

# MUNICIPAL DEBT ESSENTIALS

SEPTEMBER 24-26, 2024 | POMONA, CALIFORNIA

# SESSION ONE

## Overview of Issuer Responsibilities Post-Issuance



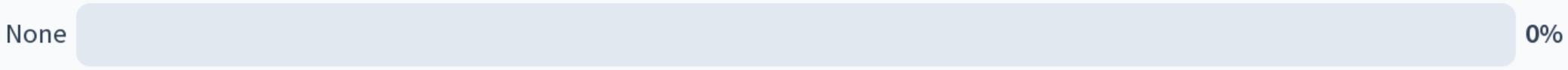
**JYOTHI PANTULU**  
*Assistant Director,*  
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*City of San Diego*

**MATTHEW WINGERT**  
*Budget Manager*  
*Los Angeles County*  
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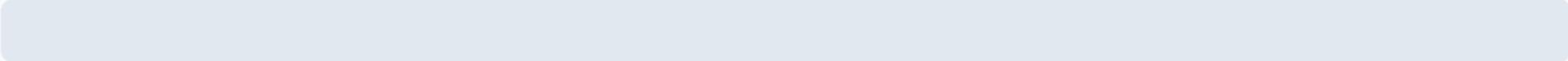
# Please tell us how many debt transactions you have been involved with in the last five years

👍 0



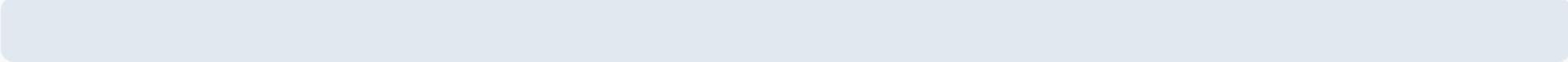
# Please tell us how long you have worked in public finance

Less than 1 year



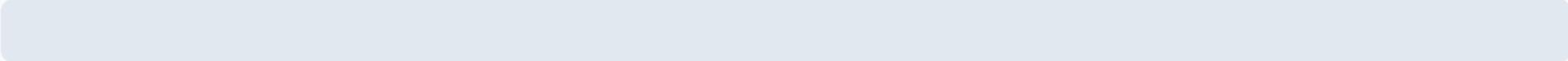
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1-2 years



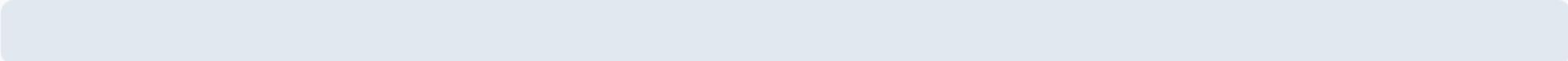
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3-4 years



0%

5+ years



0%

# Please select the most prominent type of credit your agency issues or is looking to issue

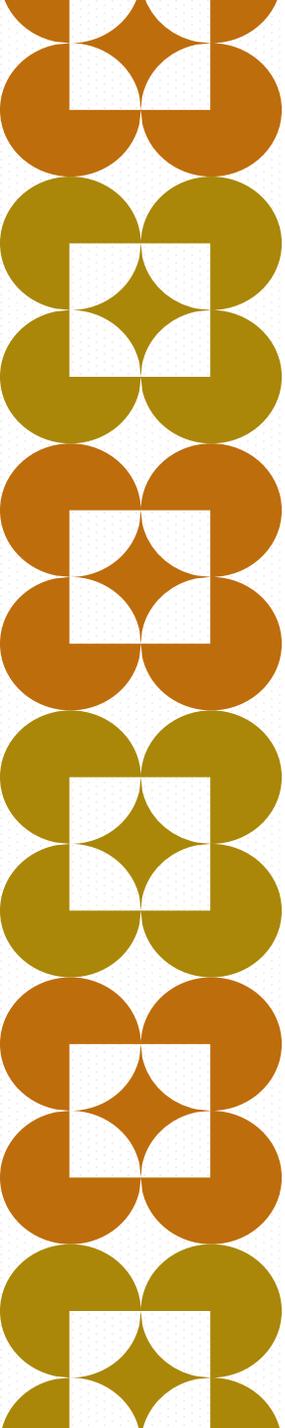


Revenue 0%

General Obligation 0%

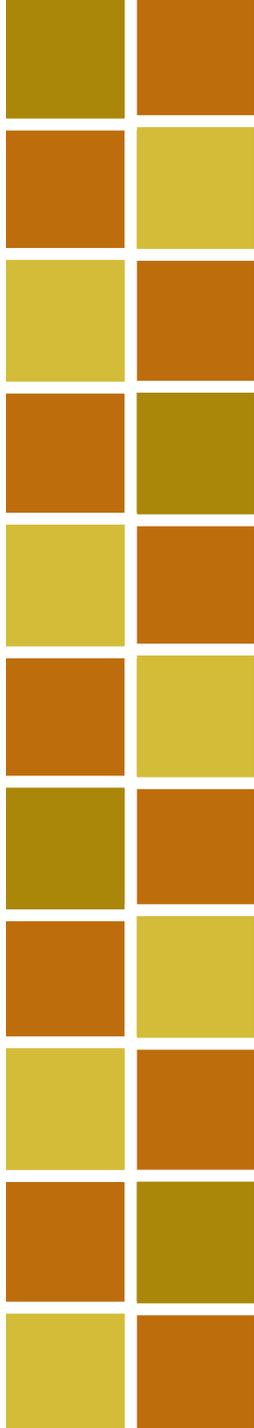
Special Districts/Tax Increment 0%

All of the above 0%



# Now That You've Priced the Bonds....

- Typically, 14-30 days between pricing and closing
- During this time:
  - Lawyers are finalizing all legal documents, including the Official Statement (offering document) to reflect the pricing of the transaction
    - Changes/adjustments cannot be material to the deal
    - If material, must sticker the O/S
  - Team reviews all closing documents
  - Arrange for all documents to be signed, typically the day before actual closing
  - Morning call to confirm receipt of funds and release of bonds to DTC
  - You should be preparing for what's next



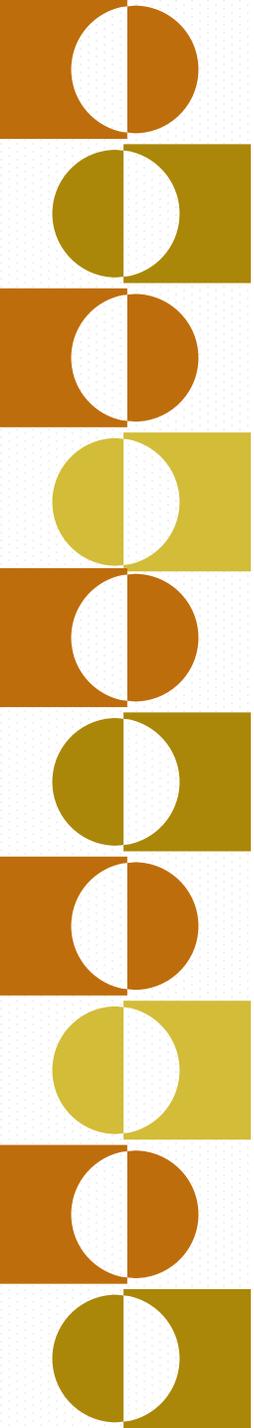
# What Is Next...

- A. YOU'RE TOTALLY DONE AND CAN GO BACK TO YOUR REGULAR JOB?
- B. TAKE THE REST OF THE DAY OFF?
- C. GO FISHING/PLAY PICKLE BALL?
- D. NOW THE REAL WORK BEGINS?

# Reality Sets In

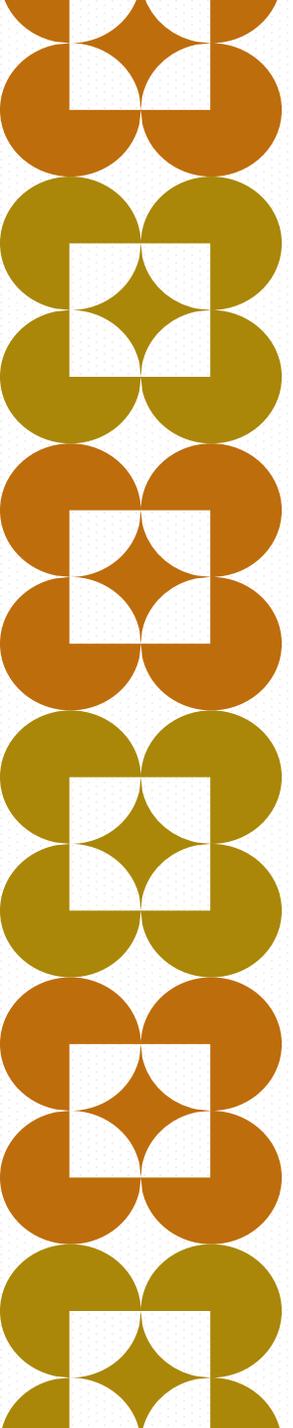
- YOU'RE BASICALLY ON YOUR OWN
  - Underwriters have moved on to their next transaction
  - Bond/Disclosure Counsel have also moved on
  - Financial Advisor has basically moved on

**So, who does that leave?**



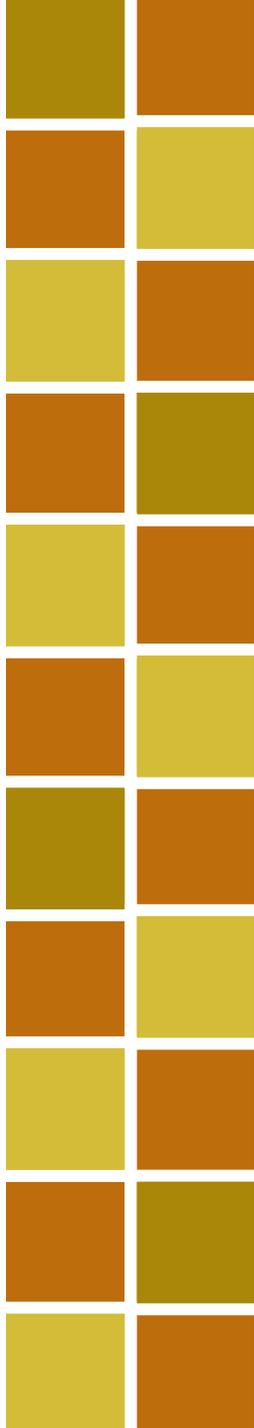
# What Do You Need To Be Thinking About?

- Paying bills
- Setting up accounts
- Recording the transaction in your general ledger
- Monitoring
  - Cashflow
  - Proper use of funds
  - Timing on the use of funds
- Reporting
  - EMMA
  - CDIAC
  - Governing Board



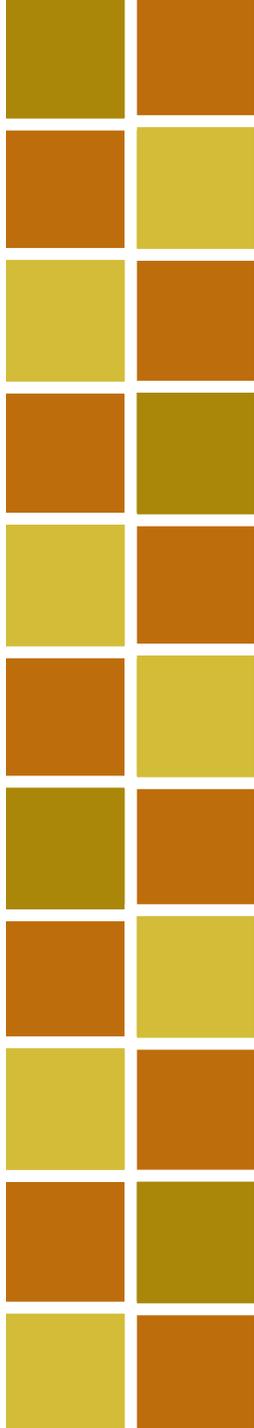
# What To Do With All This Money?

- Proceeds are received by the Issuer or Trustee
  - Trustee allocates funds between various accounts
    - Cost of Issuance
    - Construction
    - Bond Reserve
- Pay cost of issuance as invoices are received
- Determine how to invest proceeds
  - Reserve Funds
  - Construction Funds
- Let appropriate departments know that funds are available



# Understand Your Responsibilities

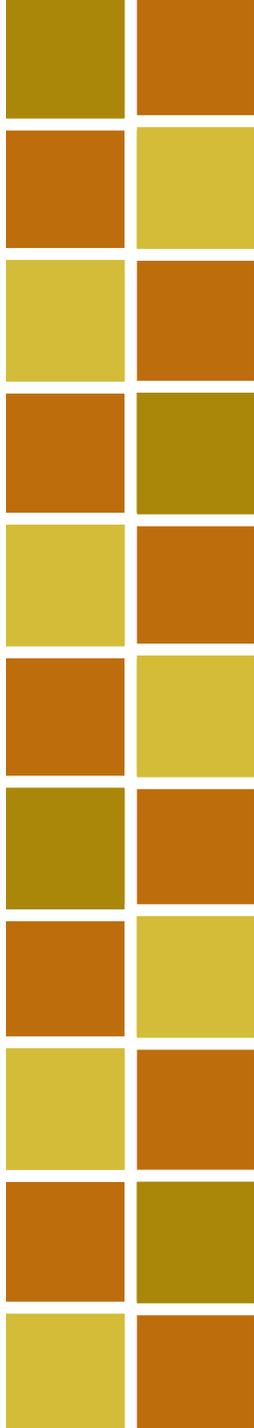
- To the Regulators
  - IRS and SEC
  - MSRB
    - Regulates Underwriters and Municipal Advisors
    - What do I do with the disclosure letters?
      - MSRB Rules G-17, G-42
- CDIAAC Reporting
  - Report of Proposed Issuance
  - Report of Final Sale
  - New Annual Debt Transparency Report
- Under the indenture, tax certificate and continuing disclosure agreement



# Understand Your Responsibilities

- (cont. 2 of 3)

- Proper use of the bond funds
  - Capital purposes
  - Projects listed
  - Like projects allowed
  - Proceeds expended in a timely manner within the tax certificate
- Properly Invested
  - Permitted investments within bond documents
  - Permitted investments within your investment policy
- Arbitrage Rebate reports prepared during the required timeframes
- Timely debt service payments
  - Include debt service in the budget
  - Monitor your cash flows to ensure adequate funds are on hand for payment



# Understand Your Responsibilities

- (cont. 3 of 3)

- Setting your proper rates
- Coordinating of project payments or bond draws with the Trustee
  - Use of the proper form
  - Attach appropriate documentation
  - Time your bond draws with cash needs
- Record Keeping
  - Accurate accounting
    - Make sure that the closing transaction is properly set up
  - Financial Statements
    - Notes to the financial statements related to debt service
  - Tracking bond payments
    - Keep track of your payments per each bond issue with details for the individual bond draws and cumulative totals. These totals should reconcile with your Trustee statements.

# GET YOURSELF ORGANIZED

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- Review your Debt Policy
- Establish a tickler system with dates & responsibilities:
- Debt service payments
- Continuing disclosure filings
  - Arbitrage rebate obligations
  - Spending timelines
  - Yield restrictions
  - Use of proceeds

# GET YOURSELF ORGANIZED

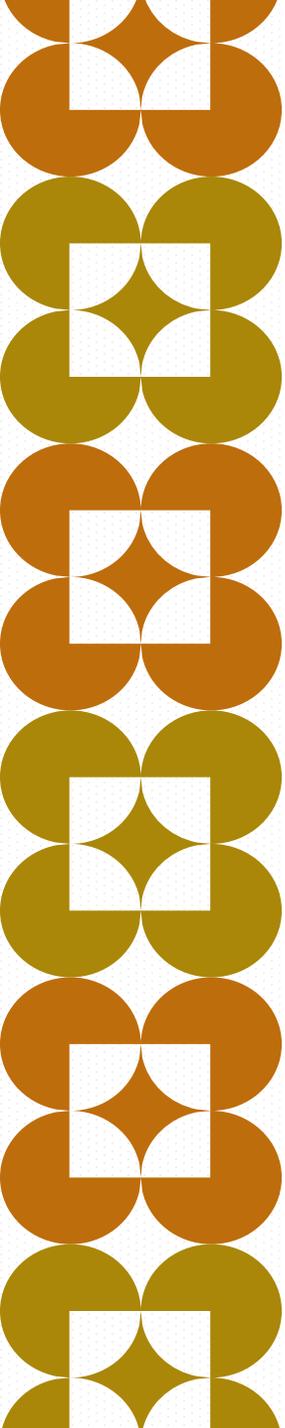
– (cont. 2 of 3)

- Know what's in your Continuing Disclosure Agreements (CDA)
- Annual filings and event filings
- Identify responsible officials
- Awareness of events that trigger a filing
  - Events that always require notification
  - Events that require notification, if material
- Events added for CDAs entered into on or after February 27, 2019
  - Financial Obligations – incurrence
  - Financial Obligations – event reflecting financial difficulty

# GET YOURSELF ORGANIZED

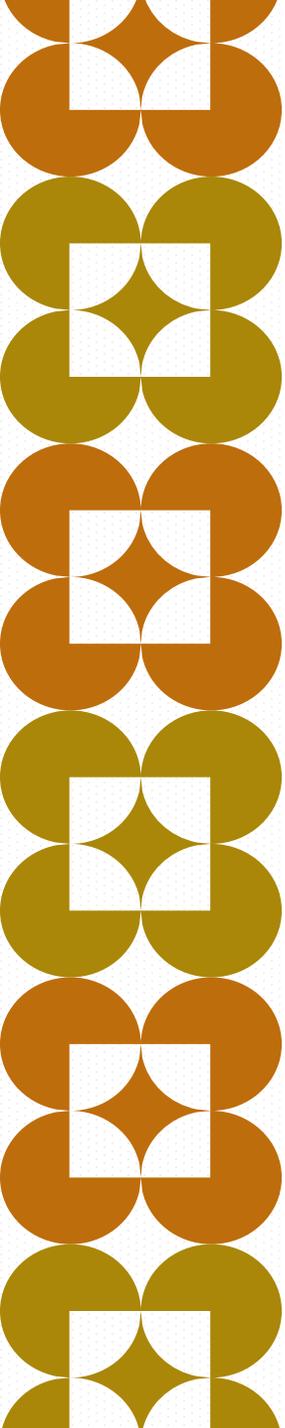
– (cont. 3 of 3)

- Searchable database of trigger events
  - Rating changes
  - New debt or SWAP
  - Document amendments
  - Bankruptcy
  - Legislation
  - Major judgment
  - Late payment/nonpayment
  - Late filing
- Backup planning



# Post-Issuance Best Practices

- Understand federal and state muni tax and securities requirements
- Develop disclosure policies and procedures to ensure compliance and peace of mind
  - Formal, written, adopted
  - Review update at least every three years
  - Use assistance of outside professionals if desired (municipal advisor, counsel)
- Elements
  - List of all compliance actions at time bonds are sold – by series
  - Documentation of sources and frequency of requirements
  - Identify and assign responsibilities by title



# Post-Issuance Best Practices

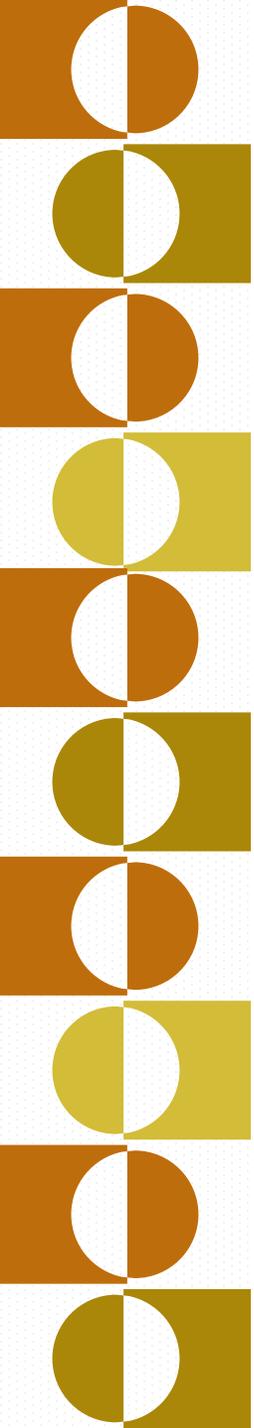
- (cont. 2 of 2)

