Rulemaking Board, Government Finance Officers Association, California Society of Municipal Finance Officers and National Association of Bond Lawyers.

² In the development of the case studies, CDIAC meet with representatives from the City and County of San Francisco, San Diego Unified School District and West Basin Municipal Water District and conducted a review of their respective administrative and bond management practices to gain an understanding of how public agencies manage bond proceeds (See Staff Report provided to the Task Force on May 21, 2015).

There is however, a framework of industry-wide accepted practices that are often followed by issuers and industry professionals to plan and manage bond financings in accordance with applicable state, local and federal laws. But guidance on how the internal management of bond proceeds should be handled is in general, only broadly considered there. Public agencies may utilize practices such as, separation of duties, dual signature authority, and reconciliation of accounting/audit trails to approve invoices for their programs, including bond funded capital improvements³. In addition, while bond proceeds are typically segregated into funds and accounts with a bond trustee, public agencies may require funds and accounts to be authorized by their governing boards, prior to implementation. The responsibility for ensuring that appropriate safeguards are in place to effectively manage and control bond proceeds, in most debt financings, ultimately rests with the issuer. In each of the case studies conducted by CDIAC, the internal controls applied to the disbursement of bond funds conformed to those applied to all other government funds.

Question 2: Are best practices the same for all issuers, or do practices vary depending on the type of issuer, type of bond, type of project? If best practices differ among issuers, is there good reason for these differences?

Staff Response: In 2014, 720 separate public agencies in California issued debt, including the State, cities, counties, and school and special districts. Over the last ten years, public agencies in California have issued over \$700 billion of 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. Despite the large number of issuers in California and variety of outstanding debt, the process of issuing debt and complying with pre- and post-issuance requirements mandated by state, local, and federal laws is very similar between issuers and types of debt.

However, the nature of the issuer and the type of debt can cause some variability in management of proceeds. Specifically, the procedures with respect to the arrangement between the controlling bond documents, the rules governing disbursements, and the roles of responsible parties may differ greatly among public agencies depending on the type of bonds, the uses of the proceeds, and the administrative practices of the public agency.

For example, upon the closing of a debt financing transaction, a common practice among issuers is to deposit proceeds from the sale of bonds with a bond trustee. The trustee, then, manages the funds according to the terms set forth in a bond resolution or indenture of trust. However, 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 may either be deposited with a trustee that is a public control agency (i.e. funds are held within the local government's treasury system)⁴ or with a private commercial bank or corporate trust company.

³ As confirmed in CDIAC's case studies approved by the public agencies, application controls within each agency's enterprise resource planning system were used to reasonably ensure completeness, accuracy, authorization, and validity of all transactions.

⁴ The disbursement of bond funds held within a public control agency may be more procedurally cumbersome when held within an agency's centralized treasury than when held by an external trustee and administered under a bond indenture.

While the involvement of a third-party fiduciary in the safekeeping of bond funds helps an issuer ensure bond proceeds are managed pursuant to a controlling bond resolution or indenture of trust, the application of practices to manage bond proceeds within the issuer's control environment may depend on the scope of the trustee's role, existing operational⁵ and reporting needs, statutory requirements, and resources available to the public agency.

Also, there is a fundamental difference between the role and responsibilities of conduit issuers and an issuer that has issued debt under its own authority. The Community Facilities District (CFD) bond issued by ABAG⁶ was a conduit bond. ABAG's Financing Authority for Non-Profits, a statutory authority also called a Joint Powers Authority (JPA),⁷ issued bonds as a conduit issuer for the CFD, a special tax assessment district created by local ordinance. Since proceeds of a conduit bond are, in general, not directly used by the issuer, the procedures utilized by a conduit issuer to manage bond proceeds would be expected to significantly differ from procedures utilized by public agencies that issue debt for their own needs and purposes.⁸ Furthermore, JPAs and other conduit issuers that are part of public agencies with broader public purposes may add complexity to debt financings and require management practices that vary from other types of issuers.

In general, it is reasonable to expect the procedures utilized by issuers to vary due to the type of bonds, use of proceeds, and the administrative practices of the respective public agency. Furthermore, as reflected in the case studies completed by CDIAC, differences among issuers may be due to statutory mandates applicable to only certain types of issuers or types of debt, such as a requirement for a school district to deposit bond proceeds with the county treasurer. Also, the size of an issuer and the availability of resources may influence the scale and scope of what a public agency determines to be a reasonable application of internal control within its organization.

There is also a fundamental difference between roles and responsibilities of a direct issuer of debt and a conduit issuer that would reasonably justify differences in how these issuers would be expected to manage bond proceeds and post-issuance requirements.

Examples on how public agencies manage bond and capital improvement programs within their respective organizations are provided in CDIAC's case studies.

