Why Issue Bonds and How to Issue Bonds

July 20, 2022

Robert Bendzinski
Bendzinski & Co. Municipal Finance Advisors

Patrick McGow
Miller, Canfield, Paddock and Stone, PLC
Part I – Why Issue Bonds?
Part II – How Do I Borrow Money?
Part III – How Do I Sell Bonds?
Part IV – Other Bond Things You Should Know
PART I – Why Issue Bonds
Should You Issue Bonds or Pay-as-you-Go?

**Advantages to Bonds**
- Complete projects sooner
- Avoid inflation Risks
- Draw greater attention from contractors or suppliers
- Keep cash on hand longer

**Advantages to PayGo**
- No interest costs
- Can change projects of capital improvement plan
- Less construction to administer each year
### SCHEDULE OF DEBT SERVICE REQUIREMENTS

**Rates as of August 6, 2020**

**On a Calendar Year Basis**

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal Due October 1</th>
<th>Interest Rate</th>
<th>Interest Due April 1</th>
<th>Interest Due October 1</th>
<th>Total Principal &amp; Interest Requirements</th>
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</thead>
<tbody>
<tr>
<td>2022</td>
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<td>$</td>
<td>$10,100</td>
<td>$10,100</td>
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<tr>
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**Total**

$1,000,000 $117,362 $127,462 $1,244,824

### Assumptions:

- **Bonds Dated:** 04/01/2022
- **First Interest Payment:** 10/01/2022
- **Number of Days:** 180
- **Subsequent Interest Payment:** 04/01/2023
- **Number of Days:** 180
- **First Principal Payment:** 04/01/2024
- **Projected Interest Rate:** 2.02%
### SCHEDULE OF DEBT SERVICE REQUIREMENTS

**Rates as of June 24, 2022**

On a Calendar Year Basis

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal Due October 1</th>
<th>Interest Rate</th>
<th>Interest Due April 1</th>
<th>Interest Due October 1</th>
<th>Total Principal &amp; Interest Requirements</th>
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</thead>
<tbody>
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<td>2022</td>
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<td>3.54%</td>
<td>$</td>
<td>$17,700</td>
<td>$17,700</td>
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<td>$17,700</td>
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<td>17,700</td>
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<tr>
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<td>16,992</td>
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<td>16,284</td>
<td>72,568</td>
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<td>15,576</td>
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<td>14,072</td>
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<td>13,275</td>
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<td>12,479</td>
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<td>2,478</td>
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<td>1,239</td>
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</table>

**Total**

$1,000,000  $212,666  $230,366  $1,443,031

### Assumptions:
- Bonds Dated: 04/01/2022
- First Interest Payment: 10/01/2022
- Number of Days: 180
- Subsequent Interest Payment: 04/01/2023
- Number of Days: 180
- First Principal Payment: 04/01/2024
- Projected Interest Rate: 3.54%
Interest Rate Comparison

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Principal &amp; Interest Requirements</th>
<th>Total Principal &amp; Interest Requirements</th>
<th>Additional Interest Costs</th>
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<td>2022</td>
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<td>15,200</td>
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<td>10,200</td>
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<tr>
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Total: $1,443,031  $1,244,824  $198,207

Based on the Bond Buyer 20 Bond Index on August 6, 2020 of 2.02% compared to the Bond Buyer 20 Bond Index on June 24, 2022.
# Pay As You Versus Bonding

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal Due</th>
<th>Interest Rate</th>
<th>Interest Due April 1</th>
<th>Interest Due October 1</th>
<th>Total Principal &amp; Interest Requirements</th>
<th>Cash Contribution</th>
<th>Balance After Paying Debt Service</th>
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<td>$ 17,700</td>
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<td>$ 73,806</td>
<td>0</td>
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</tr>
</tbody>
</table>

| $1,000,000 | $ 212,666 | $ 230,366 | $ 1,443,031 | $1,000,000 |

**Assumptions:**
- Bonds Dated: 04/01/2022
- First Interest Payment: 10/01/2022
- Number of Days: 180
- Subsequent Interest Payment: 04/01/2023
- Number of Days: 180
- First Principal Payment: 04/01/2024
- Projected Interest Rate: 3.54%
What’s Going on with Interest Rates?
Historical Trend of Interest Rates