- Elements

- Create policies and procedures that reflect who you are
- Determine if outside vendor may be of assistance
- Monitor changes in laws and regulations
- Identify records to be maintained, for how long and how to maintain
- Train responsible employees
- Determine how to identify and correct mistakes
- Other considerations
  - Bond Indentures/Bond Ordinance/Bond Resolution
  - Other internal finance policies and how they relate to debt management and post issuance compliance

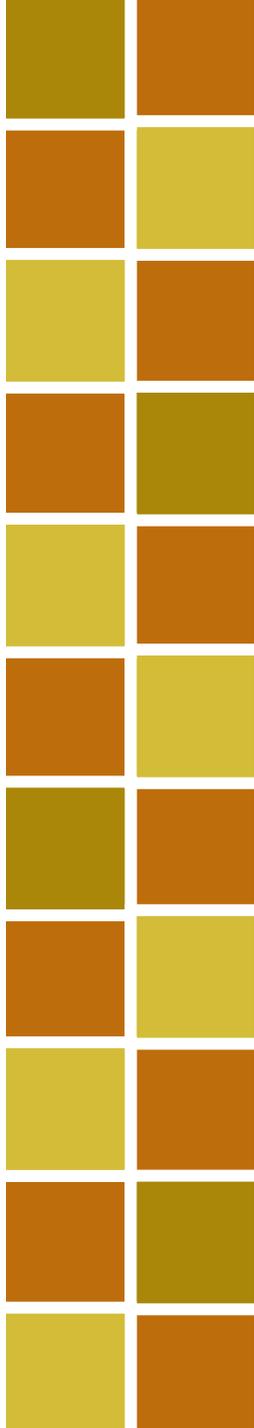
# Post-Issuance Tax Compliance

- Remember all those documents you signed at closing?
  - You now have a legal (and moral) obligation to comply
- Record retention
- Arbitrage and yield restriction
- Correct expenditure of proceeds
- Tracking use of proceeds
- Understanding and monitoring private use
- Remedies when things go sideways (call counsel, IRS VCAP program)



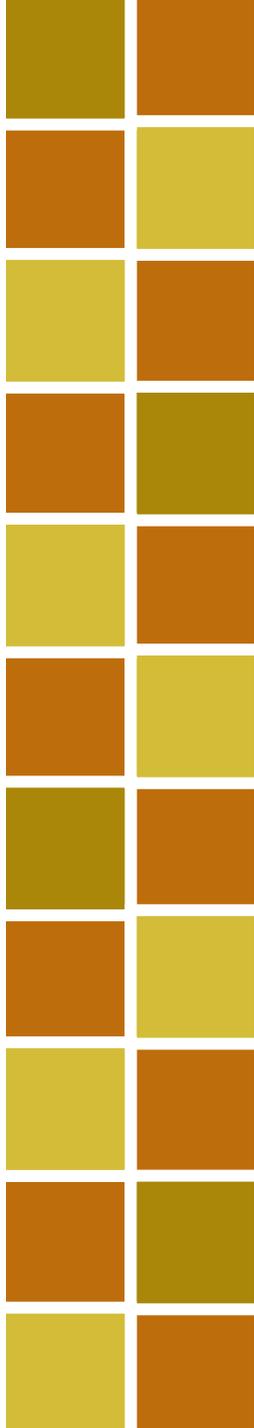
# Record Retention

- General rule: life of the bonds plus three years
  - If new money bonds are refunded, extends to life of refunding bonds plus three years
- What do you keep?
  - Basic records relating to the bond transaction
  - Documents evidencing the expenditure of bond proceeds
  - Documents evidencing the use of bond-financed property by public and private sources
  - Documents evidencing all sources of payment and security of the bonds
  - Documents pertaining to the investment of bond proceeds
- How do you keep it?
  - IRS Electronic storage guidelines



# Your Relationship With Your Trustee

- While most of your team moves on to their next deal, you and the Trustee are actively involved for the life of the bonds
- Select your Trustee based upon **experience, professionalism and resources**, not just price
- Trustee performs administrative functions on your behalf which directly reflects on you and your agency and the bond holders
- Selection of the Trustee should begin prior to the closing and as early in the document review process as possible



# Your Relationship With Your Trustee

– (cont. 2 of 2)

## WHAT SKILLS SHOULD THEY POSSESS?

- Legal knowledge and document review skills
- Understanding of investments and settlement process
- Accounting skills
- System knowledge
- Communication skills
- Organization skills
- In general, they should possess a wealth of information related to your bond issue
- Get them to share this knowledge with you

# It's Now Time For Arbitrage Calculation

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- Arbitrage is the ability to earn profit by capitalizing on differences between investments or markets
- In the case of public finance, Arbitrage refers to ability to profit from investment of tax-exempt bond proceeds in taxable securities
- The ability to earn arbitrage depends on the relationship between taxable and tax-exempt rates and the shape of the yield curve
- Positive arbitrage represents earnings above the arbitrage yield. Negative arbitrage represents earnings below the arbitrage yield (i.e., “losses”)

# Arbitrage Rebate Compliance Activities

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- Internal monitoring of rebate compliance
- Recommend annual calculations during construction period
  - Set aside annual rebate liability in Rebate Fund
  - Get it out of the Construction Fund
- Paying rebate is not bad, just need to monitor and pay as required
- Pay attention to requirements in Tax/Arbitrage Certificate

# When is Rebate Calculated?

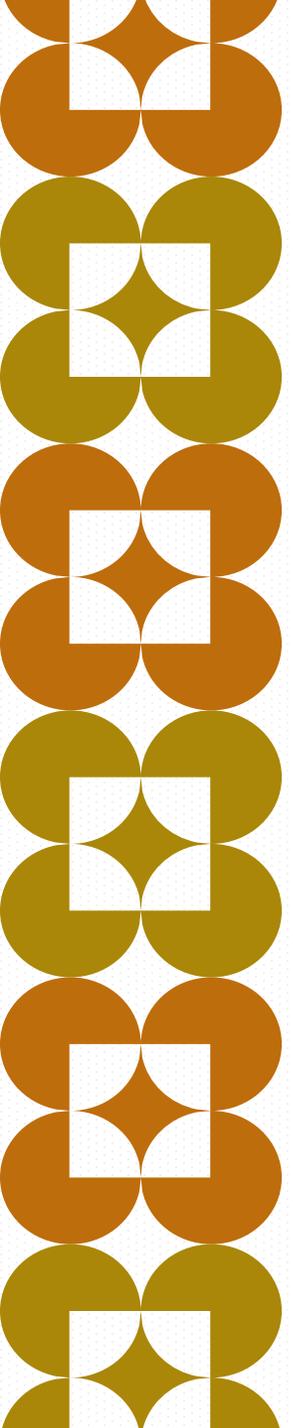
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## **REQUIRED:**

- Every five years, and on Final Maturity
- Refunding Triggers New Final Maturity
- 8038-T: Only file if rebate is owed
- When required by bond indenture

## **RECOMMENDED:**

- Annually during construction period



# Accounting & Expenditure of Proceeds

- Reasonable expectations vs. actual facts – are you spending funds on correct items?
- General Accounting
- Best Practice: Open communication with those responsible for spending the money
- Reallocation of bond proceeds
- Tracking proceeds

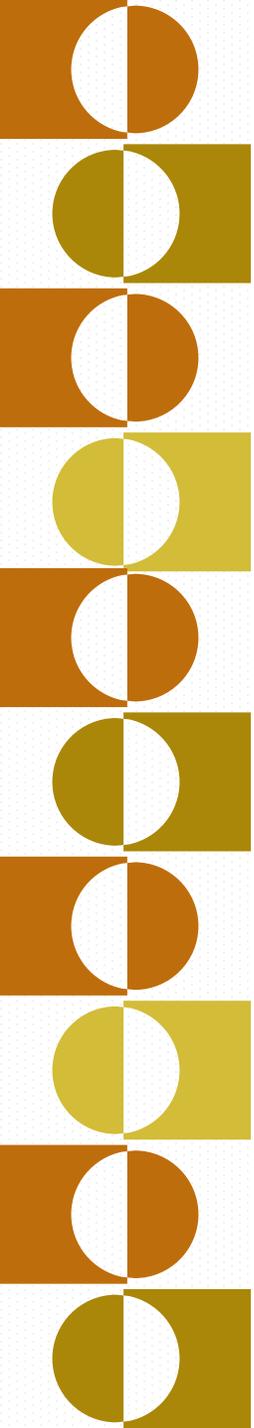
# Private Use/Payment Tests

**PRIVATE BUSINESS USE TEST:** No more than 10% of the proceeds of the bonds can be used for Private Business Use

**PRIVATE PAYMENT TEST:** No more than 10% of the payment of principal or interest on the bonds is made or secured by payments for Private Business Use

- BOTH tests must be “met” in order to have Private Activity Bonds
- Live and learn: the federal government is treated as a PRIVATE party

**Be sure to talk with bond counsel about existing and changing federal tax laws**



# Other Compliance Issues

- Bond Indenture Requirements/Covenants
  - Coverage Ratios
  - Progress Reports/Financial Reports
  - Additional Bonds Tests
- Debt Policy Requirements

# QUESTIONS?



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# SESSION TWO

## Continuing Disclosure



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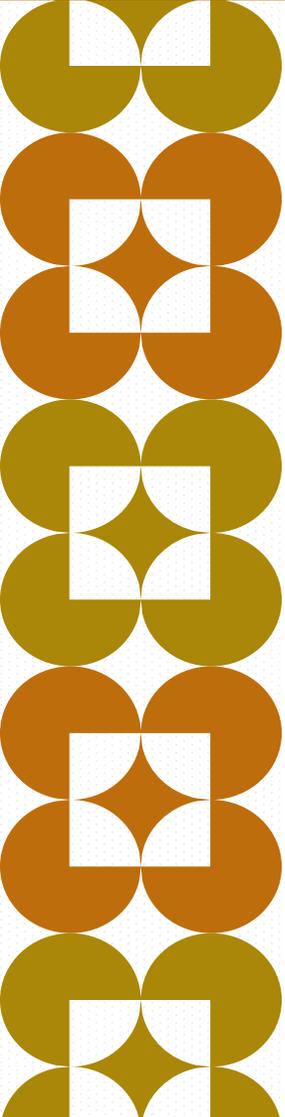


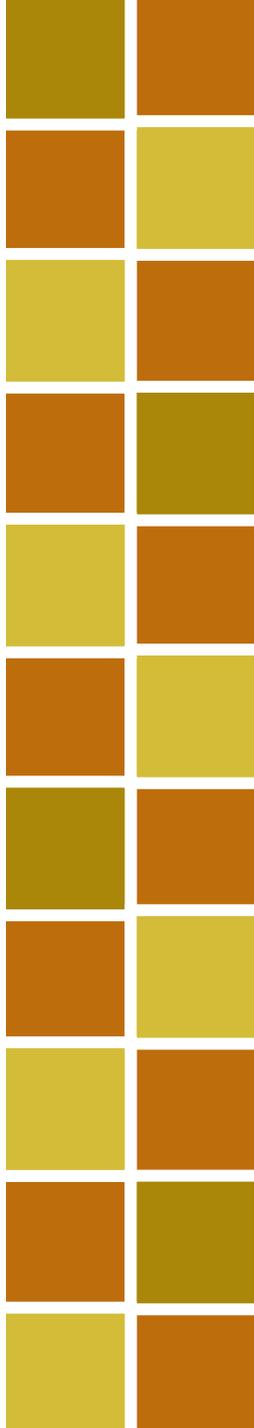
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# WHY IS DISCLOSURE NECESSARY?

- 
- Investors in municipal securities have rights under federal securities laws
  - All “material” information must be disclosed
    - What is material?
  - Policy: Parties buying and selling municipal securities should have access to information necessary to make an informed investment decision



# THE “MATERIALITY” STANDARD

## SEC Rule 405

“The term material, when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to [invest].”

- Guidance comes primarily from court decisions and SEC enforcement cases.
- Materiality is determined in context of all the facts and circumstances, but usually on a retroactive basis
- What is material is an evolving concept - materiality threshold

# FEDERAL SECURITIES LAWS

- **SECURITIES ACT OF 1933** — registration requirement for most securities, but does not include municipal bonds
- **SECURITIES EXCHANGE ACT OF 1934** — creates ongoing disclosure requirements for public companies and regulates brokers and dealers
- Both the 1933 Act and the 1934 Act contain antifraud provisions, which do apply to municipal securities



# WHEN DO DISCLOSURE RULES APPLY?

- Rule 10b-5 applies whenever an issuer is “speaking to the market”
  - New offerings
  - **Reporting under Continuing Disclosure Undertakings (“CDUs”)**
  - **Voluntary filings on EMMA website**
  - Other circumstances
    - Public statements by officials—“speaking to the market” will depend on who is making the statement and the audience (“Political speech” has in the past been viewed as OK, but certain SEC actions suggest using greater caution)
    - Investor websites

# CONTINUING DISCLOSURE AND RULE 15c2-12

## Originally enacted in 1989

- ... to prevent dealers from underwriting an issue of municipal bonds unless the underwriter has been able to “obtain and review a preliminary official statement that the issuer of such securities or an obligated person deems final as of its date.”

## Amended in 1994

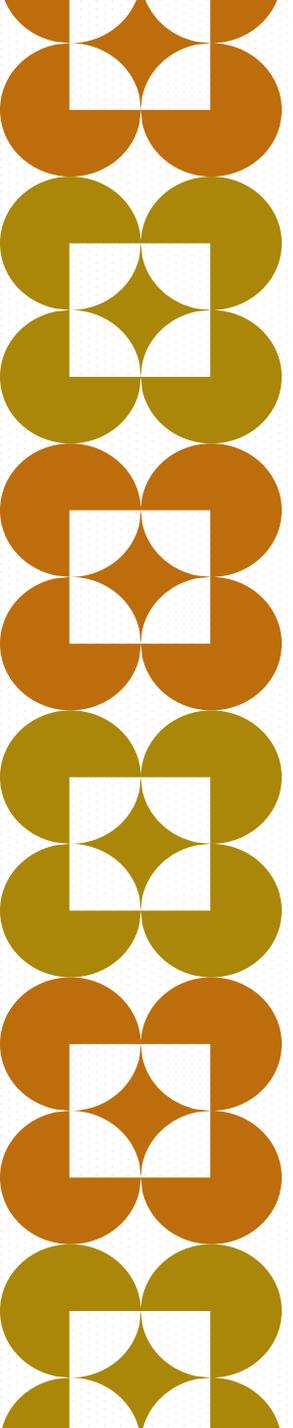
- ...to add continuing disclosure requirements. Underwriters must reasonably determine that the issuer or an obligor has entered into a binding commitment to provide continuing disclosure.
- This includes Annual Reports, Listed Events, and notices of failure to file Annual Reports on time.

## Amended in 2010

- ...to add additional Listed Events, more specific timing requirements for reporting Listed Events, and reporting requirements for new variable rate debt.

## Amended in 2018

- ...to add additional two (2) Listed Events; must be included in new CDUs but do not apply retroactively to CDUs in existence prior to *February 27, 2019* (the “Compliance Date”).
- According to *SEC News Release*, the adopted amendments “focus on material financial obligations that could impact an issuer’s liquidity, overall creditworthiness, or an existing security holder’s rights.”
- Better inform investors and market participants about the financial condition of issuers of municipal securities and obligated persons.
- Provides more timely information about “financial obligations” that previously were not reported on EMMA, particularly private placements and bank loans.



# TIMING OF ANNUAL REPORTS AND LISTED EVENTS

## ANNUAL REPORTS

- Audited financial statements
- Financial information and operating data as specified in the continuing disclosure agreement; essentially updates key financial and operating data contained in the original offering document that is available from the issuer or the obligor's records
- Filing required annually by a fixed date specified in the continuing disclosure agreement up to one (1) year after the end of the fiscal year

## LISTED EVENTS

- Listed events notices must be filed “not in excess of 10 business days after the occurrence of the event”
- Note that some of the events have a materiality qualifier, others do not (they are deemed automatically material)
- In addition, the issuer or obligor must file a notice of failure to provide an annual report on or before the time required by the CDU

## LISTED EVENTS THAT REQUIRE NOTIFICATION WITHIN TEN (10) BUSINESS DAYS (EMPHASIS ADDED):

1. Principal and interest payment delinquencies;
2. Nonpayment-related defaults, ***if material***;
3. Unscheduled draws on debt service reserves reflecting financial difficulties;
4. Unscheduled draws on credit enhancements reflecting financial difficulties;
5. Substitution of credit or liquidity providers, or their failure to perform;
6. Adverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB), or other ***material*** notices or determinations with respect to the tax status of the security or other ***material*** events affecting the tax status of the security;
7. Modification to rights of security holders, ***if material***;
8. Bond calls, ***if material***, and tender offers;
9. Defeasances;
10. Release, substitution, or sale of property securing payments of the security, ***if material***;

## LISTED EVENTS THAT REQUIRE NOTIFICATION WITHIN TEN (10) BUSINESS DAYS (EMPHASIS ADDED):

11. Rating changes;
12. Bankruptcy, insolvency, receivership, or similar event of an obligated person;
13. The consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, **if material**;
14. Appointment of a successor trustee or additional trustee or the change of name of a trustee, **if material**;
15. Incurrence of a financial obligation of the obligated person, **if material**, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, **if material**;
16. Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, any of which **reflect financial difficulties**.