⁵ Operational procedures of a public agency may need to work in tandem with standard operating procedures or business processes of the bond trustee. In general, a private trustee looks to the terms and conditions of the indenture to monitor compliance with disbursement procedures while a public control agency may require disbursement procedures to conform to standard operating procedures and management oversight that are proprietary to a centralized treasury system.

⁶ According to its website, ABAG is a regional planning agency that helps solve problems in areas such as land use, housing, environmental quality and economic development. In addition to its regional planning function, ABAG also provides conduit financing through its Financing Authority for Non-Profits.

⁷ JPAs and other types of conduit issuers may act as a "conduit" for issuing tax-exempt debt on behalf of eligible borrowers that may include a non-governmental purpose.

⁸ In general, compliance with covenants and other obligations with respect to a conduit bond is the responsibility of the borrower as the primary obligor and user of bond proceeds. Conduit issuers may retain certain rights with respect to tax compliance and therefore, may have a limited role in managing post issuance activities for conduit bonds.

Question 3: Timely Bond Proceeds Expenditures—What are the rules concerning the spend down of bond proceeds?

Staff Response: The Committee oversight report noted that unspent funds remained in ABAG CFD bond fund accounts at the trustee for years without any disbursements being made and that fact may have made them more susceptible to misappropriation. In general, municipal bonds are tax-exempt and issuers must comply with federal tax laws⁹ to maintain the tax-exempt status on the applicable bonds while the debt remains outstanding. Tax laws generally restrict the rate of return on investments purchased with gross bond proceeds to a yield that is not materially higher than the yield on the issued bonds. However, there are important exceptions to the yield restriction rule that issuers may look forward to utilizing as they plan and implement debt financings.

An important arbitrage rebate¹⁰ exception to consider is the “three-year temporary period,” during which the yield restriction does not apply to bond proceeds to be used to finance a project and costs related to the issuance of debt. During this period of time commencing from the issuance date, proceeds may be invested without regard to yield so long as the issuer reasonably expects to meet the following requirements.

- Spend five percent of net proceeds in six months
- Spend 85 percent of net proceeds in three years
- Diligently work to complete the project and spend down net proceeds

Public agencies may employ practices that seek to size bond issuances in amounts that are reasonably expected to be used within timeframes that comply with tax law and other requirements. In CDIAC’s case study of a school district, the issuance of general obligation bonds were planned and issued only in amounts the school district expected to expend within the applicable spend down period.

The Committee report recommended policy makers may wish to identify policies that would help ensure bond proceeds are used in a timely and transparent manner. While public agencies may adopt debt management policies that consider debt affordability criteria, arbitrage rebate compliance, investment of bond proceeds, and many other debt management activities, there are no existing guidelines and policies to address the timely spend-down of bond proceeds.

⁹ At the closing of a tax-exempt debt financing, the issuer and, in the case of a conduit issuer, the borrower executes a tax certificate that contains certifications to satisfy requirements of the Internal Revenue Code and the regulations issued thereunder in order for interest payment on the debt to be tax exempt. It also may contain certain selections made by the issuer or borrower at the time of bond issuance that are required under the Internal Revenue Code regarding how proceeds are expected to be allocated and used. Tax certificates also describe the rules applicable to the investment of bond proceeds under federal tax law, as well as the agreements of the issuer and obligors to comply with arbitrage restrictions regarding the investment and use of funds.

¹⁰ *The California Debt Issuance Primer* provides an overview of the basic federal tax concepts and rules applicable to public finance (see Chapter 3).

Question 4: Transparency of Bond Indenture Amendments—What are the laws concerning public disclosure of agendas, staff reports, minutes and how is this to be disclosed?

Staff Response: The Committee report noted that an amended indenture was adopted by ABAG without the knowledge and approval of officials at the City and County of San Francisco. This raises policy questions regarding transparency. Accordingly, the Committee report recommended policy makers may wish to consider whether increased transparency should be directed to changes to bond indentures that do not require bondholders' approval.

Public agencies may be required to follow open meeting practices pursuant to state law and issuers of tax-exempt debt are required to obtain authorization for bond issuances from their governing bodies that are subject to statutory open meeting requirements.

The Ralph M. Brown Act (Brown Act) set forth in Government Code section 54950 et seq., governs meetings conducted by local legislative bodies, such as boards of supervisors, city councils, and school boards. The Brown Act intends to balance public access to meetings of multi-member public bodies, on the one hand, and the need for confidential candor, debate, and information gathering on the other.¹¹

Furthermore, the Bagley-Keene Open Meeting Act (Bagley-Keene Act), set forth in Government Code sections 11120-11132, covers all state boards and commissions. Generally, it requires these bodies to publicly notice their meetings, prepare agendas, accept public testimony and conduct their meetings in public unless specifically authorized by the Bagley-Keene Act to meet in closed session.¹²

While there may be minor differences between the Brown Act and Bagley-Keene Act (collectively, Acts) regarding open meeting requirements, the Acts were adopted by the legislature to establish a presumption in favor of public access, facilitate participation in governmental decisions, and to curb misuse of the democratic process by public bodies. Specifically, the Acts stipulate requirements, exceptions and prohibitions applicable to public meetings related to the following.