20 Year - Bond Buyer GO Index

0.00%  2.00%  4.00%  6.00%  8.00%  10.00%  12.00%  14.00%  16.00%

01/01/1980 01/01/1981 01/01/1982 01/01/1983 01/01/1984 01/01/1985 01/01/1986 01/01/1987 01/01/1988 01/01/1989 01/01/1990 01/01/1991 01/01/1992 01/01/1993 01/01/1994 01/01/1995 01/01/1996 01/01/1997 01/01/1998 01/01/1999 01/01/2000 01/01/2001 01/01/2002 01/01/2003 01/01/2004 01/01/2005 01/01/2006 01/01/2007 01/01/2008 01/01/2009 01/01/2010 01/01/2011 01/01/2012 01/01/2013 01/01/2014 01/01/2015 01/01/2016 01/01/2017 01/01/2018 01/01/2019 01/01/2020 01/01/2021 01/01/2022 01/01/2023 01/01/2024 01/01/2025 01/01/2026 01/01/2027 01/01/2028 01/01/2029 01/01/2030 01/01/2031 01/01/2032 01/01/2033 01/01/2034 01/01/2035 01/01/2036 01/01/2037 01/01/2038 01/01/2039 01/01/2040 01/01/2041 01/01/2042 01/01/2043 01/01/2044 01/01/2045 01/01/2046 01/01/2047 01/01/2048 01/01/2049 01/01/2050 01/01/2051 01/01/2052 01/01/2053 01/01/2054 01/01/2055 01/01/2056 01/01/2057 01/01/2058 01/01/2059 01/01/2060

13.44%  2.02%
Part II – How Do I Borrow Money?
Can we just go **borrow** money from the bank?

- **Dillon’s Rule**
  - A municipality may only exercise those powers expressly granted, necessarily implied, or which are essential — not simply convenient, but indispensable.

- **Revised Municipal Finance Act, Public Act 34 of 2001**
  - [a] municipality shall not issue a municipal security except in accordance with this act."
  
  “Security” means “an evidence of debt such as a …contract, obligation…or other similar instrument issued by a municipality, which pledges payment of the debt by the municipality from an identified source of revenue.”
How does a Municipality borrow money?

- Municipal Bonds
- Installment Purchase Agreements
What is Not Allowed?

1. Lines of Credit (except School Districts)
2. Mortgages *
3. Commercial Bank Loans or Promissory Notes

But... A local bank can buy the municipality’s municipal bonds or installment purchase agreements.
YES - several statutes authorize the issuance of bonds after a notice and referendum process.

1. Municipality adopts Resolution of Intent to Issue Bonds.
2. Notice to Electors is published in the local newspaper as a ¼ page advertisement.
3. Referendum period expires 45 days after publication.
4. Municipality may issue bonds unless petitions signed by 10% of registered voters is filed within the 45-day period.
What is a Municipal Bond?

- A written promise to pay
- Issued by a state or local government
- Typically repaid over a period of 1 to 40 years
- May be tax-exempt to investors for certain public projects
WHY?

- So … why can’t we just go borrow the money?
- Why do we need to jump through all these hoops?
Blame the Railroads!
What’s in the Capital Improvement Program that needs financing?
- How much to borrow?
- What is the source of funds for repayment?
- Submit to voters at an election or not?
- How long do we need to repay the debt?
- What tool is right for the job?
THE DEBT TOOLBOX
Municipal Bonds – Different types for various needs

- Voted Unlimited Tax General Obligation Bonds
- Capital Improvement Bonds
- Installment Purchase Agreements
- Special Assessment Bonds
- Revenue System Bonds
- Contract (Authority or County-issued) Bonds
- Cash Flow (Tax Anticipation) Notes
- Pension/OPEB Bonds
- Refunding Bonds
The Security for a Bond May Be Different than the Source of Repayment

Sources of Repayment:

- **Taxes**
  - General Operating Taxes
  - Special Voted Millages
  - Voted Debt Millage
- **Rates and Charges from System Users**
- **Special Assessments**
- **Tax Increment Revenues**
- **Act 51 Gas and Weight Taxes**
Main Categories of Municipal Bonds

General Obligation Bonds:
- Backed by the full faith and credit taxing power of municipality
  - Limited tax (not voted)
  - Unlimited tax (voted)
- Municipality may use various sources of revenues to repay debt

Revenue Bonds:
- Paid by identified revenues, usually user rates, charges, fees, etc
- Not approved by voters
- Generally not considered a debt of the municipality’s General Fund
- Often require the funding of a Debt Service Reserve Fund
- Usually require rate covenant or coverage ratios
Public Act 116 of 1923