# INCURRENCE OF A FINANCIAL OBLIGATION: LISTED EVENT (15)

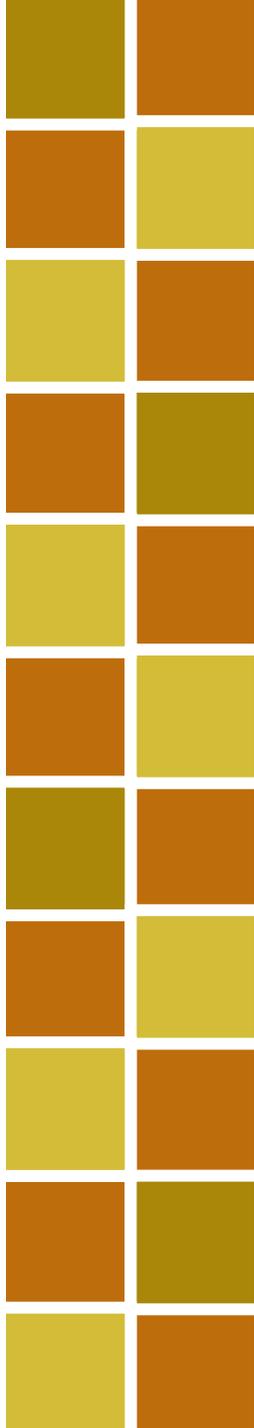
## *Key Takeaways:*

- Disclosure will provide investors with important information about current financial conditions and potential liabilities, including potential impacts on the liquidity and overall creditworthiness of the issuer or obligated person or which may otherwise affect security holders of the debt to which the CDU relates
- A financial obligation generally should be considered to be incurred when it is enforceable against an issuer or obligated person
- Applies to CDUs entered on or after the Compliance Date; and new, material financial obligations incurred on and after the date the CDU was entered.
- The second part of event (15) can be retroactive, and requires reporting of material changes to any financial obligation whether incurred before or after the date of a new CDU
- Does not include municipal securities as to which a final official statement has been provided to the Municipal Securities Rulemaking Board (“MSRB”) consistent with Rule (e.g., posted on EMMA and having an effective CDU) this exception is designed to avoid duplication of regulations

# INCURRENCE OF A FINANCIAL OBLIGATION: LISTED EVENT (15) - (cont. 2 of 2)

## *Key Takeaways:*

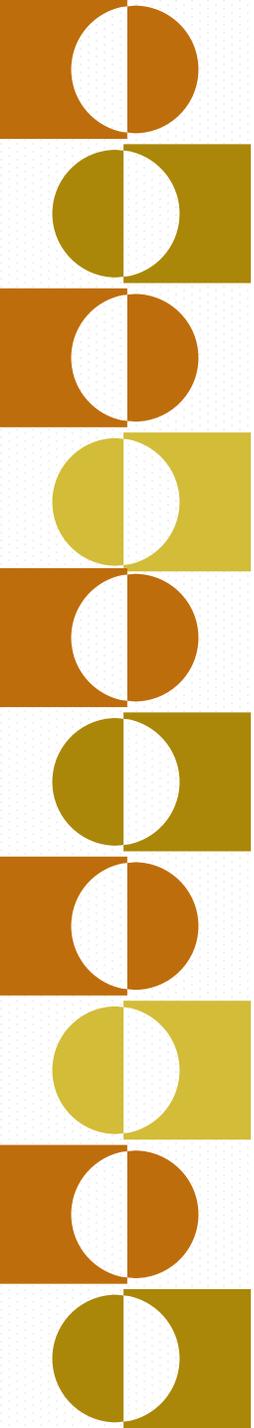
- A “financial obligation” is defined as a: (i) debt obligation, (ii) derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation, or (iii) a guarantee of either (i) or (ii)
- A debt obligation is any short-term or long-term debt obligation under the terms of an indenture, loan agreement, lease, or similar contract that represents a borrowing of money to be repaid at a later date; the term is broader than the state law definition of debt and focuses on impacts to liquidity or creditworthiness of the issuer
- Not every incurrence of a financial obligation or agreement to terms is material; materiality determinations under (15) should be based on whether the information would be important to the total mix of information made available to the reasonable investor consider potential impacts on the issuer’s liquidity or creditworthiness or the rights of security holders to which the CDU relates
- Lines of credit, draw-down bonds, or commercial paper only needs to be reported once, when the debt is legally enforceable (whether or not any funds are immediately drawn or borrowed) and not on each draw or CP issuance, as long as the initial reporting contains all the material terms of the borrowing program



# ... REFLECT FINANCIAL DIFFICULTIES: LISTED EVENT (16)

## *Key Takeaways:*

- An event that occurs under the terms of a financial obligation pursuant to (16) that occurs on or after the Compliance Date must be disclosed regardless of whether such financial obligation was incurred before or after the Compliance Date
- **“Reflect Financial Difficulties”** concept used since adoption of the Rule; existing disclosure events, including unscheduled draws on debt service reserves (3) and unscheduled draws on credit enhancements (4)
- Consider whether the event may have potential adverse impact on the liquidity and overall creditworthiness of the issuer/obligated person or affect security holders
- **“Default”** can be monetary default (failure to pay principal/interest or other funds due) or failure to comply with specific covenants; does not have to be an “event of default” as defined in bond documents
- **“Other Similar Events”** broad concept to capture circumstances that reflect financial difficulties even if they do not qualify under any of the prior types of events

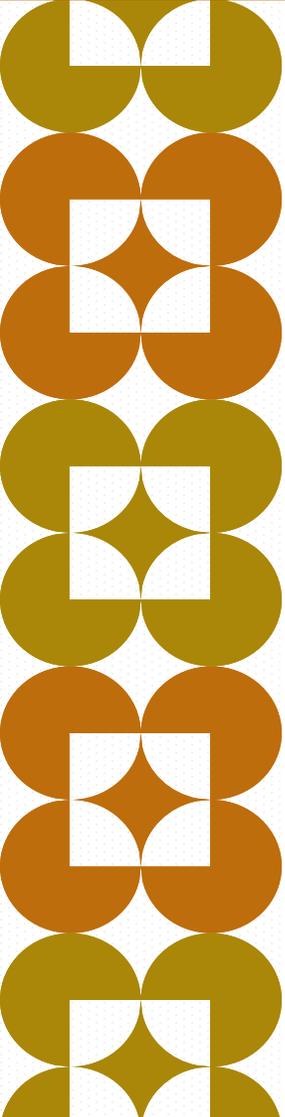


# UNDERWRITER CONSIDERATIONS

Understand the approach of underwriters to verifying that issuers have complied with the new rules once deals are offered after February 27, 2019:

- Rule 15c2-12 requires underwriters to independently investigate an issuer's compliance with its CDU reporting over the past five (5) years
- For an issuer's first deal after the Compliance Date, underwriters may want to see new policies and procedures to confirm appropriate internal controls will be in place
- For subsequent deals, they will need to determine if event (15) or (16) have occurred and were reported within the requisite ten (10) business days

# CONSEQUENCES OF FAILURE TO COMPLY

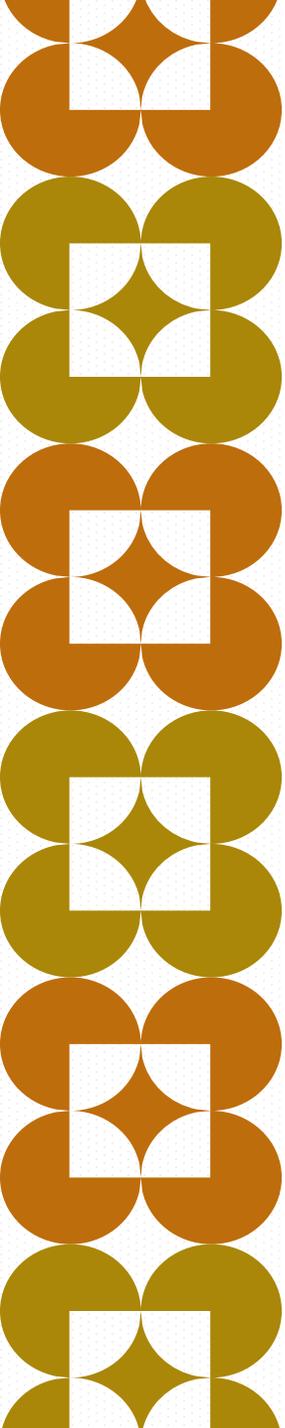
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- Non-compliance is not an event of default under bond documents or continuing disclosure agreements, but bondholders have the right to sue for compliance with continuing disclosure obligations
  - Must disclose a material failure to comply in future official statements for five (5) years following the failure
  - Can give rise to a securities law fraud case if there is a misstatement about past compliance in a later offering document
  - No clear guidance on what is a “material” failure to comply, especially as to late filings (Underwriters now insist on listing any non-compliance, even if seemingly trivial)

Since the mid-2000's, the SEC has ramped up enforcement focused on the municipal market.

- Inadequate pension disclosures
- Misleading or incomplete financial disclosures
- Failure to disclose the use of unusual accounting actions
- Failure to disclose shortcomings in economic development projects
- Failure to disclose financial or legal risks
- Failures of continuing disclosure

# RESULTS OF SEC ENFORCEMENT ACTIONS

- Governmental agencies were levied civil fines, up to hundreds of thousands of dollars
- Required to retain outside consultants and/or legal counsel to review disclosure practices
- Individuals working for agencies were fined and, in some cases, barred from participating in municipal securities offerings
- In one instance, an individual sentenced to jail for 2 1/2 years
- Cost of defending cases brought by the SEC can be significant
- Bad publicity, political damage, and possible rating reductions
- SEC doesn't need to prove that allegations resulted in any bond default, loss of value, or harm to investors



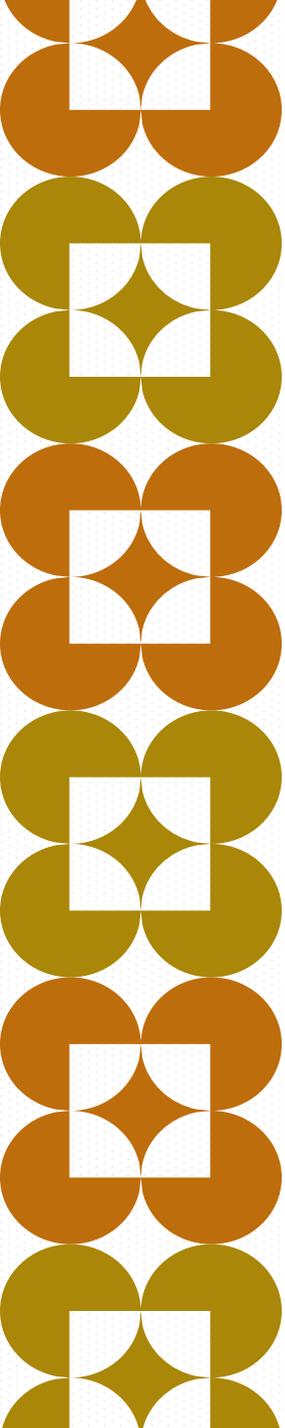
# ENFORCEMENT ACTIONS RELATING TO CONTINUING DISCLOSURES

## Pre-Municipalities Continuing Disclosure Cooperation Initiative (“MCDC”) Case #1

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### CITY OF HARRISBURG (2013)

- May of 2013, the SEC charged the City of Harrisburg, Pa. (“City”) with securities fraud for its misleading public statements when its financial condition was deteriorating and financial information available to municipal bond investors was either incomplete or outdated
- SEC investigation found that the City made misleading statements in the City’s budget report, annual and mid-year financial statements and a State of the City address and also failed to comply with continuing disclosure requirements to provide certain ongoing financial information and audited financial statements for the benefit of investors from 2009 to 2011
- The City was nearly bankrupt, under state receivership, and as of March 2013, had missed approximately \$13.9 million in general obligation debt service payments, and was the obligated person for approximately \$455 million of outstanding debt for several of its component units
- Significant because this was the first time the SEC charged a municipality for misleading statements made outside of its securities disclosure documents
- The City settled with the SEC and was ordered to cease and desist from committing or causing violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.



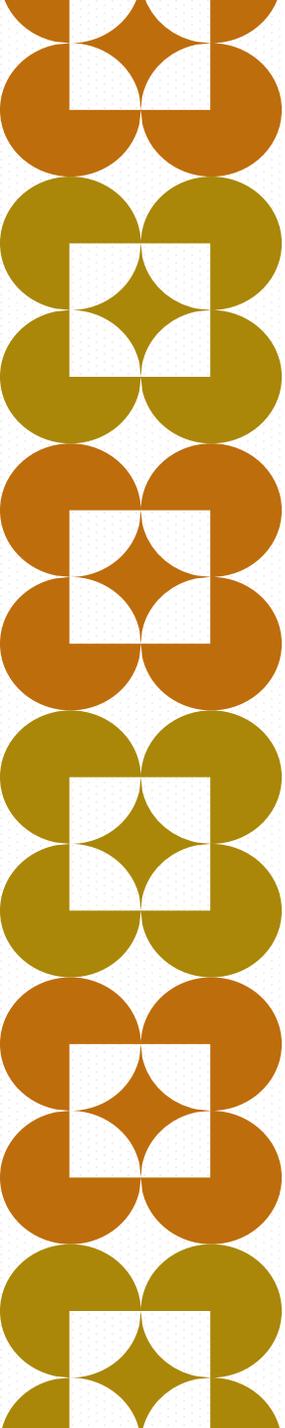
# ENFORCEMENT ACTIONS RELATING TO CONTINUING DISCLOSURES

## Pre-MCDC Initiative Case #2

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### WEST CLARK COMMUNITY SCHOOLS, INDIANA AND CITY SECURITIES CORPORATION (2013)

- In the summer of 2013, the SEC settled an antifraud case against a small school district in Indiana which stated in its Official Statement (2007) that it had not failed to comply in all material respects with any prior continuing disclosure undertakings but had, in fact, failed to file any annual reports—SEC alleged this misstatement in the Official Statement was a violation of Section 17(a)(2) of 1933 Act
- The underwriter paid a \$580,000 settlement (\$280k disgorgement and \$300k penalty) for failing to investigate the issuer's statements, and the individual at the underwriter paid approximately \$38,475 (\$20k disgorgement and \$18k penalty) with a one-year collateral bar and a permanent supervisory bar
- Significant because this was the first time the SEC charged (i) a municipal issuer with falsely claiming in an Official Statement that it was fully compliant with annual disclosure obligations and (ii) an underwriter and its principal for not doing the necessary research to attest to the truthfulness of the issuer's claims



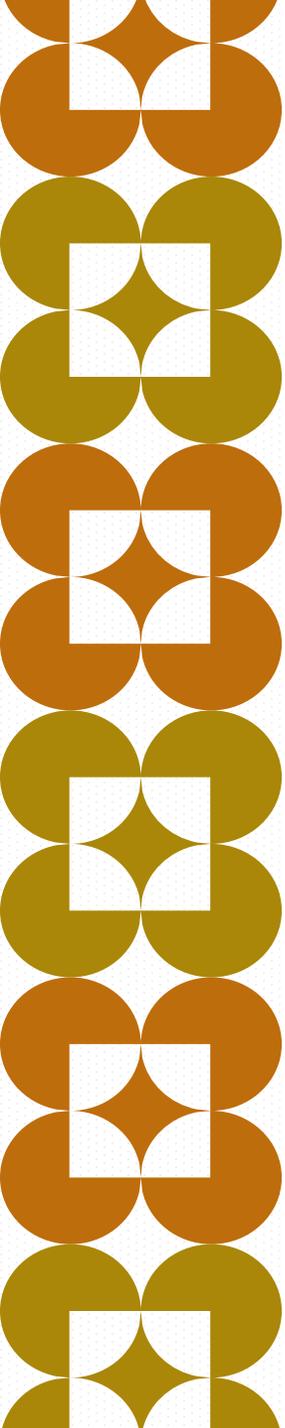
# ENFORCEMENT ACTIONS RELATING TO CONTINUING DISCLOSURES

## Post-MCDC Initiative Case #1

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### CITY OF BEAUMONT, CA (2017)

- Beaumont Financing Authority (“BFA”) issued approximately \$260 million in municipal bonds in 24 separate offerings from 2003 to 2013, each underwritten by O’Connor & Company Securities, Inc. (“O’Connor”).
- From 2004 to 2013, BFA regularly failed to provide investors with the promised information (in a complete and timely manner) and failed to disclose this fact when it issued bonds in 2012 and 2013 totaling more than \$32 million.
- BFA and O’Connor did not voluntarily report to the SEC under MCDC. O’Connor was found to have failed to conduct reasonable due diligence on CDU compliance.
- The BFA and O’Connor would have been eligible for more lenient remedies had they self-reported during the MCDC Initiative. The SEC went beyond the MCDC settlements by including individual issuer officers and requiring that BFA engage an independent consultant.



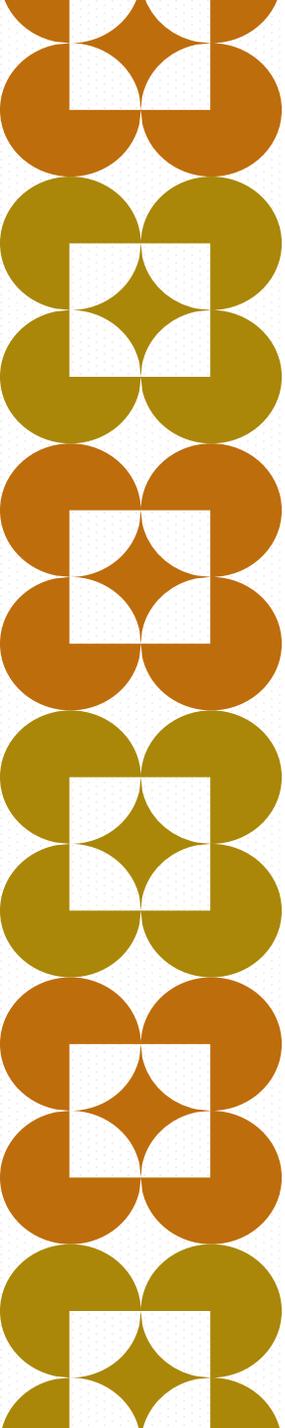
# ENFORCEMENT ACTIONS RELATING TO CONTINUING DISCLOSURES

Post-MCDC Initiative Case #1, cont.

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## CITY OF BEAUMONT, CA (2017)

- Significant because (i) BFA was required to hire an independent consultant on securities procedures and (ii) an individual official (city manager) was fined \$37,500 and agreed to be permanently barred from participating in any future municipal bond offerings.
- O'Connor was fined \$150,000 and was ordered to retain a consultant to review its policies and procedures. Its investment banker was ordered to pay a \$15,000 penalty and serve a six month suspension from the securities industry.



# ENFORCEMENT ACTIONS RELATING TO CONTINUING DISCLOSURES

## Post-MCDC Initiative Case #2

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### LAWSON FINANCIAL CORP (2017)

- Lawson Financial Corporation (“Lawson Financial”) was the underwriter for multiple issues for entities controlled by Richard Brogdon (“Brogdon”), the proceeds of which were to be used for projects for nursing homes, assisted living facilities, and retirement housing.
- The offering documents represented that the borrowers had not failed to comply with any prior CDUs, when, in fact, they had consistently failed to provide the required information.
- The SEC found that Lawson Financial conducted inadequate due diligence, did not review EMMA, and solely relied on Brogdon’s representations. Lawson Financial and Robert Lawson paid disgorgement of approximately \$198,000, Lawson Financial paid a penalty of approximately \$198,000, and Robert Lawson paid a penalty of \$80,000 and was barred from the securities industry for three years. Penalties were approximately double what the firm would have paid under the MCDC Initiative.
- Lawson Financial’s counsel was also charged and paid nearly \$45,000 and agreed to the entry of an order permanently suspending him from appearing and practicing before the SEC as an attorney.
- The SEC separately charged Brogdon with fraud and is seeking an order for Brogdon to repay \$85 million to investors.