- Locations and types of meetings
- Posting of notices and agendas
- Public testimony/comments
- Public access to meetings, information and records

In the case studies completed by CDIAC, the governing body of each public agency followed open meeting requirements in the approval of authorizing bond resolutions, controlling bond documents, disclosures and other required approvals. In addition, the public agencies maintained extensive archives of records on their websites, including but not limited to, copies of agendas/notices, meeting minutes, staff reports and controlling bond documents that were reviewed and approved by their governing bodies. Issuers may disclose proposed bond document amendments to their governing bodies, but practices may vary, depending on statutory authority and administrative practices.

¹¹ Source: *The Brown Act: Open Meetings for Local Legislative Bodies*, California Attorney General's Office

¹² Source: *A Handy Guide to the Bagley-Keene Open Meeting Act 2004*, California Attorney General's Office

Question 5: Fraud Detection--Is there a framework of laws, policies, and practices that can help to detect malfeasance after it occurs?

Staff Response: The Committee report suggests policymakers consider what can be learned from the City and County of San Francisco in their swift discovery of missing bond proceeds and to inquire into what laws, policies and practices can improve the rapid detection of malfeasance after it occurs. The swift discovery on the part of City and County staff was due to the periodic reconciliation of bond funds and timely investment reporting requirements. The implementation of practices that aid in fraud detection will depend, in part, on what is determined to be administratively reasonable, however, public agencies may benefit from the diverse framework of guidelines on fraud detection that include the following sources of information.

2015 Internal Control Guidelines – California Local Agencies

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 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.

http://www.sco.ca.gov/pubs_guides.html

Financial Integrity and State Manager's Accountability Act

Government Code sections 13400 through 13407, known as the Financial Integrity and State Manager's Accountability Act of 1983 (FISMA), was enacted to reduce the waste of resources and strengthen accounting and administrative control. FISMA requires each state agency to maintain effective systems of internal accounting and administrative control, to evaluate the effectiveness of these controls on an ongoing basis, and to biennially review and prepare a report on the adequacy of the agency's systems of internal accounting and administrative control.

<http://www.dof.ca.gov/osae/fisma>

Committee of Sponsoring Organizations of the Treadway Commission

The Committee of Sponsoring Organizations' (COSO) mission is to provide thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control and fraud deterrence designed to improve organizational performance and governance and to reduce the extent of fraud in organizations.

<http://www.coso.org>

U.S. Government Accountability Office (GAO)

Internal control helps an entity run its operations efficiently and effectively, report reliable information about its operations, and comply with applicable laws and regulations. *A standard for Internal Control in the Federal Government, known as the "Green Book,"* sets the standards for an effective internal control system for federal agencies. In addition, the GAO, *Internal Control Management and Evaluation Tool*, could be useful in assessing internal control as it relates to the achievement of the objectives in any of the three major control categories, i.e., effectiveness and efficiency of operations, reliability of financial reporting, and compliance with laws and regulations. It may also be useful with respect to the subset objective of safeguarding assets from fraud, waste, abuse, or misuse. In addition, the tool may be used when considering internal control as it relates to any of the various activities of an agency, such as

administration, human capital management, financial management, acquisition and procurement, and provision of goods or services.

<http://www.gao.gov>

Question 6: Are current best practices sufficient to ensure appropriate accountability to the public for the management of bond funds?

Best practices for the management of bond proceeds is broadly defined as the administration of accounting and internal controls as generally applied within a public agency, widely accepted practices utilized by issuers and professional consultants in the pre-issuance and post-issuance phases of a bond financing, and conforming guidelines as consistently applied by controlling bond documents, including, but not limited to, an indenture or bond resolution, loan agreement, tax certificate and continuing disclosure agreement.

Based on a review and analysis of information provided to the Task Force in expert testimony, case studies of public agency issuers, and research conducted by CDIAC, there is an opportunity to improve guidelines utilized by public agencies to efficiently manage and safeguard bond funds, including:

- The development of policies and procedures regarding the application of general accepted administrative and accounting internal controls to bond funds;
- Application of existing accounting of and reporting practices used for other governmental to bond funds; and,
- Increased transparency and accountability that demonstrates to the public how bond funds are efficiently and appropriately used.