- **Unlimited Tax**
  - Voter approved
  - Levy debt millage at rate necessary to pay principal and interest on the bonds
  - Issued to finance roads, city hall, library, fire station or other public buildings
Public Act 99 of 1933 – Purchase of Lands and Property for Public Purposes Act

- Financing Real or Personal Property
  - Real Property
    - Land or Buildings
  - Personal Property
    - Fire trucks, police cars, water meters, copy machines, or other equipment
- No notices or referendum required
- Maximum term of 15 years for city, village or township
- Maximum term of 10 years for counties
- Debt limit: 1 ¼% of Issuer’s taxable value
Acts 119-123 of 2016

- Financing for Energy Conservation Improvements only
- Municipality can pledge the financed assets
- Does not count as debt
- Subject to annual appropriation
- Hazards
  - Underlying ESCo contract
  - ESCo/bank control of the process
  - Call your finance team!!
Capital Improvement Bonds

Public Act 34 of 2001 – Revised Municipal Finance Act

- Finance cost of any capital improvement item

- Limited tax
  - Cannot increase taxes above maximum rate
  - Paid from existing tax and/or revenue sources
  - Notice and referendum period

- Debt Limit: 5% of Municipality’s SEV
Special Assessment Bonds

Act 188 of 1954 – Township Public Improvements Act OR City Charter (Act 279 of 1909 - Home Rule City Act)

- Finances various public improvements supported by special assessments (roads, water, sewer, etc.)
- Principal and interest on the bonds is paid from annual special assessment collections
- Special assessment roll is pledged as security for the bonds
- Municipality may also pledge its full faith and credit as additional security
Revenue Bonds

Public Act 94 of 1933 – Revenue Bond Act

- Issued to finance self-supporting public improvements
  - Principal and inteWater and sewer systems
  - Garbage and refuse disposal facilities
  - Electric and gas utilities
  - Cable television systems
- Principal and interest on the bonds is paid from revenues of the system
- Generally not considered a debt of the Municipality’s general fund
- Rates and charges must be set at an amount sufficient to pay at least 100% of operation, maintenance and debt service
Public Act 34 of 2001 – Revised Municipal Finance Act

- Cash flow borrowing to provide funds for expenses incurred prior to collection of sufficient tax receipts
- Short term (1 year or less) borrowing
- No notice or referendum required
- Borrowing amount limited based on budgeted property tax revenue

- Act allows local governments to issue bonds to pay all or part of the costs of certain retirement programs
- Bonds can be used to pay for unfunded pension liability OR unfunded accrued health care liability
- The local unit must prepare and approve a Comprehensive Financial Plan as part of the bond issuance process
- Many technical procedural requirements and structuring requirements mandated by law
- The legislation, as amended, currently sunsets December 2023
Pension Bonds
• Must be in connection with closure of the Defined Benefit Plan to new or existing employees and implementation of a Defined Contribution Plan
• Bond size cannot exceed the difference between 95% of the actuarial value of liabilities and 100% of the actuarial or market value of assets for that retirement program
• Net present value savings of at least 15% required

OPEB Bonds
• Must be in connection with closure of a postemployment healthcare plan to new employees or where it has already been closed
• Bond size cannot exceed the difference between 60% of the actuarial value of liabilities and 100% of the actuarial or market value of assets of the costs of the unfunded accrued health care liability
• Net present value savings of at least 20% required
OPEB/Pension Bonds

- Net present value savings between the actuarially determined amortization payments at the plan's investment rate of return and the bond's debt service requirements at the time of issuance, shall be at least:
  - 15% of the par amount of a proposed municipal security for Pension Bonds,
  - or 20% of the par amount of a proposed municipal security for OPEB Bonds

- Level debt service required

- No capitalized interest

- No prior Unfunded Actuarially Accrued Liability Payments

- The local unit must prepare and approve a Comprehensive Financial Plan as part of the bond issuance process

- The legislation, as amended, currently sunsets December 2023
Refunding Bonds (Refinancing)

- Refunding Bonds are the issuance of new bonds at lower interest rates to replace bonds currently outstanding at higher rates to achieve debt service savings.

- Refunding Bonds can also be issued to restructure the payments on existing bonds.