# CASE FOR ESTABLISHING POLICIES AND PROCEDURES

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- Shows the organization cares about compliance and is actively managing its compliance
- Might be a mitigating factor when SEC calls
- May lessen the risk of personal liability for staff
- Greater attention to disclosure made for continuing disclosure compliance and for new offerings

# ESTABLISHING POLICIES AND PROCEDURES

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- Establish internal written procedures to comply with CDUs
- Identify key personnel and their responsibilities for CDU compliance
- Review annual reports and event notices
- Review historical compliance with CDU undertakings
- Assign a coordinator
- Monitor compliance
- Information gathering/Internal ticker system/create a template or chart for annual reports and event filings
- Training

# AVOIDING PITFALLS

- ✓ Double check all CUSIPs to ensure all outstanding Bonds are covered
- ✓ Remember that there are also CDIAC Annual Debt Transparency Reports (ADTR) due
- ✓ For special financings, like CFDs or redevelopment refinancings, you may need input from other entities (e.g., merchant builders for CFDs)
  - ✓ Confirm that you have Continuing Disclosure requirements for those other entities

# QUESTIONS?



**MARC BAUER**  
*Partner*  
Orrick, Herrington  
& Sutcliffe LLP



**DAVID SONG**  
*Associate, Project Finance  
and Public Finance*  
Nixon Peabody LLP



**DANIEL WILES**  
*Assistant Treasurer  
and Tax Collector – Finance  
and Investments*  
County of Los Angeles

# SESSION THREE

## Investing Bond Proceeds, Arbitrage, and IRS Tax Compliance



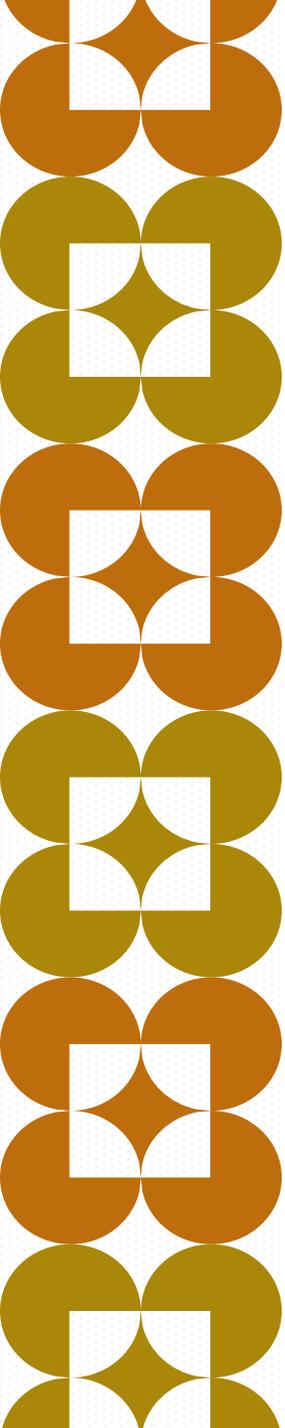
**GLENN CASTERLINE**  
*Managing Director*  
BLX Group LLC



**MONIQUE SPYKE**  
*Managing Director*  
PFM Asset Management LLC



**JOHN STANLEY**  
*Partner*  
Orrick Herrington  
& Sutcliffe LLP



# The Bonds Have Been Issued ... Now What?

## Congratulations!

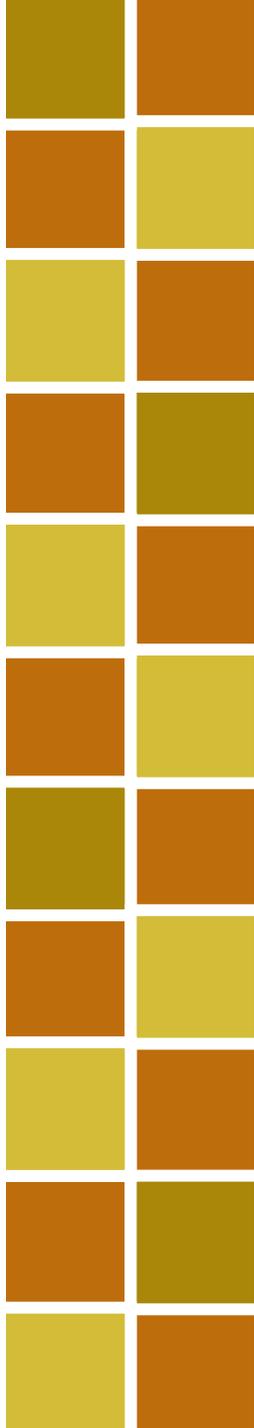
- Months of careful planning is over
- At last, the Bonds have been issued
- You've locked in a low cost of funds
- Now it's time to get back to your regular duties

## Do Not Forget About the Bond Proceeds

- Probably on your "To Do List"
- Typically, are forgotten
- Are unique assets considering the arbitrage rebate and yield restriction requirements

## Do Not Forget About the Arbitrage Rebate Requirements

- Positive arbitrage is BACK!!!



# Overview of Arbitrage & Rebate

- General rule is that you cannot invest proceeds of tax-exempt bonds in investments with a yield materially higher than the yield on the bonds
  - Several important exceptions apply
- Intent of these rules is to restrict situations where an issuer might:
  - Issue more bonds than needed
  - Issue bonds earlier than needed
  - Keep bonds outstanding longer than needed
- Hedge bond limitations are an independent non-arbitrage restriction, which generally requires an issuer to expect to spend 85% within 3 years.

# What do the arbitrage rules apply to?

- Proceeds of Bonds
  - Sale proceeds
  - Investment proceeds (earnings on investments of sale proceeds)
  - Transferred proceeds (unspent proceeds of refunded bonds)
- Replacement or "Gross Proceeds"
  - Debt service funds (P&I accounts, sinking fund accounts, etc.)
  - Cash-funded reserve funds, pledged funds, and defeasance escrows
- Arbitrage restrictions apply until proceeds are spent

# Arbitrage – Yield Restriction vs. Rebate

## YIELD RESTRICTION

**Can you invest proceeds at a higher yield? Only during a "temporary period."**

- 3-year temporary period for new money project funds
- 90 days for current refunding escrows
- Reserve funds / bona fide debt service funds
- 30-day period for other funds

## REBATE

**Can you keep earnings above the bond yield? Only if you meet an exception from rebate:**

- Spending exceptions (spend the money quickly enough)
- Small issuer exception (issuers that don't issue more than \$5mm)
- Debt service fund exception

# Most Common Yield Restriction Exceptions

# 1

## NEW MONEY BONDS

### Three Year Temporary Period

- Must expect to spend 85% of proceeds within 3 years
- Must incur a binding obligation to spend at least 5% of the proceeds within 6 months after issuance
- Must proceed with due diligence in spending proceeds
- After 3 years, must make "yield reduction payments"

# 2

## CURRENT REFUNDING BONDS

### 90-day Temporary Period

# 3

## RESERVE FUNDS

### Lesser of Three Tests (10%/125% AADS/MADS)

# 4

## BONA FIDE DEBT SERVICE FUNDS

### Up to 13 Months of Depleted Annually

# Spending Exceptions from Rebate

6

## Month Exception

No rebate owed if all proceeds spent within 6 months

18

## Month Exception

No rebate owed if...

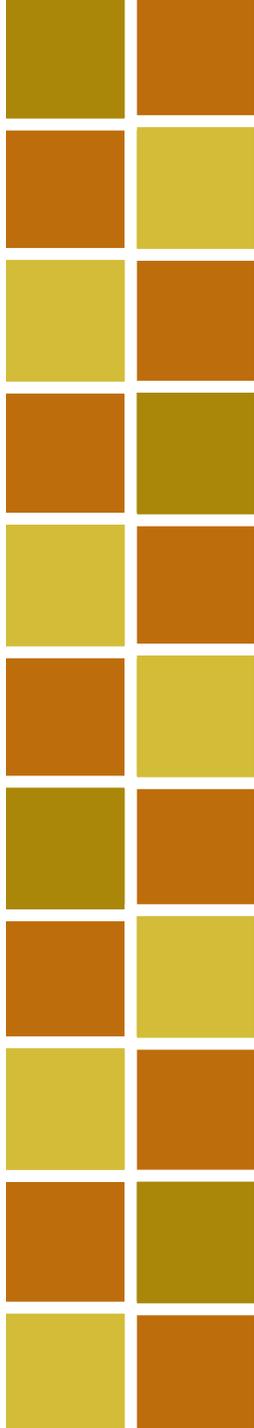
- 15% of proceeds are spent within 6 months
- 60% are spent within 12 months
- 100% are spent within 18 months

24

## Month Exception

No rebate owed if at least 75% of the proceeds are spent on construction costs (not acquisition costs) of property owned by a governmental or 501(c)(3) entity, and...

- 10% of proceeds are spent within 6 months
- 45% are spent within 12 months
- 75% are spent within 18 months
- 100% are spent within 24 months



# Timing Issues for Rebate and Yield Reduction

- Investment earnings are blended over time for rebate and yield reduction
  - Periods with positive arbitrage can be offset against periods with negative earnings relative to bond yield, and vice versa
- Yield restriction analysis is only blended outside a temporary period
  - After 3-year temporary period for new money, proceeds "not allowed" to be invested above the bond yield, but if they are, can make yield reduction payments
  - Negative arbitrage during that initial 3-year temporary period cannot be used to offset positive arbitrage in later years (different from rebate)

# Calculating and Paying Rebate and Yield Reduction Payments

- If rebate or yield reduction payments are owed, first payment must be no later than 5 years after issuance (60 days after fifth year), and every five years thereafter
  - Must pay at least 90% of liability every 5 years, and then 100% of liability after retirement of bonds
  - Possible to have a payment due for one 5-year period, and then a refund in a later 5-year period
- Best practice is to monitor on an annual basis to avoid surprises
- Working with rebate consultants

## Do you currently work with an arbitrage rebate consultant?

Yes

0%

No

0%

# Why Bother Worrying About Investments?

## COSTS

- Interest costs accrue on bonds immediately so...
  - Negative carry (i.e., negative arbitrage) on investments increases financing cost
- Improved investment performance will...
  - Reduce negative carry and even lower overall borrowing costs

## TYPICAL FUNDS

- Project Funds
  - Net funding + more earnings = smaller bond issue
  - Gross funding + more earnings = more project funds
- Reserve Funds
  - Earnings will offset debt service costs
  - Higher earnings here can offset costs of negative carry in Project Funds
- Debt Service Funds
  - More earnings = less net debt service (this is a good thing!)

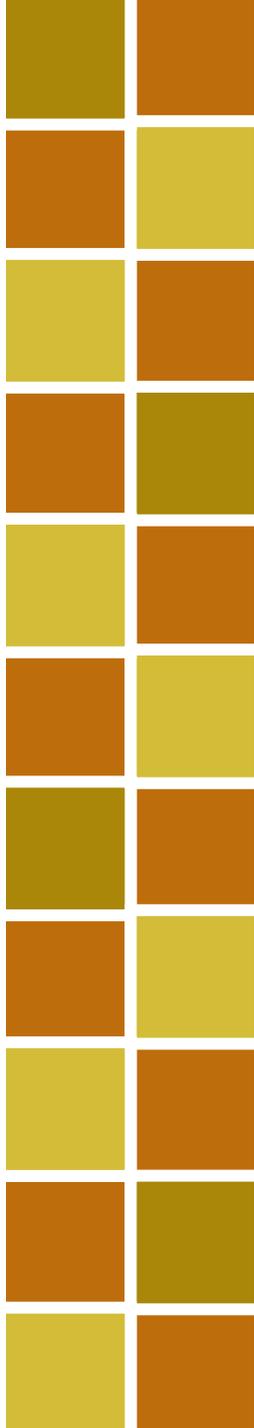


# **Bond Proceeds Investment Strategy**

## An Optimal Bond Proceeds Reinvestment Strategy Should...

- Ensure safety of principal while providing adequate liquidity
- Consider current and future interest rate expectations
- Take into account any applicable arbitrage rebate regulations
- Provide a reasonable risk-adjusted return





# Key Questions to Consider When Investing Bond Proceeds

- What is my credit risk, and how can I manage it?
- How does this instrument or investment strategy provide liquidity for both expected and unforeseen draws?
- What are the rebate implications of my reinvestment strategy?
- What is the yield of the instrument or investment strategy, and how can my return change through time?
- Does this reflect my view of market conditions? How does this instrument or investment strategy manage market and reinvestment risk?

# Typical Permitted Investments for Bond Proceeds

## MONEY MARKET/SHORT-TERM INVESTMENTS

- Money Market Funds
- Local Government Investment Pools (LGIPs)

## OPEN-MARKET AND CUSTOM SECURITIES

- U.S. Treasuries and Direct Obligations (examples: Treasury Bills, Treasury Notes)
- Federal Agency Securities (examples: Fannie Mae, Freddie Mac) (includes both open-market and reverse-inquiry securities)
- Commercial Paper (examples: JPMorgan, Toyota)

## STRUCTURED INVESTMENTS

- Guaranteed Investment Contracts (GICs)
- Flexible Repurchase Agreements (Flex Repos)
- Forward Delivery Agreements (FDAs)

# Active Management vs. Passive Strategies

## ACTIVE MANAGEMENT

- Ideal for funds with expansive permitted investments and/or uncertain liquidity needs
- Advisor goal: generate incremental earnings via swapping amongst individual CUSIPs, sectors, and duration buckets to attempt to offset advisory fees
- Enhanced ability to take advantage of benefit from near-constant duration exposure

## PASSIVE STRATEGIES

- Ideal for funds with conservative, straightforward permitted investments and predictable liquidity needs
- One-time engagements with subsequent opportunities to restructure in the future
- May require significant change to market conditions and/or cash flow requirements for restructurings to add value

ACTIVE MANAGEMENT	PASSIVE STRATEGIES
Real-time monitoring of holdings through time	Periodic/ad-hoc monitoring
More frequent trades to manage duration and/or liquidity	Wholesale restructurings to rebalance to target
Greater ability to take advantage of short-term securities mispricings	No ability to take advantage of short-term opportunities
Enhanced ability to add incremental net value	May require substantial changes in market conditions to add value
Advisor has fiduciary responsibility	No fiduciary responsibility once portfolio is structured

## When investing bond proceeds, it's important to consider which of the following?



# Types of Risk to Manage in Bond Proceeds Investments

## CREDIT RISK

- Is there a government guarantee?
- Who is the ultimate obligor?
- What type of credit?

## LIQUIDITY RISK

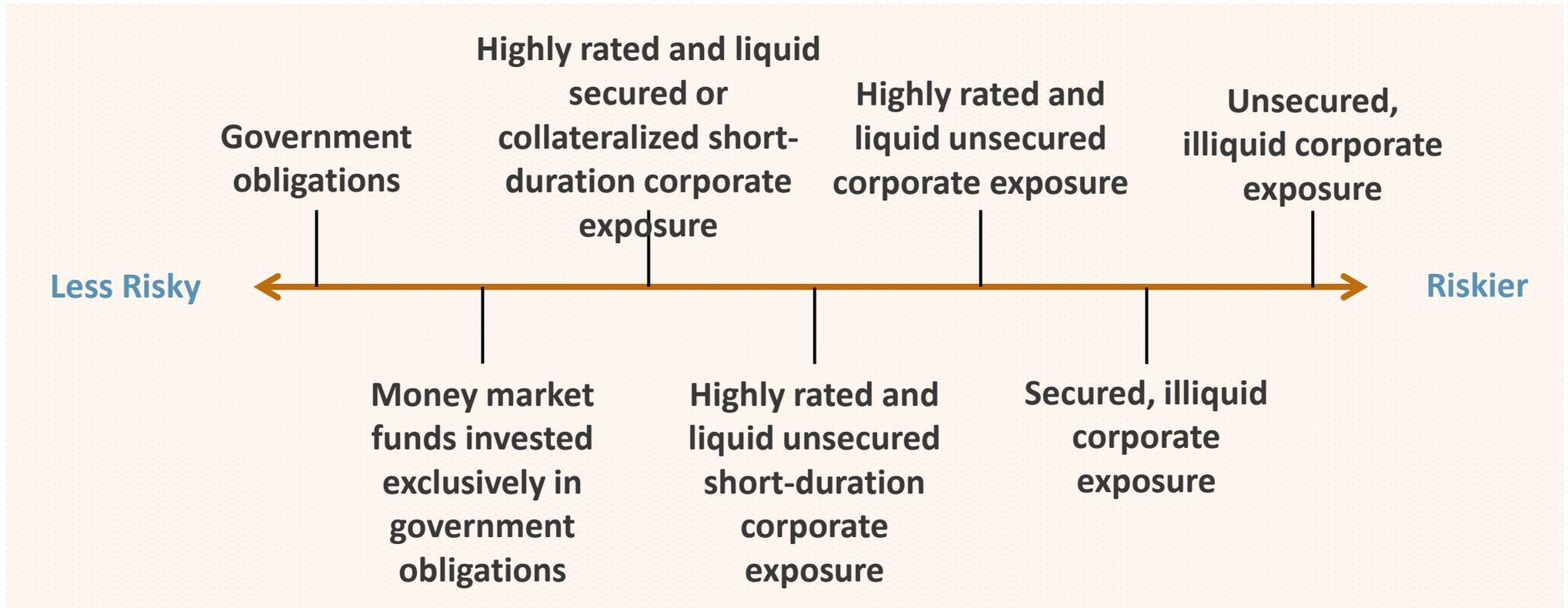
- How quickly and easily can I access the proceeds?
- Are there redemption fees or gates?
- Is there a secondary market that I can access in the event of emergency?

## REINVESTMENT RISK

- What might happen to my return if interest rates go up or down?
- Does the strategy give me any ability to take advantage of changes in interest rates

# Credit Risk: Risk Aversion and Yield

- For any given yield or return a rational investor will choose the least risky investment
  - Given the choice between a 30-day Treasury Bill at 5.23% or 30-day commercial paper at 5.23%, a rational investor would choose the Treasury Bill because it is less risky
- By extension, investors require more yield or return for riskier investments



# Liquidity Considerations of Various Investment Alternatives

Strategy	Liquidity Considerations	Additional Points of Consideration
Money market fund	Typically offer same-day liquidity which is a function of cut-off times	Are there redemption fees or gates?
Passively structured portfolio	Underlying investments offer same-day liquidity, but logistical considerations may cause delays	Requires trustee to sell investments or advisor to be engaged which may take time to put into place
Managed portfolio	Underlying investments offer same-day liquidity; function of advisors to access capital markets	How are liquidity needs communicated to advisor?
Structured Investment	Typically have a notice period; official notice may need to come from trustee	<b>No secondary market</b>

# Reinvestment Risk

- Impact of interest rate movements on return/yield of instrument
  - Does the strategy give me any ability to take advantage of changes in interest rates or am I “locked in”?

STRATEGY	INTEREST RATE SCENARIO		
	Rising Rates	Falling Rates	Stable Rates
Money market fund	Yield of fund tends to follow short-term rates (with lag)	Yield of fund tends to follow short-term rates (with lag)	Yield of fund will tend to remain stable
Passively structured portfolio	Yields locked in; reinvestments will occur at higher rates	Yields locked in; reinvestments will occur at lower rates	Yields locked in
Managed portfolio	Yields locked in; manager has ability to alter portfolio to take advantage of opportunities	Yields locked in; reinvestment at lower rates	Yields locked in
Structured Investment	Yields locked in	Yields locked in	Yields locked in

## What are some of the risks to consider when investing bond proceeds?

Credit Risk

0%

Reinvestment Risk

0%

Liquidity Risk

0%

All of the above

0%



# **Strategy Development**

# Project Fund Investment Process

## Define Universe of Investments

- Bond indentures, state law, and investment policy
- Sector specialist recommendations
- Identify value

## Identify Constraints & Objectives

- Draw schedule expectations
- Liquidity buffer

## Initial Portfolio Optimization

- Meet initial expected cash flow needs
- Horizon and relative value analyses

# Sample Treasury and Credit Portfolio

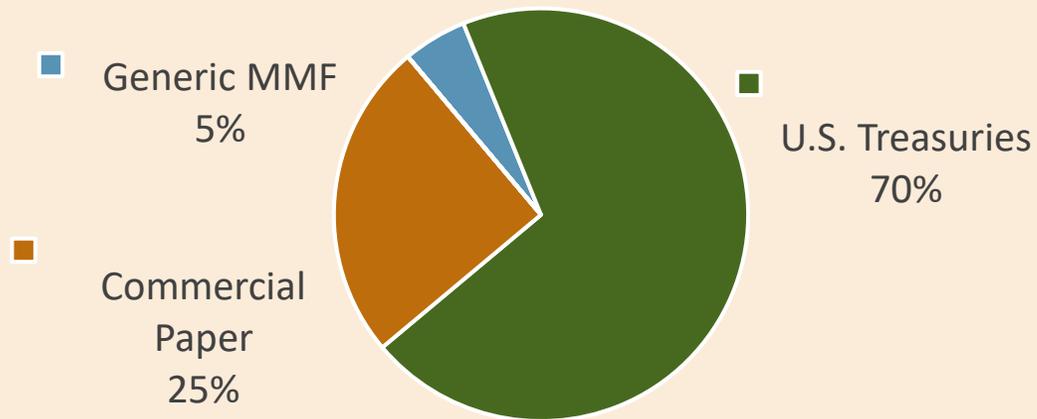
## Portfolio Statistics Summary

Approximate Cash Balance (Total)	\$15,000,000
Approximate Par Amount (Investments)	\$285,000,000
Weighted Average Maturity	544 days
Average Life of Draw Schedule	564 days
Average Gross Yield (IRR)	4.96%
Estimated Gross Earnings	\$22,204,000

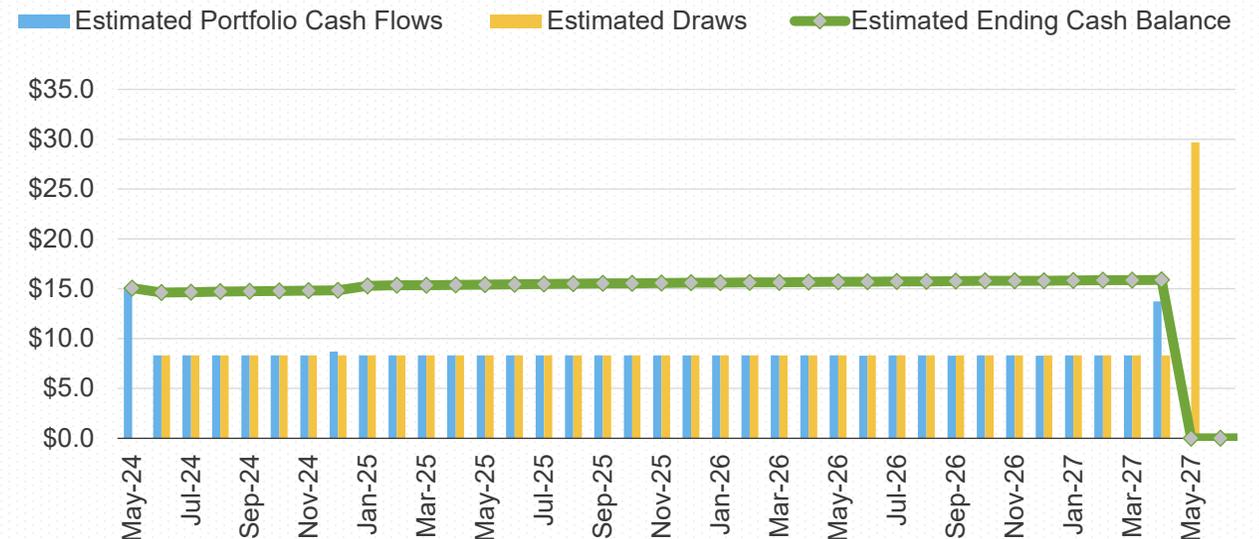
## Strategy Overview

- Approximately 70% allocation to Treasuries, 25% to commercial paper, with the balance in a money market fund
- Commercial paper structured to meet draws inside of nine months
- Treasury maturities laddered to closely match the remaining draws
- Treasuries can be swapped into higher-yielding commercial paper as securities near maturity

## Sector Allocation



## Portfolio Cash Flows vs Estimated Draws (\$ in millions)



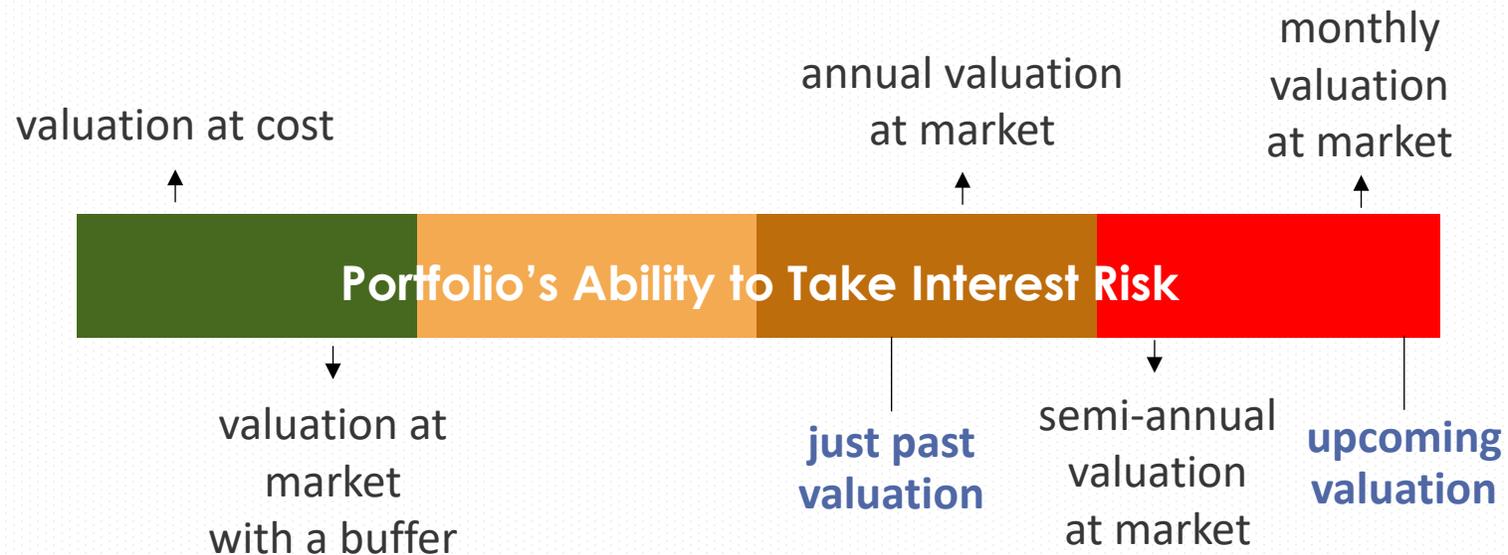
# Investing Reserve Funds

Unique considerations for reserve funds impact reinvestment strategy

Investment Decision Factor	Considerations
Market Outlook	Does the strategy account for the interest rate outlook?
Risk Management	Is interest rate risk based on the investment valuation methodology and frequency?
Replenishment Requirements	If investment values decline, must the reserve funds be replenished?
Opportunity Costs	Are there yield enhancement opportunities within your risk management parameters?

# Managing Downside (Replenishment) Risk in Reserves

- Reserve funds are typically funded for the benefit of the underlying bondholders
  - Most indentures require reserve funds to be valued periodically with any shortfalls due to investment losses made up
- In addition to credit, liquidity, and tax risk, the management of reserves also requires focusing on mitigating risk that losses in market value of investments will require additional deposits into reserves
- Sensitivity and breakeven analyses to determine potential outcomes under different interest rate assumptions



# Investing Debt Service Funds

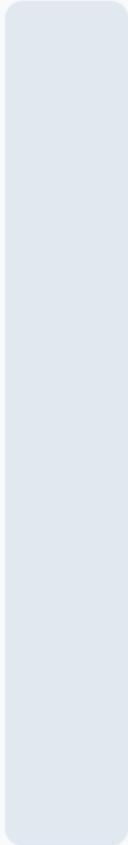
- 1/6th of semi-annual interest payment and 1/12th of principal payment is deposited into debt service fund monthly
- Bona fide debt service funds are typically not subject to rebate
- Investment alternatives include:
  - Ultra-short duration bias: money market fund
  - Short duration bias: managed portfolio of securities
  - Long duration bias: structured investments such as FDAs

Strategy	Gross Yield*	Key Benefits	Key Limitations
Money market fund	5.26%	Can take advantage of increases in interest rates; administrative simplicity	Ultra-short duration
Managed portfolio	5.13% to 5.18%	Extends duration while retaining flexibility to reinvest at higher rates	Duration cannot be extended beyond upcoming principal and interest payment dates
Structured Investment	4.55%	Synthetically extends duration beyond upcoming liquidity needs	Locks in yield; cannot take advantage of increases in interest rates

*\*Yields sourced from Bloomberg Finance L.P. as of April 1, 2024, and subject to change based on underlying market conditions. Please see further disclosures at the end of this presentation.*

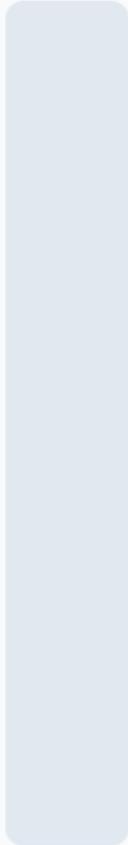
True or False: in the context of reserve fund accounts, funds that are valued more frequently have more ability to take risk relative to accounts that are valued less frequently.

0%

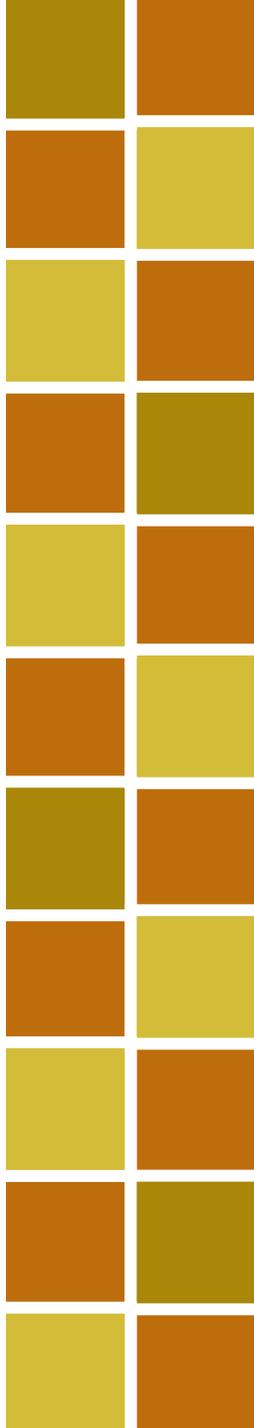


True

0%



False



# Don't Forget About the Bond Proceeds!

- Consider your investment strategy soon before or after your bonds are issues
- It's GOOD to owe rebate!
- Maximize earnings on your bond proceeds
- Actively manage upcoming arbitrage rebate payments
- Avoid surprises (i.e., spent all the investment earnings)
- It's BETTER to keep all the investment earnings
- Aim at meeting one of the spending exception to the arbitrage rebate requirements

# QUESTIONS?



**GLENN CASTERLINE**  
*Managing Director*  
BLX Group LLC



**MONIQUE SPYKE**  
*Managing Director*  
PFM Asset Management LLC



**JOHN STANLEY**  
*Partner*  
Orrick Herrington  
& Sutcliffe LLP

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# SESSION FOUR

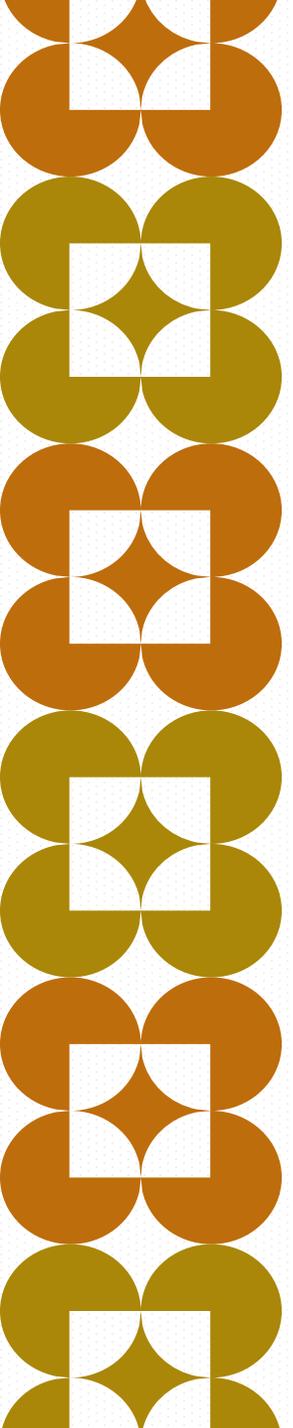
## Post Issuance Accountability



**JAY GOLDSTONE**  
*Special Advisor to the Mayor*  
City of San Diego

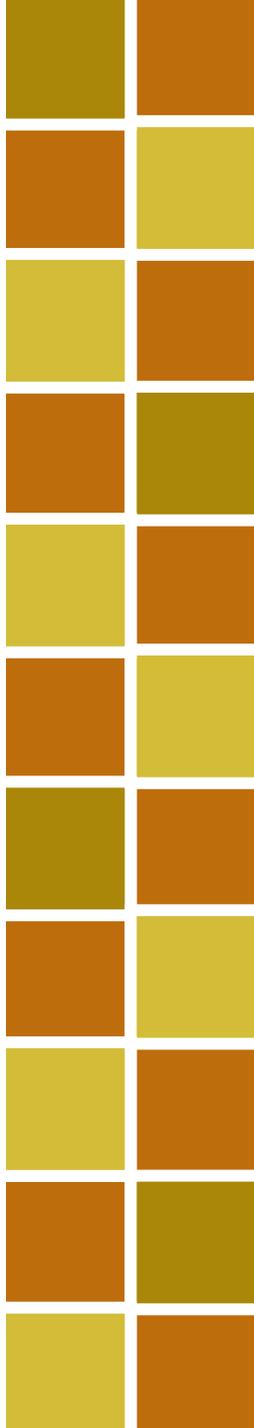
**LINDA HURLEY, CPA**  
*Partner*  
Macias Gini & O'Connell LLP





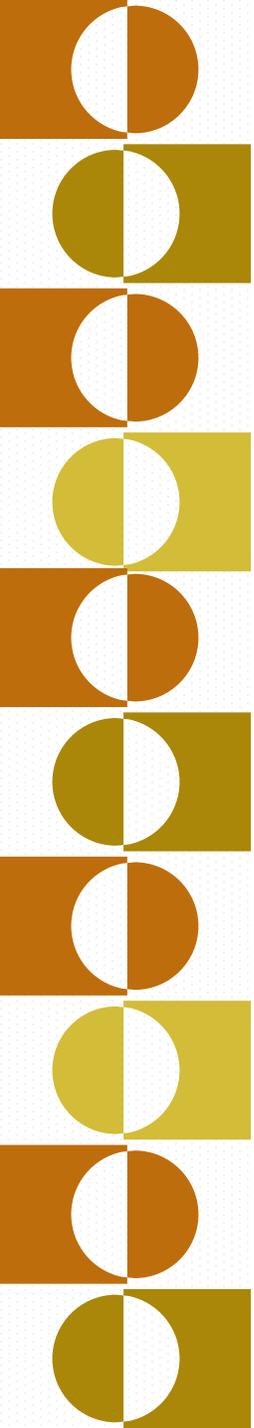
# LEARNING OBJECTIVES

- Identify and assess potential issues and challenges affecting accounting and compliance post-issuance and develop strategies to mitigate these risks
- Know how to prepare for an external audit
- Sharing of best practices for post issuance and debt portfolio management



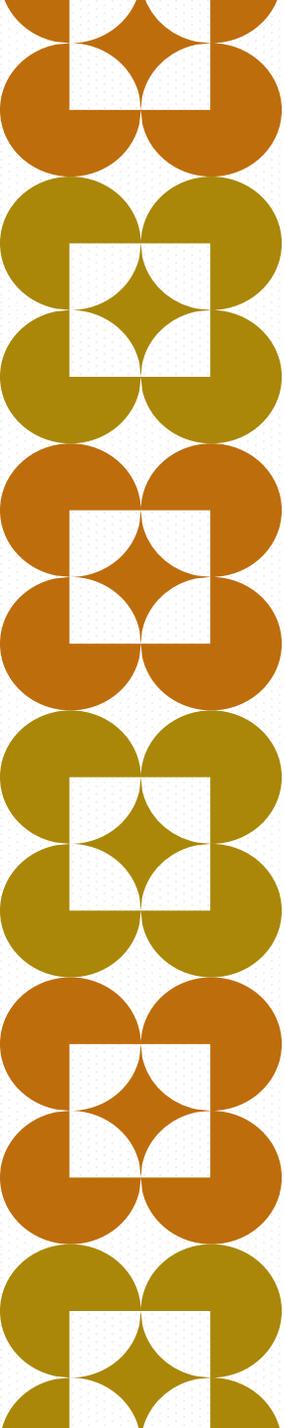
# What Do You Need To Be Thinking About?

- Setting up your accounts
- Properly recording the transaction in your general ledger
- Monitoring
  - Cashflow
  - Proper use of funds
  - Timing on the use of funds
- Reporting
  - EMMA
  - CDIAC
  - Governing Board



# What Could Go Wrong?

- Improper use of the bond funds
- Missed bond payment
- Violation of a bond covenant
- Missing financial and other records and documents
- Delayed ACFR
- Delayed reporting as required under your Continuing Disclosure Agreement (CDA)

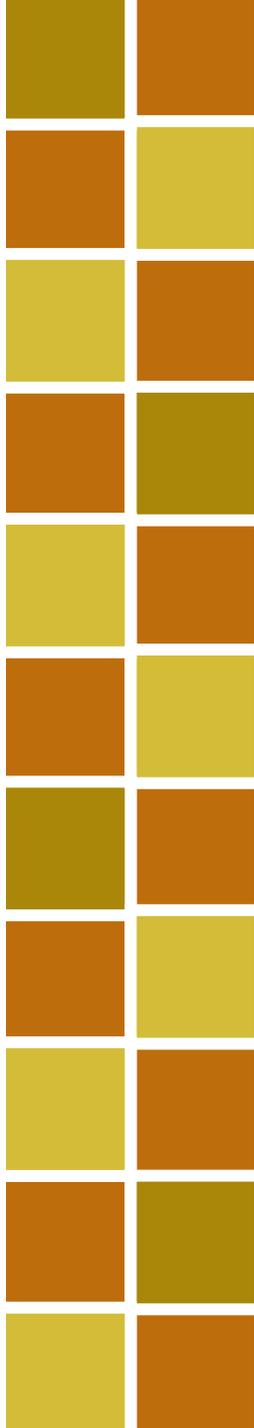


# Improper Use of Bond Funds

- Private Business Use and Payment Test:
  - No more than 10% of the proceeds of the bonds can be used for Private Business Use; and
  - No more than 10% of the payment of principal or interest on the bonds is made or secured by payments for Private Business Use
- Spent proceeds on an unqualified project(s)
- Comingled funds with other cash
- Used proceeds to cover operations and maintenance
- Mis-matching the life of the assets to the maturity of the bonds

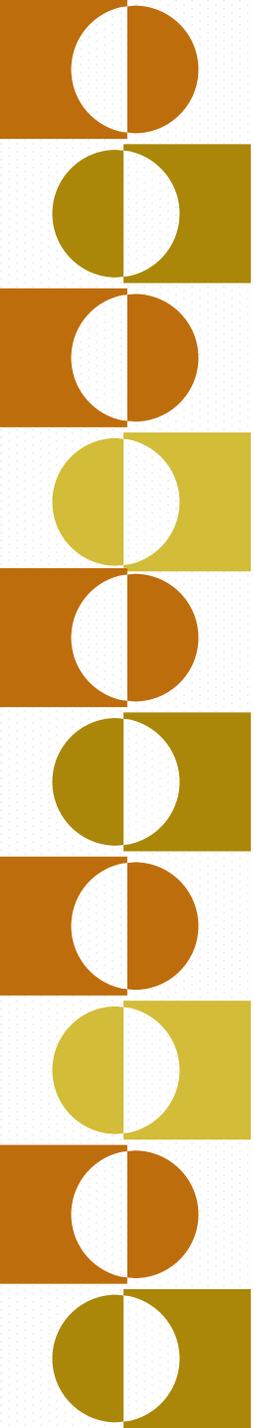
# Missed a Bond Payment

- Where is your tickler system
- Staff on vacation
- No backup support
- Poor communications with Trustee/Paying Agent
- A default
- Reputational risk



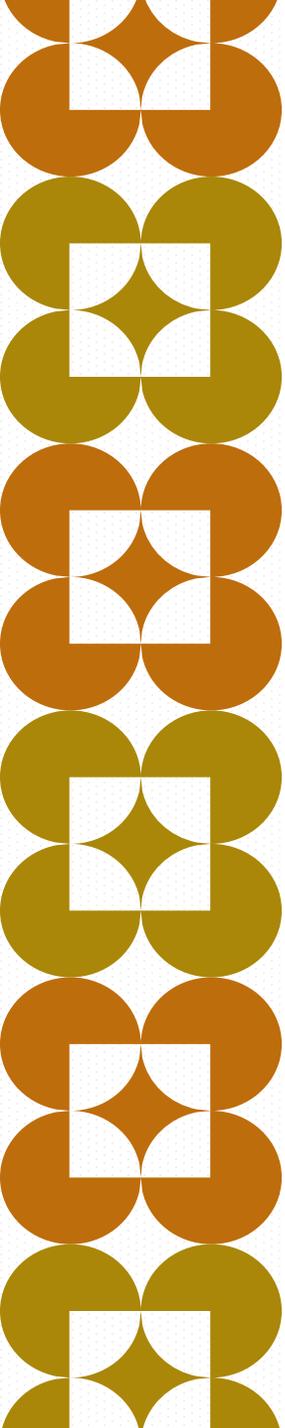
# Violation of a Bond Covenant

- Coverage ratios
- Additional bonds tests
- Reserve requirements
- Parity tests
- Bank loan terms