- What makes a Refunding Work
  - Lower interest rates; or
  - Higher short-term investment rates; or
  - Passage of Time (redemption provisions & yield curve)
**Refunding Bonds (Refinancing)**

- **Current Refunding** – refunding bonds are issued less than 90 days before the call date on the Bonds To Be Refunded (can be tax-exempt)

- **Advance Refunding** – refunding bonds are issued more than 90 days before the call date on the Bonds to Be Refunded (currently, cannot be tax-exempt, have seen Taxable Advance Refundings in prior years when interest rates were lower)
Overall Debt Limits

- City/County/Village/Charter Township
  - 10% of SEV

- General Law Township
  - No statutory limit

- Exceptions for City, Village, Charter Township:
  - Revenue Bonds
  - Special Assessment bonds
  - Michigan Transportation Fund Bonds
  - Court Ordered, or EGLE-Ordered Bonds
  - Bonds to Protect Public Health by Abating Pollution
  - CSO Abatement Bonds
Debt Limit for Certain Borrowings

- Capital Improvement Bonds
  - 5% of SEV

- Special Assessment Bonds
  - 3% SEV in any year; 12% SEV overall

- Installment Purchase Agreements
  - 1 ¼% of Taxable Value

- Revenue Bonds
  - No debt limit; but practical limit is Net Revenues sufficient to pay Bonds
Who Should Issue the Bonds?

- **Municipality**
  - Using one of the prior Bond statutes

- **County**
  - Public Works, County Agency, Drain Commissioner

- **Authority**
  - Act 233 Water and Sewer Authority
  - Other TIF Authority or Special Purpose Authority
County Issued Bonds

Public Act 185 of 1957 – County Department and Board of Public Works Act

Public Act 342 of 1939 – County Public Improvement Act

Public Act 40 of 1956 – The Drain Code of 1956

Mechanisms for Local Units of Government to finance certain improvements through County.

- County/Local Unit enter into contract
- County issues bonds to acquire and construct public improvement
- LUG pays county semi-annually pursuant to contract; county in turn pays principal and interest on the bonds
Act 233 of 1955 – Municipal Sewage and Water Supply Systems

- Two or more local units create a municipal authority to own or finance sewage disposal systems, water supply systems and solid waste management systems

- Authority/Local Unit enter into contract

- Authority issues bonds to acquire and construct project

- Local Unit pledges limited tax full faith and credit; Local Unit pays Authority semi-annually pursuant to contract; Authority pays principal and interest on bonds
Placement With Federal Or State Government

- **USDA Rural Development**
  - Federal lending/grant program for rural communities
  - “Lender of last resort” concept
  - 40 year financing with low interest rate

- **EGLE / Michigan Finance Authority (SRF/DWRF/SQWIF)**
  - Coordination between engineering plan and finance plan is required
  - Investment grade rating or equivalent is required
  - Must still issue “bonds” and follow statutory procedure
  - 20/30 year financings with low interest rates
  - Frequently revenue bond structure
    - Can be junior lien
    - Can pledge distributable aid to enhance credit
Part III – How Do I Sell Bonds?
THE TEAM
The Financing Team

**Bond Counsel**

- Provides an expert opinion with respect to the legality of the transaction, enforceability of the issuer’s obligation, and the tax-exempt nature of the interest paid on the bonds (no prospective purchaser will buy the bonds without an approving opinion of bond counsel).

- Prepares the authorizing documents
  - Resolutions, notice of intent, competitive sale notice, and the bonds

- Assists in the planning and structuring of the financing, superintends details of the sale of the bonds, assists participants to the transaction (issuer, municipal advisor, underwriter)
Registered Municipal Advisor

- In order to comply with rules and regulations set forth by the MSRB and the SEC including but not limited to:

  • Provide an explicit fiduciary responsibility solely to the Issuer;
  • Dealing fairly with all persons;
  • Will not engage in any deceptive, dishonest or unfair practices;
  • Provide a duty of loyalty and care to the Issuer; and
  • Make recommendations that are solely in the best interest of the Issuer.
THE BOND SALE
Public Sale - Two Methods

- **Competitive Sale**
  - Bond sale bids received on a certain time and date
  - Sale is open to all bidders with lowest true interest cost winning

- **Negotiated Sale**
  - Underwriter is selected prior to sale
  - Underwriter offers bonds for sale to investors and obtains market rates from orders
  - Allows for more discussion about issue prior to sale
  - Flexibility on sale date and time if market conditions change
Direct Placement to Banks