# Missing Financial and Other Records

- Must maintain for at least three years beyond final maturity
- What documents does your auditor need
- What if the IRS comes knocking on your door
- What if the SEC, via your underwriter, wants proof

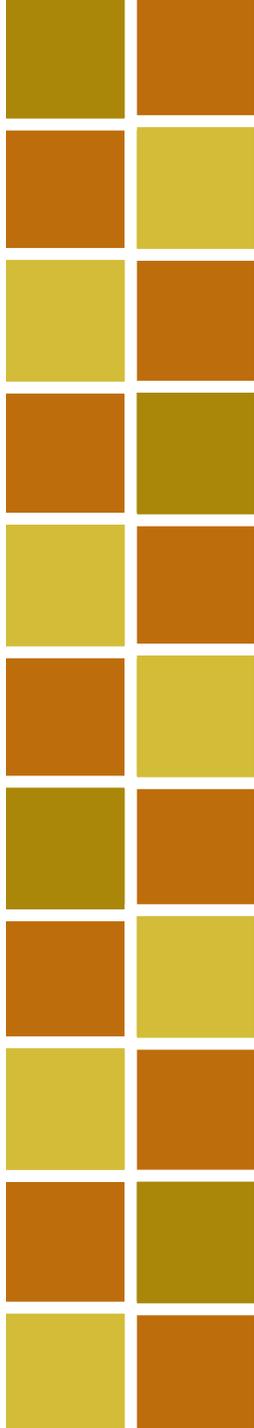


# Delayed ACFR

- Understand why
- Report on EMMA
- Work with your auditors
- Careful what your organization then say publicly
- Determine how to prevent this from re-occurring

# Delayed Reporting as Required Under Your CDA

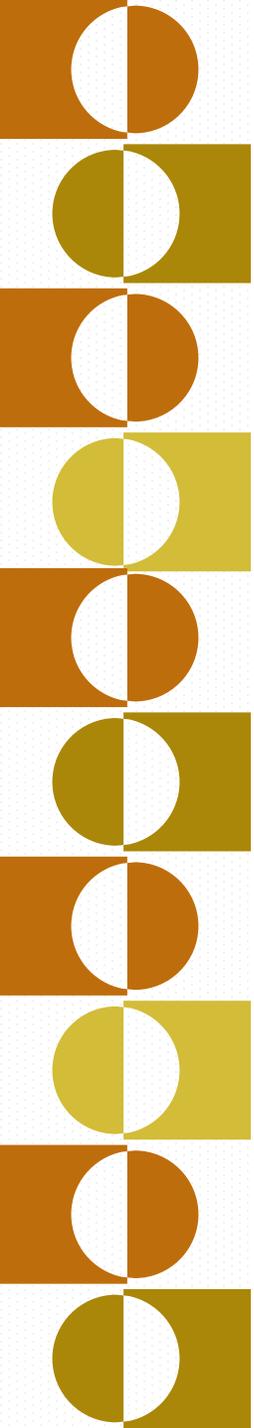
- Material event
- Report on EMMA
- Reputational risk
- Might impact future access to the markets



# In The End...

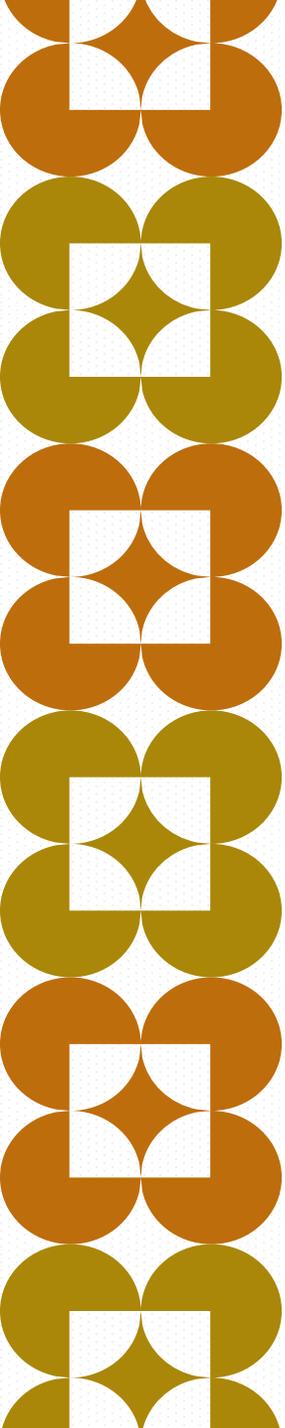
## Get Yourself Organized

- Establish a tickler system with dates & responsibilities:
  - Debt service payments
  - Continuing disclosure filings
  - Arbitrage rebate obligations
  - Spending timelines
  - Yield restrictions
  - Use of proceeds



# The Auditors are Coming... Now What?

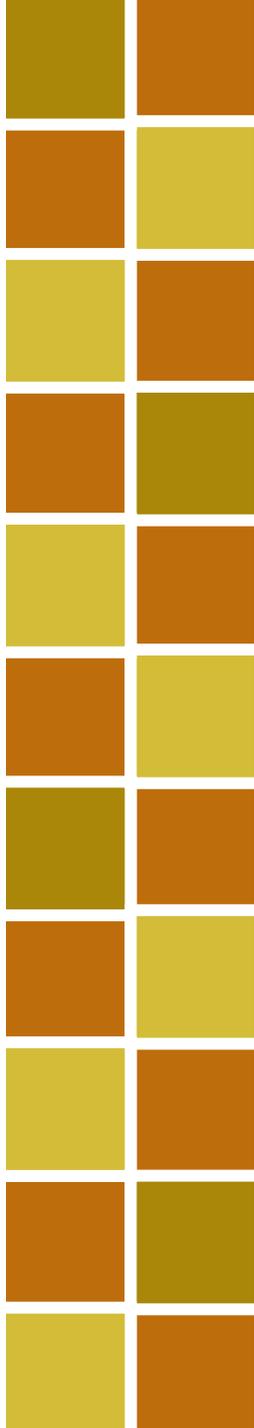
- Audit Scope
  - ACFR / Basic Financial Statements
  - Special Bond Specific Audit



# The Auditors are Coming...

## Now What? – (cont. 2 of 6)

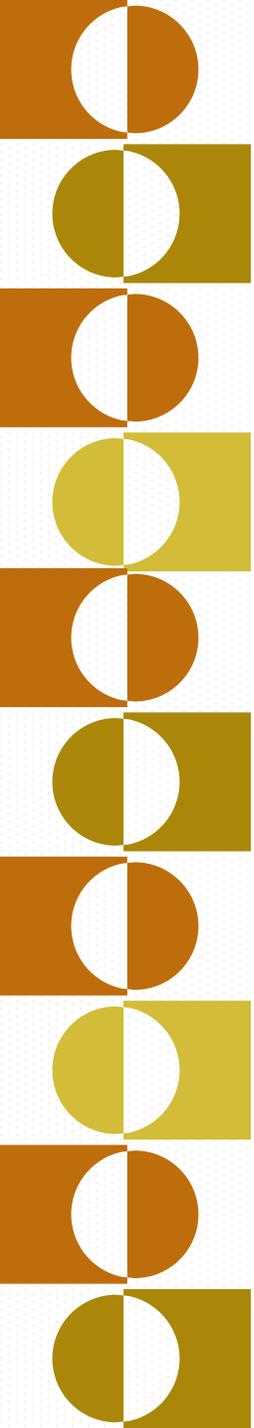
- Audit Scope - ACFR / Basic Financial Statements
  - Includes all debt activities and disclosures
    - Materiality
    - Significance of the current year activity
  - Accounting of the debt transactions (debits/credits)
    - New debt transactions
    - Refunding transactions
    - Current year activities of existing transactions (debt service)
    - Net position classifications
  - Disclosures
  - Compliance (GAGAS)



# The Auditors are Coming...

## Now What? – (cont. 3 of 6)

- Preparing for an Audit
  - Confirmation of Scope
    - Type of Audit
    - Current Year Activities
  - “Prepared By Client” List (PBC)
  - Account Reconciliations
    - Fiscal Agent/Restricted Cash Accounts
    - Debt allocations – Shared projects/purpose
    - Debt service expenditures - principal, interest, amort. prem/disc/def charges
    - New debt – refunding (gain/loss), escrow deposits, debt defeasance, cost of issuance, deferred inflows/outflows def charges



# The Auditors are Coming...

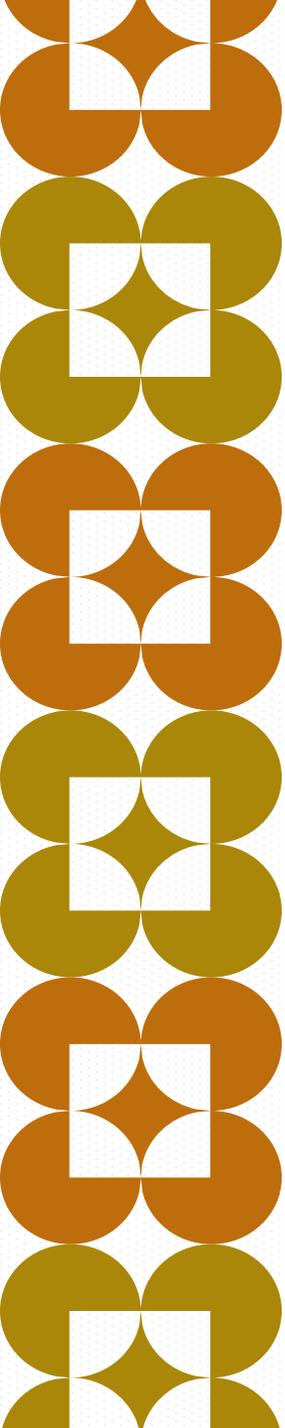
## Now What? – (cont. 4 of 6)

- “Prepared By Client” List (PBC)
  - Long Term Debt Roll forward (incl. premium/discount/capital appreciation/deferred charges)
  - Confirmation and authorizations
  - Amortization Schedules
  - Interest accrual calculations
  - Allocation/Transfer worksheets for fund reporting
    - Gov vs Proprietary
    - Transfer of resources to pay debt service in DSF or GF
    - Transfer/Use of proceeds – CPF or GF
  - Official statements of newly issued/refunded debt
  - New notes payable agreements
  - New certificates of participation
  - Arbitrage Worksheet and reports
  - Conduit debt activity
  - Calculation of net investment in capital assets and restrictions related to debt

# The Auditors are Coming...

## Now What? – (cont. 5 of 6)

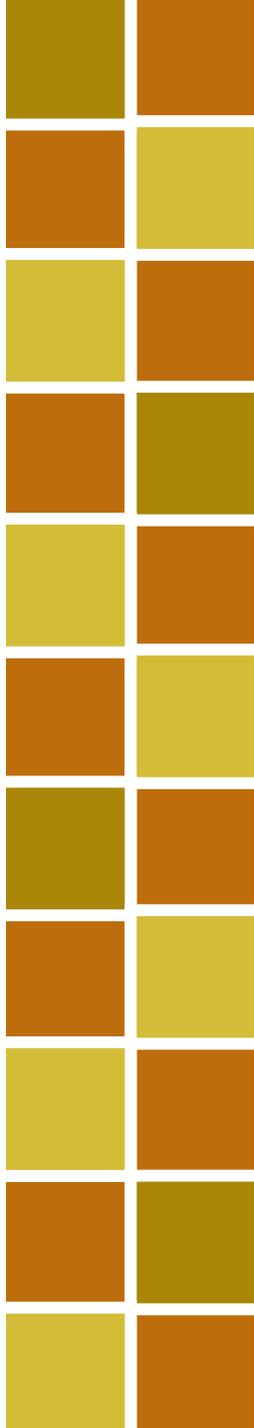
- Disclosures
  - Cash and Investments
    - Investment Policies
    - Restrictions on proceeds
    - Fiscal agent accounts



# The Auditors are Coming...

## Now What? – (cont. 6 of 6)

- Disclosures
  - Long Term Debt:
    - Terminology – LTD vs LT Liabilities/Obligations
      - LT Liabilities/Obligations include
        - Debt (bonds, notes, COPs, special assessments, etc.)
        - Leases and SBITA
        - Compensated Absences
        - Pension and OPEB
        - Pollution Remediation
        - Claims Liabilities
    - Schedule of original issue, maturity dates, interest rates, outstanding amount
    - Roll-Forward
      - $BB + \text{New} - \text{Reduction} = \text{EB}$
      - Due within 1 year
    - 1-5 years, then 5-year increments for debt service requirements
    - Narrative – Purpose, summary of terms, pledged revenues



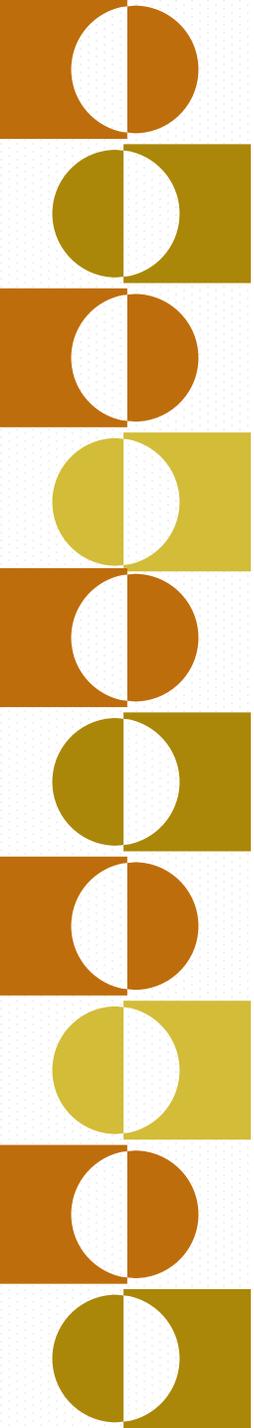
# Rewind for Debt Issuance – Auditor Association

- Investor Expectations Gap
- Consent Letter
  - Additional engagement and audit effort
- Additional Disclosure

[AUDIT FIRM], our independent auditor, has not been engaged to perform, and has not performed, since the date of its report included herein, any procedures on the financial statements addressed in that report. [AUDIT FIRM] also has not performed any procedures relating to this official statement or memorandum.

Article: An Auditor's Dilemma: To Consent or Not to Consent

<https://www.cpai.com/Education-Resources/my-firm/Audit-Attest-Services/An-Auditor-s-Dilemma-To-Consent-or-Not-to-Consent>



# Is Another Audit Really Necessary?

- Special Bond Specific “Audit”
  - Why have this done?
    - Voter Approved Taxes and Bond Measures
    - Concerns of improprieties/ Accountability to community
    - Internal Audit Risk Assessment Plan
    - Debt Portfolio/Program Manager Changes

# Is Another Audit Really Necessary?

– (cont. 2 of 3)

- Special Bond Specific “Audit”

- Voter Approved Local Tax and Bond Measures

- CA Government Code section 50075.1 and 50075.3 (taxes)
    - CA Government Code section 53410 and 53411 (bonds)

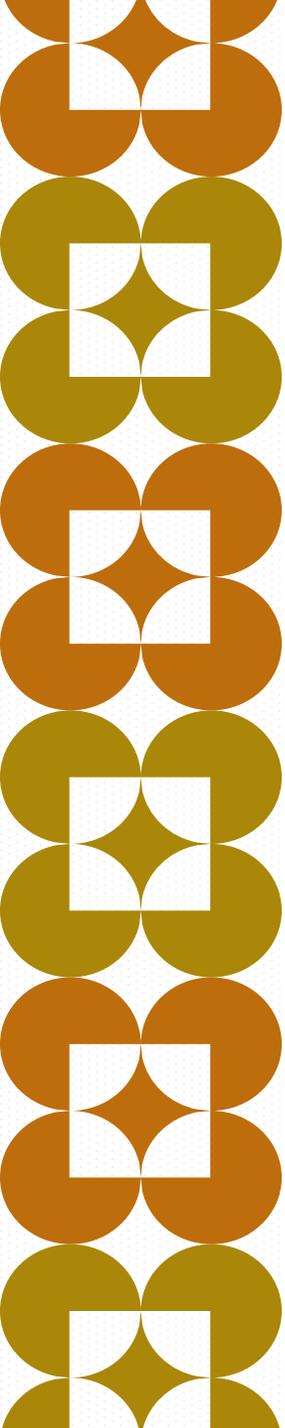
The chief fiscal officer of the issuing local agency shall file a report with its governing body no later than January 1, 2002, and at least once a year thereafter. The annual report shall contain all of the following:

(a) The amount of funds collected and expended.

(b) The status of any project required or authorized to be funded as identified in subdivision (a) of Section 53410.

- Audit Requirement

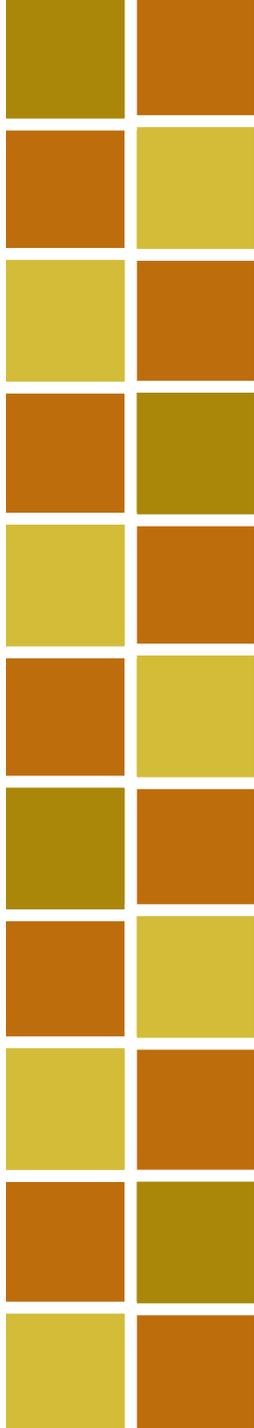
- Audit vs. audit
  - Consult an Auditor prior to finalizing Measure



# Is Another Audit Really Necessary?

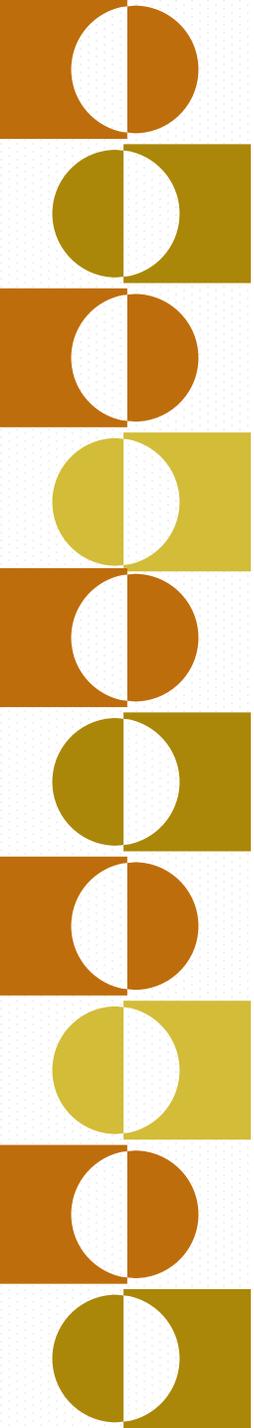
– (cont. 3 of 3)

- Special Bond Specific “Audit”
  - Financial Audit
    - Special revenue funds, Debt services funds, Capital projects funds
    - Inflows/Outflows of debt funded projects
    - Rate Covenant Calculations
  - Compliance Examination
    - Voter approved Measures
  - Agreed Upon Procedures (AUP)
    - Procedures designed and agreed to by management for specific purposes



# Post Issuance Best Practices

- Know what's in your Continuing Disclosure Agreements (CDA)
- Understand federal and state muni tax and securities requirements
- List of all compliance actions at time bonds are sold – by series
- Documentation of sources and frequency of requirements

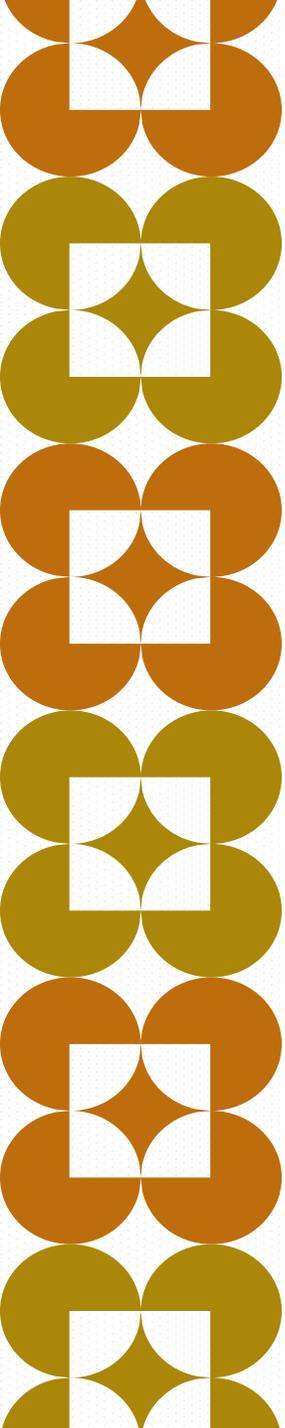


# Debt Management Best Practices

- Develop and document disclosure policies and procedures to ensure compliance and peace of mind
  - Formal, written, adopted
  - Review update at least every three years
  - Use assistance of outside professionals if desired (municipal advisor, counsel, arbitrage consultant)
  - Design approach to address various disclosure requirements
- Elements
  - Identify and assign responsibilities by department and title
  - Train responsible employees

# Debt Management Best Practices – (cont. 2 of 3)

- Elements (cont.)
  - Create policies and procedures that reflect who you are
  - Monitor changes in laws and regulations
  - Identify records to be maintained, for how long and how to maintain
  - Determine how to identify and correct mistakes
  - Other considerations
    - Bond Indentures/Bond Ordinance/Bond Resolution
    - Other internal finance policies and how they relate to debt management and post issuance compliance



# Debt Management Best Practices – (cont. 3 of 3)

- Tools
  - Use of spreadsheets
  - Use of software solutions for long-term obligations
    - Manages timing of cash flow
    - Sources of cash flows
    - Amortization
    - Monitors compliance with covenants
    - Manages timing of regulatory reporting – continuing disclosure, reportable events
    - Develops accounting entries and disclosures
- Management of proceeds
- Accounting set-up – Funds used
  - What resource are pledged and what is the intent operating intent (policy/budget)
  - GF, CPF, DSF, EF, ISF
  - Allocations/transfer policies and procedures

# QUESTIONS?



**JAY GOLDSTONE**  
*Special Advisor to the Mayor*  
City of San Diego

**LINDA HURLEY, CPA**  
*Partner*  
Macias Gini & O'Connell LLP



# SESSION FIVE

## Refunding an Issue



**BLAKE BOEHM**  
*Managing Director*  
KNN Public Finance LLC

**KARMA PEMBA**  
*Co-head of California K-14*  
RBC Capital Markets



## PAYING OFF AN EXISTING LOAN WITH A NEW LOAN:



### MORTGAGE EXAMPLE:

- Mortgages can be prepaid at any time
- Considerations:
  - » Transaction cost
  - » Term of new loan (e.g., a new 30-year loan would extend overall repayment)



### BOND EXAMPLE:

- Bond investor has call protection, most commonly for 10 years
- Borrower has call option

## OPTIONAL REDEMPTION:



### SAMPLE PROVISION:

The Series 2024 Bonds maturing on and after **August 1, 2033**, are subject to redemption prior to their respective stated maturity dates, at the option of the County, ... on or after **August 1, 2034** at the principal amount of the Bonds called for redemption, together with interest accrued thereon, **without premium.....**

First 10 years call protected

First optional call date

Call price – at par in this case

# TYPES OF REFUNDINGS & TIMING

» Refunding bonds are characterized as either current refunding or advance refunding



## CURRENT REFUNDING:

- New bond proceeds are used to call refunded bonds within 90 days
- Tax-exempt bonds can be issued to currently refund outstanding tax-exempt bonds



## ADVANCE REFUNDING:

- Refunding bonds are issued more than 90-days before call date
- Proceeds sized to be sufficient to fund an escrow that, along with interest earnings, will pay debt service until the call date and then call the bonds
- Advance refundings are typically less efficient, especially when the interest rate earned on escrow is less than the borrowing rate (negative arbitrage)

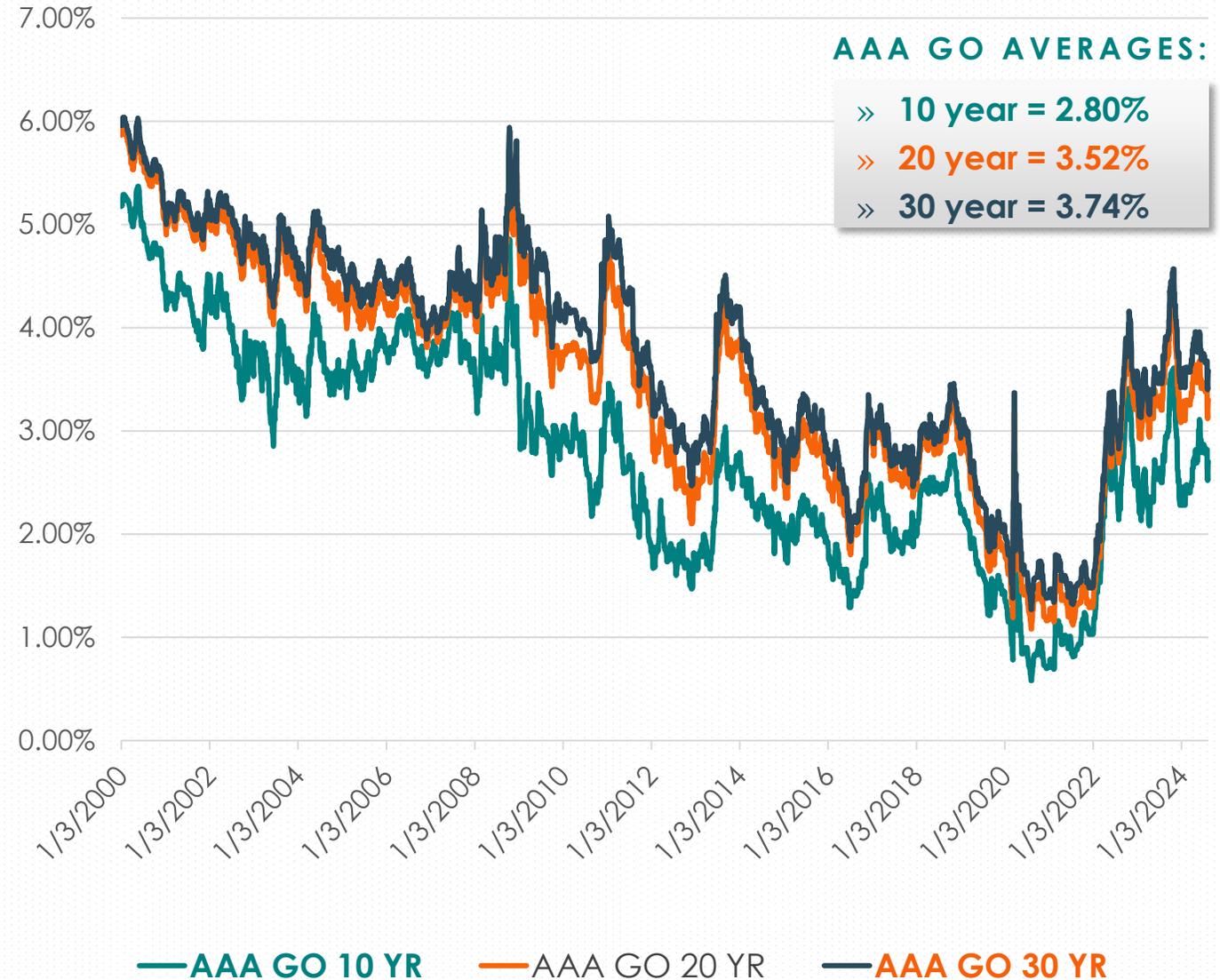
Tax-exempt advance refunding eliminated in 2017

Some agencies have issued Taxable bonds to advance refund, still generating savings.



- **What goes up, must (?) go down**
- **When to examine a bond for a refunding?**
  - » Nine months to a year before the optional call date
  - » More frequently if market and policies might support a taxable advance refunding
- **When evaluating a bond for refunding savings, the coupon rate of existing debt is compared to the true interest cost of the refunding bonds**

## CYCLICALITY OF INTEREST RATES

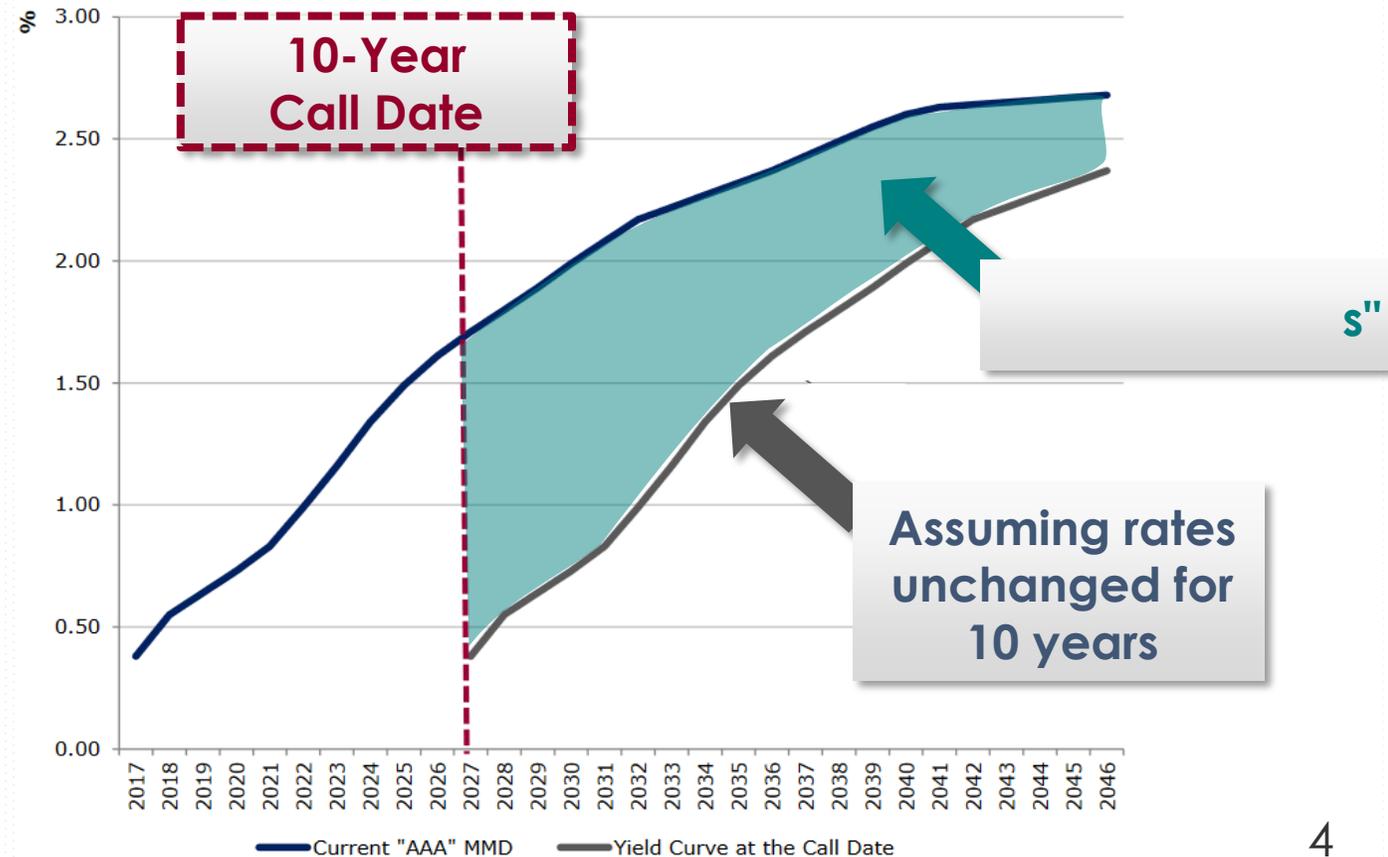


# WHAT CREATES SAVINGS?

- Because of the typical shape of the yield curve, the passage of time alone may create savings
- At the optional call date, there is a "roll down" for corresponding maturities (e.g., years 10-30 are now years 0-20)
- The common use of "premium couponing" (e.g., 5% coupons to yield 3% to the investor) creates a higher likelihood of future refunding: creates "optionality"

## ROLLING DOWN THE YIELD CURVE

YEAR	PAR	COUPON	YIELD
2032	\$1,975,000	5.000	2.500
2033	\$2,075,000	5.000	2.610
2034	\$2,180,000	5.000	2.720
2035	\$2,290,000	5.000	2.820

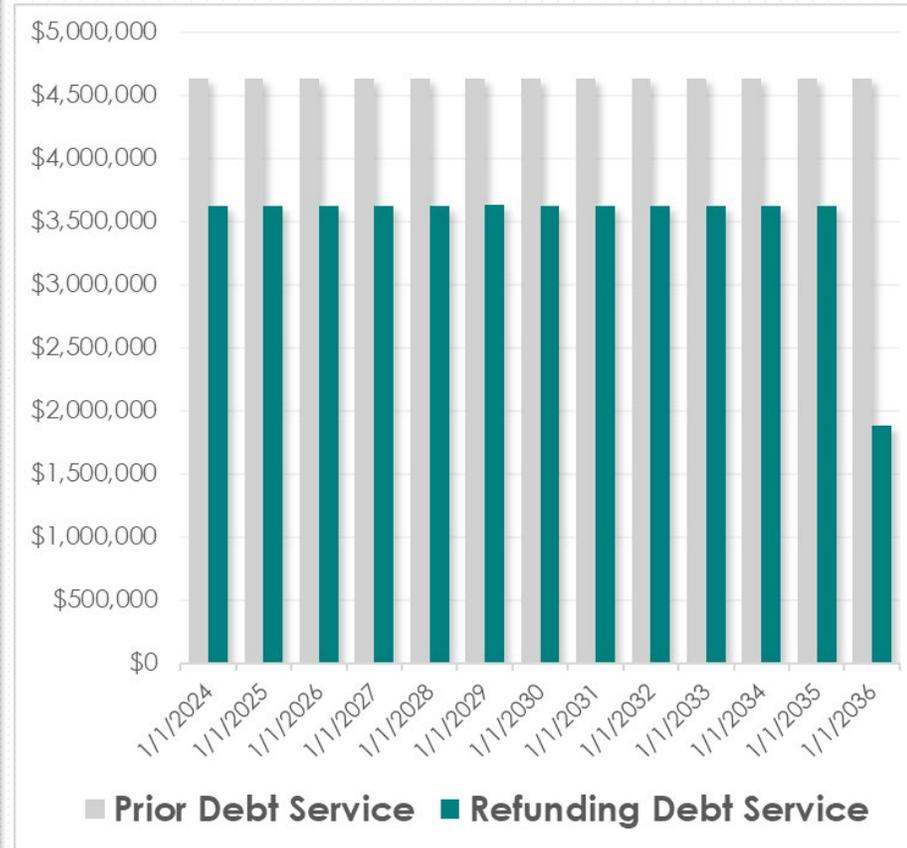


# MEASURING SAVINGS

- **Savings typically presented as “present value savings”**
- Future cashflows typically discounted by the arbitrage yield on the refunding bonds (the current cost of funds)
- Most common measurement is present value savings divided by par amount of refunded bonds, shown as a percent
- Net-to-net refunding takes into account other factors, such as investment earnings on debt service reserve fund

## Savings Summary:

- » \$845,073 Avg. Annual Cash Flow Savings
- » \$11,540,160 NPV Savings
- » 26.4% Savings of Refunded Bonds (Par Amount of \$35.7M)



Date	Prior Debt Service	Refunding Debt Service	Savings	Present Value Savings
2/1/2024	\$4,629,263	\$3,623,350	\$997,027	\$970,601
2/1/2025	\$4,629,263	\$3,622,100	\$998,277	\$960,388
2/1/2026	\$4,629,263	\$3,625,600	\$994,777	\$945,783
2/1/2027	\$4,628,013	\$3,623,350	\$995,777	\$935,413
2/1/2028	\$4,627,263	\$3,625,350	\$993,027	\$921,455
2/1/2029	\$4,630,700	\$3,626,100	\$995,714	\$912,793
2/1/2030	\$4,630,500	\$3,625,350	\$996,264	\$902,251
2/1/2031	\$4,629,700	\$3,622,850	\$997,964	\$892,861
2/1/2032	\$4,628,100	\$3,623,350	\$995,864	\$880,214
2/1/2033	\$4,630,500	\$3,622,750	\$998,864	\$872,113
2/1/2034	\$4,630,500	\$3,624,800	\$996,814	\$859,936
2/1/2035	\$4,630,500	\$3,623,850	\$997,764	\$850,488
2/1/2036	\$4,630,500	\$1,884,900	\$515,334	\$434,014
<b>Total</b>	<b>\$62,541,481</b>	<b>\$47,503,333</b>	<b>\$12,676,102</b>	<b>\$11,539,860</b>

# WHEN TO PULL THE TRIGGER?



## A MOVING TARGET:

- Rule of thumb was often 3% PV savings
- "Conservative" policies called for 5% savings
- Prior to recent interest rate run-up, double-digit savings were common



## FORMAL POLICY VS. WISE PRACTICE

- Policies typically set a "minimum" goal
  - » Risk of losing an opportunity
  - » Risk of leaving significant savings on the table
- Refunding options have value; in practice, only can be exercised every ten years
- Prior to the call date, the challenge of a forward or advance
  - » Bird in the hand vs. potential future savings
- After the call date, the call option is a 'wasting asset'

## CITY & COUNTY OF SAN FRANCISCO DEBT POLICY



GOs will be used to finance or refinance the construction of real property or real property include but are not limited to libraries, hospitals, cultural, affordable housing, and educational finance facilities or projects that benefit the public, achieve a particular public safety or social objective for City

RBs will be used to finance the acquisition,

Absent any significant non-economic factors, it is the policy of the City that a refunding should produce minimum debt service savings of at least 3% of the par value of the refunded bonds on a net present value basis, using the refunding issue's True Interest Cost ("TIC")<sup>1</sup> as the discount rate.

may be eligible for capital lease financing. Eligible equipment must have a per unit cost of at least \$100,000 unless it is an integral part of a system (such as a computer network) where the aggregate of the various components must total at least \$100,000. The useful life of the item must be in excess of three years and at least 120% of the financing and refinancing term.

5. Refunding Obligations: Refunding bonds will be issued typically to achieve debt service savings for the City, although other non-economic factors may support the issuance of such obligations. Pursuant to section Charter section 9.109 and section 4.3.8.4(b) of the City's Administrative Code, the Board of Supervisors will establish by resolution the minimum savings to be generated by the issuance of such refunding.

Absent any significant non-economic factors, it is the policy of the City that a refunding should produce minimum debt service savings of at least 3% of the par

### BEST PRACTICES



## Refunding Municipal Bonds

Issuers should include guidelines and criteria in their debt management policies that address when a refunding is permitted based on potential debt service savings or other criteria, preservation of future refunding flexibility when issuing any new money debt, and monitoring of refunding opportunities on outstanding debt.

# ANALYZING YOUR BREAK-EVEN

- Evaluating today's known savings vs potential future savings
- When evaluating a taxable advance refunding, it is helpful to calculate the break-even rate as compared to a future current refunding
- **Negative arbitrage** is the dollar cost of the escrow above what the dollar cost if invested at the arbitrage yield
- **Escrow efficiency** measures the relationship of this cost to the escrow relative savings

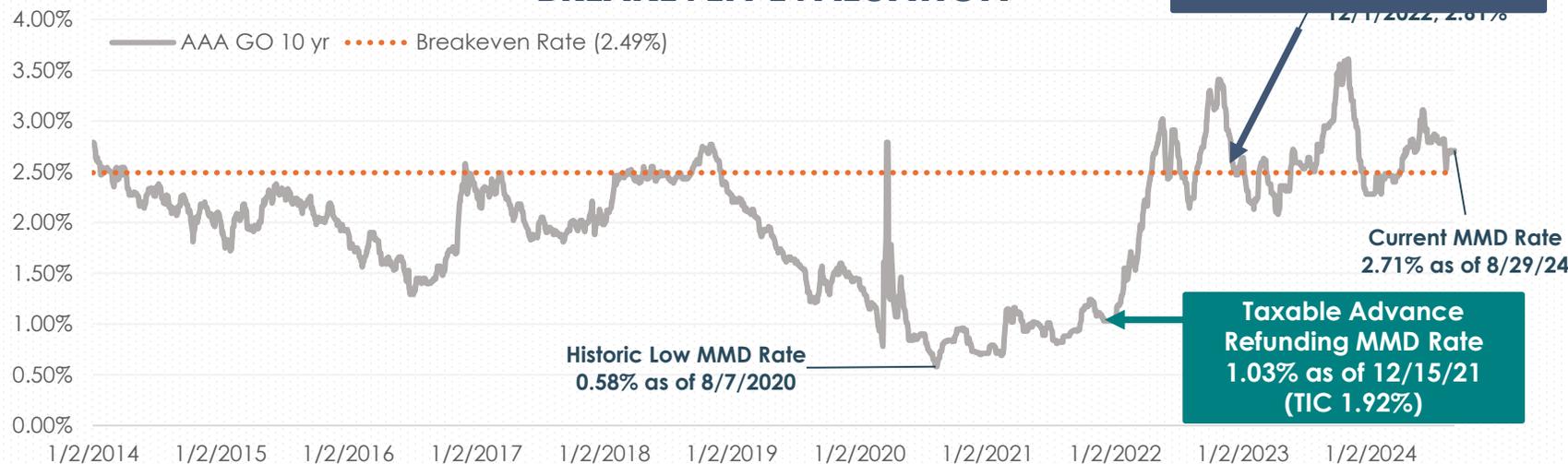
## SAMPLE ANALYSIS 2021:

	TAXABLE ADVANCE REFUNDING 12/15/2021	TAX-EXEMPT CURRENT REFUNDING 12/1/2022	BREAKEVEN ANALYSIS
<b>SUMMARY OF REFUNDING SAVINGS:</b>	<b>SEPTEMBER 2021 RATES</b>	<b>SEPTEMBER 2021 RATES</b>	<b>+156 BASIS POINTS</b>
True Interest Cost (TIC):	1.92%	0.93%	2.49%
Escrow Size	\$233,864,124	\$213,912,804	\$213,912,804
Negative Arbitrage	\$7,255,650	\$140,882	\$417,508
<b>Net Present Value (PV) Savings</b>	<b>\$31,221,695</b>	<b>\$49,548,834</b>	<b>\$31,154,833</b>
<b>% Savings of Refunded Bonds</b>	<b>14.7%</b>	<b>23.3%</b>	<b>14.6%</b>
<b>Escrow Efficiency</b>	<b>81.1%</b>	<b>99.7%</b>	<b>98.7%</b>

## ESCROW EFFICIENCY CALCULATION:

$$\begin{array}{ccccccc}
 \$31,221,695 & / & \$31,221,695 & + & \$7,255,650 & = & 81.1\% \\
 \text{NET PRESENT} & & \text{NET PRESENT} & & \text{NEGATIVE} & & \text{ESCROW} \\
 \text{VALUE SAVINGS} & & \text{VALUE SAVINGS} & & \text{ARBITRAGE} & & \text{EFFICIENCY}
 \end{array}$$

## BREAKEVEN EVALUATION



# MMA FINE TUNES POTENTIAL SAVINGS ON A REFUNDING

- When a partial refunding is possible, no need to refund maturities that don't meet goals

## MATURITY-BY-MATURITY REFUNDING MONITOR

REFUNDED MATURITY	REFUNDED COUPON	REFUNDED PAR	CALL DATE	CALL PRICE	ESCROW RATE	REFUNDING YIELD	REFUNDING PAR	NPV SAVINGS	SAVINGS AS % OF REFUNDED PAR	NEGATIVE ARBITRAGE	ESCROW EFFICIENCY
8/1/2025	4.00%	\$2,090,000	8/1/2024	100	1.32%	1.54%	\$2,222,072	\$28,223	1.35%	\$7,952	78%
8/1/2026	4.00%	2,440,000	8/1/2024	100	1.32%	1.77%	2,594,189	68,798	2.82%	18,930	78%
8/1/2027	3.00%	2,815,000	8/1/2024	100	1.32%	1.92%	2,936,953	38,995	1.39%	28,753	58%
8/1/2028	4.00%	3,185,000	8/1/2024	100	1.32%	2.07%	3,386,268	165,324	5.19%	41,038	80%
8/1/2029	4.00%	3,615,000	8/1/2024	100	1.32%	2.22%	3,843,440	212,836	5.89%	55,801	79%
8/1/2030	4.00%	4,070,000	8/1/2024	100	1.32%	2.18%	4,327,193	313,378	7.70%	60,056	84%
8/1/2031	4.00%	4,555,000	8/1/2024	100	1.32%	2.28%	4,842,841	381,061	8.37%	74,945	84%
8/1/2032	4.00%	5,080,000	8/1/2024	100	1.32%	2.38%	5,401,017	448,020	8.82%	92,188	83%
8/1/2033	4.00%	5,635,000	8/1/2024	100	1.32%	2.53%	5,991,089	482,587	8.56%	116,540	81%
8/1/2034	4.00%	6,225,000	8/1/2024	100	1.32%	2.68%	6,618,372	500,516	8.04%	144,467	78%
8/1/2039	4.00%	41,455,000	8/1/2024	100	1.32%	3.05%	44,074,639	2,500,909	6.03%	1,217,266	67%

# OTHER REFUNDING CONSIDERATIONS

## CASH FLOW RESTRUCTURE:

- Restructuring debt payments with a modified amortization schedule and/or repayment term can help issuers better align with annual cash flows.

## RISK REDUCTION:

- Refunding bonds can help to take advantage of enhanced credit profile and/or valuation if there has been improvement since the original issuance.
- Replacing variable-rate debt with fixed-rate debt.



## RATE MANAGEMENT:

- Front-loading savings can help to reduce and/or stabilize rates for escalating debt service.

## AMEND OR REMOVE RESTRICTIVE COVENANT:

- Onerous covenants may be revisited and potentially removed, particularly when replacing a short-term note with longer term debt.

# FORWARD DELIVERY REFUNDING

- Tax-exempt current refunding will always generate greater savings than taxable advance, all else equal... but waiting until near the call date entails risk of interest rates rising
- Forward delivery refunding is a middle-ground approach: locks in the bulk of the economics, at the expense of leaving a slice of potential savings on the table
  - » Refunding bonds are priced, locking-in savings, well ahead of the call date (e.g., a year)
  - » Bonds settle within 90 days of call date, allowing for tax-exempt status
  - » Pricing premium for delayed settlement -- typically ~5 bps per month between pricing and delivery but can vary
  - » A relatively short “forward” usually more favorable than issuing advance refunding bonds at taxable rates

- **Additional considerations:**

- » Some potential incremental effort (updating OS)
- » Savings begin only after the call date
- » Practical limit to how far ahead of the call date a forward is feasible

- If a forward is not feasible, more exotic strategies (e.g., "Cinderella" refunding) can accomplish similar objectives

## EXAMPLE: OPTIONS IN FALL 2024 FOR BONDS CALLABLE IN SUMMER 2025

	TAXABLE ADVANCE	T-E CURRENT*	T-E FORWARD
PRICE:	Oct 2024	May 2025	Oct 2024
SETTLE:	Nov 2024	May 2025	May 2025
CALL DATE:	Aug 2025	Aug 2025	Aug 2025
NPV SAVINGS:	\$8m / 10%	\$12m / 15%	\$10m / 12.5%

\* illustrative option in fall 2024

# TENDER OPTIONS

- **Refunding** is a financial process by which an issuer refinances outstanding bonds that have reached their first optional call date by issuing new bonds
  - » Gives the Issuer the right to retire all or part of the bonds before maturity at the **Issuer's discretion**
- **Tender** is an alternate financing process used to achieve issuer savings available to refinance bonds that have not reached their first optional call date to capture savings
  - » A tender gives bond holders the right to give back their bonds before maturity at the **investor's discretion**

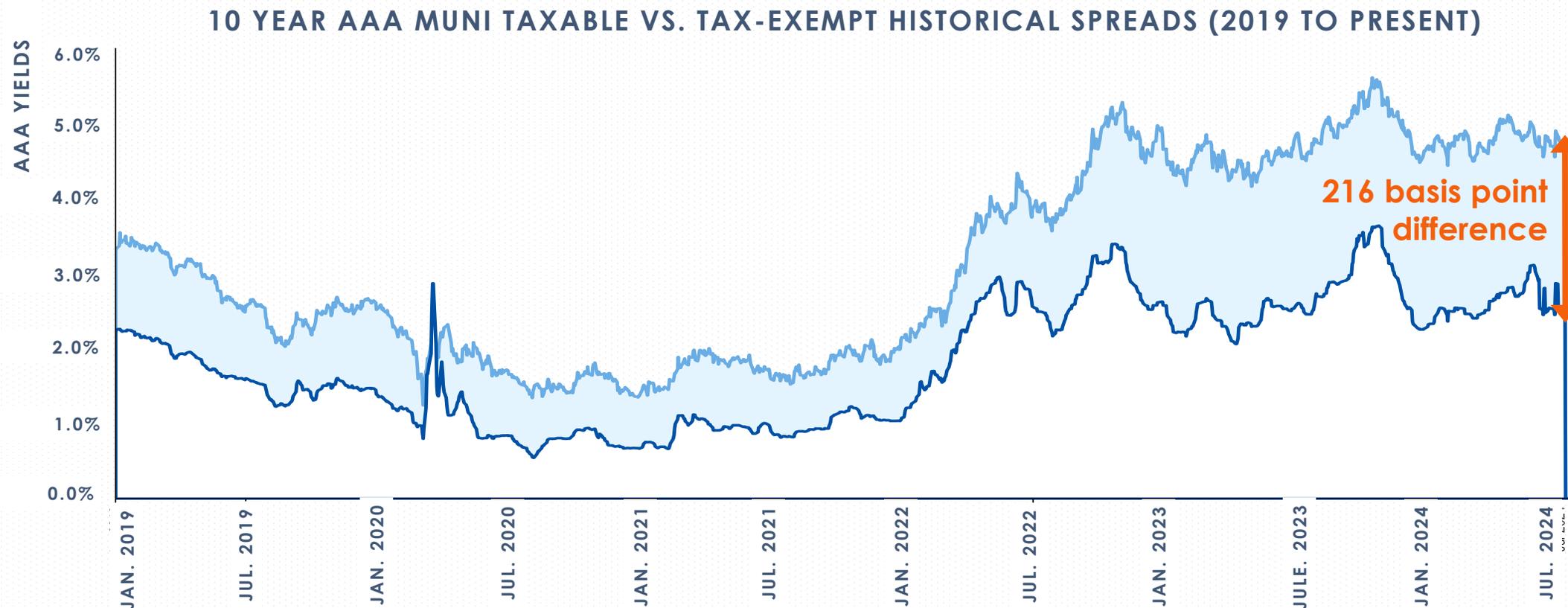
## TENDER MECHANICS

- **Issuer makes a public offer (through an investment bank) to Bond Holders (investors) to give up their bonds at a predetermined price in exchange for cash**
  - » High-interest rate environment incentive for investors to give up bonds to buy higher coupons
  - » Investor has the discretion to participate in a tender
  - » Issuer is in control of what bonds are ultimately accepted for refinancing (i.e., must meet a minimum savings threshold)
- **Issuer issues refunding bonds in connection with the tender process**
  - » To generate cash to pay investors for their bonds
- **Net result is taxpayer savings**
  - » Understanding holder types and investor motivations is key to generating high levels of participation



# TENDER MARKET DYNAMICS

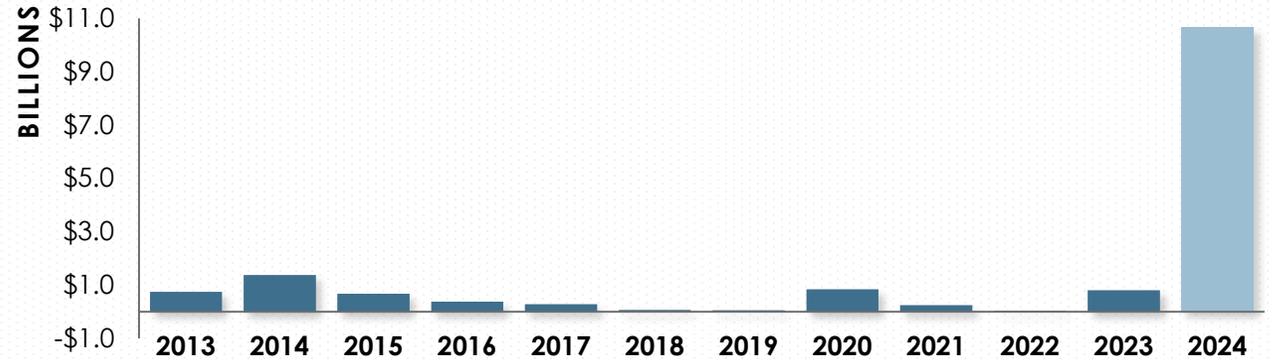
- This current opportunity to buy back debt at deep discounts, generate economic savings, and enhance optionality is market driven, with benefits and challenges changing over time
- Many investors who purchased bonds in previous low-interest rate environments have seen the value of their bonds decrease as interest rates have risen over the past two years



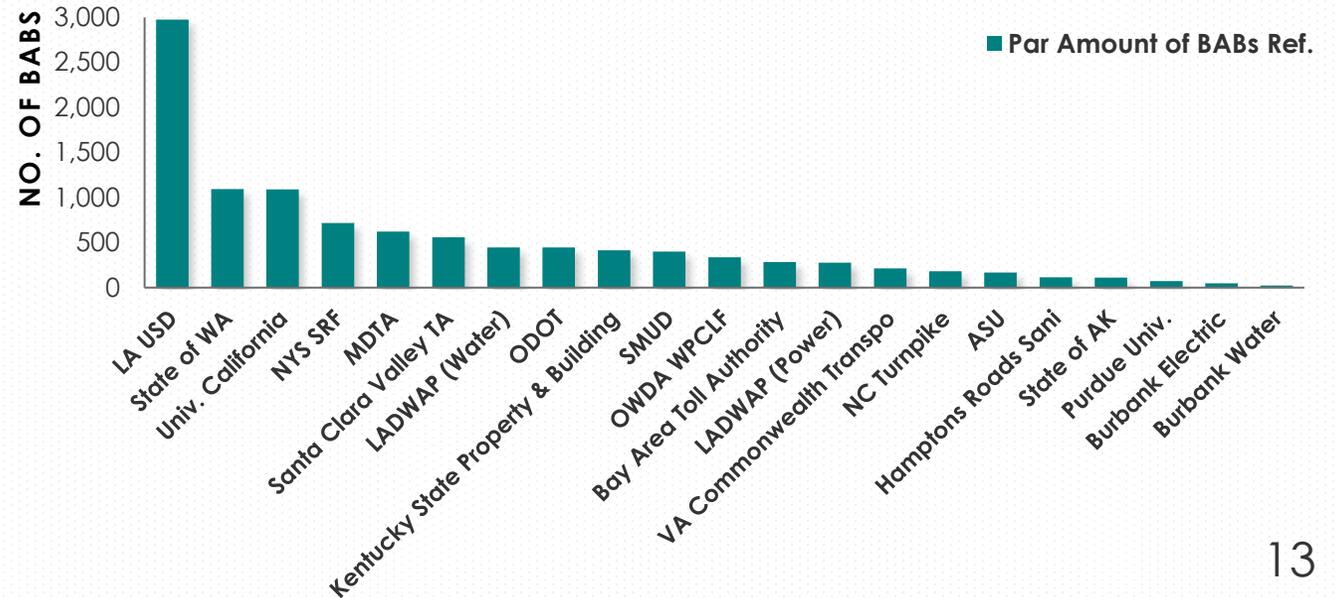
# BABS

- **Build America Bonds ("BABs") are taxable bonds subsidized by the Federal Government**
  - » Introduced in 2009 as part of the American Recovery and Reinvestment Act
  - » Bond program expired in 2010
  - » Most BABs were sold with a "make-whole redemption" language
  - » The primary benefit of refinancing BABs using the extraordinary redemption provision make-whole call is to eliminate future sequestration risk, not to achieve debt service savings
  - » Under current market conditions, high taxable rates have reduced the make whole call prices for taxable debt, and certain BABs can be refunded with tax-exempt bonds at a slight cost or even with some savings
  - » Saw a significant increase in BABs refundings in 2024

BAB REFUNDED PAR AMOUNT (\$B) SINCE ANNOUNCEMENT OF SEQUESTRATION



SOME OF THE LARGEST ISSUERS IN THE MUNI MARKET ARE REFUNDING OUTSTANDING BABS WITH MWC ERPS



# LEGAL CONSIDERATIONS

- Refunding is an issuance of new bonds (the refunding bonds) to pay debt service on a prior issue (the refunded bonds)
- Legal Authority:
  - » General Obligation refunding bonds are typically issued under Articles 9 and 11 of Chapter 3 of Part 1 of Division 2 of Title 5 of the Government Code
  - » Revenue refunding bonds are typically issued under Article 10 of Chapter 3 of Part 1 of Division 2 of Title 5 of the Government Code
- Purpose of a refunding is either to reduce the debt service on the financing or to remove or replace a restrictive covenant imposed by the terms of the refunded bonds (for example, an excessive coverage ratio)
- For accounting purposes, refunded bonds are not considered part of the issuer's outstanding debt because the refunded bonds are to be paid from the proceeds of the refunding bonds and not from the revenues originally pledged
- Refunded bonds may continue to hold a lien on the revenues originally pledged, however, unless the indenture or bond resolution provides for defeasance of the refunded bonds prior to maturity or redemption
- General rule is there must be savings

# CONCLUSION



- Remember that the option to call bonds has a value
- It can only be exercised once every ten years
- Use it wisely!!



- Question debt policy refunding targets
- Rules-of-thumb: they may not be well informed



- With the common use of 5% or higher coupons (premium bonds), municipal bond loans can be thought of as bullet loans (effectively "coming due" in ten years), but with an interest rate cap of 5% if you don't refund



- Approach refunding opportunities with caution
- Virtually everybody advising you regarding a refunding only makes money if you refund your bonds

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# QUESTIONS?



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