- Request for Proposals
- Single institution purchases bonds for its own portfolio
  - Sophisticated investor (Qualified Institutional Buyer)
  - “Big boy” letter
  - Restrictions on transfer
- Usually “Qualified Tax Exempt” (QTE) bonds
- Generally 1 interest rate on all Bonds
- Lower issuance costs than a public offering
- Banks prefer shorter duration
- Still a negotiated sale for state law purposes
- Security and basic bond features are the same as traditional negotiated/competitive; same legal authority.
A rating is required by Act 34 for any bond issue over $5 Million

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<th>S&amp;P</th>
<th>Moody’s</th>
<th>Fitch</th>
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Ratings modifiers: S&P and Fitch use “+” or “-” Moody’s uses numbers 1, 2, or 3
# Moody’s Scorecard

## Scorecard Factors and Weights

### Local Governments

<table>
<thead>
<tr>
<th>Broad Scorecard Factors</th>
<th>Factor Weighting</th>
<th>Sub-factors</th>
<th>Sub-factor Weighting</th>
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<tr>
<td>Economy/Tax Base</td>
<td>30%</td>
<td>Tax Base Size (full value)</td>
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<td>Full Value Per Capita</td>
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<td>Wealth (median family income)</td>
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<td>Finances</td>
<td>30%</td>
<td>Fund Balance (% of revenues)</td>
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<td>Fund Balance Trend (5-year change)</td>
<td>5%</td>
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<tr>
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<td>Cash Balance (% of revenues)</td>
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<td>Cash Balance Trend (5-year change)</td>
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<tr>
<td>Management</td>
<td>20%</td>
<td>Institutional Framework</td>
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<td>Operating History</td>
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<td>Debt/Pensions</td>
<td>20%</td>
<td>Debt to Full Value</td>
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<td>Debt to Revenue</td>
<td>5%</td>
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<td>Moody's-adjusted Net Pension Liability (3-year average) to Full Value</td>
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<tr>
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<td></td>
<td>Moody's-adjusted Net Pension Liability (3-year average) to Revenue</td>
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</table>

*Source: Moody’s Investor Service*
Chart 1: Analytical Framework For Local GO Ratings

| Criteria | U.S. Public Finance: U.S. Local Governments General Obligation Ratings: Methodology And Assumptions |

- **Institutional Framework**: 10%
- **Economy**: 30%
- **Management**: 20%
- **Financial Measures**
  - **Liquidity**: 10%
  - **Budgetary Performance**: 10%
  - **Budgetary Flexibility**: 10%
- **Debt & Contingent Liabilities**: 10%

**Indicative Rating**

**Positive Overriding Factors**
- High income levels (one- or two-notch adjustment)
- Sustained high fund balances (one-notch adjustment)

**Negative Overriding Factors**
- Low market value per capita (one-notch adjustment)
- Low nominal fund balance (one-notch adjustment)
- Weak liquidity (caps rating at 'BBB+' or 'BBB-')
- Weak management (caps rating at 'A' or 'BBB-')
- Lack of willingness to pay obligations (caps rating at 'BBB-' for leases and 'B' for debt)
- Large or chronic negative fund balances (caps rating at 'A+', 'A-', or 'BBB')
- Budgetary flexibility score of '5' (caps rating at 'A+')
- Structural imbalance (caps rating at 'BBB+')

**Potential one-notch adjustment (but not higher than cap)**

**Final Rating**

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Part IV – What Else Do I Need to Know
FEDERAL REGULATORS

- Securities and Exchange Commission (SEC)
- Internal Revenue Service (IRS)
Municipal Bonds are not subject to Direct Regulation by the SEC (Tower Amendment- 1977)
  – No Registration Requirements
  – Subject to Antifraud Rules

Also subject to Indirect Regulation
  – Rule 15c2-12

SEC Enforcement Actions
Rule 15c2-12 Disclosure

During Issuance of Bonds
- Preparation of Official Statement with financial information
- Applies to public sale of bonds over $1,000,000

After Issuance of Bonds
- Continuing Disclosure Undertaking
  - Annual Filings of Financial Audit and Updated Financial Information
  - Filing for Material Events
Tax Exempt Bonds – Congress’ “Gift” to State and Local Units of Government

**General Rule:** Tax-Exempt Bond-Financed Assets must be:
- Owned and operated by a governmental entity; and
- Used for a public purpose
Private Use/Change in Use

- The tax exemption on bonds depends upon the use of the assets that are bond-financed
- No private business use arrangement with private entity beyond permitted *de minimis* amount (e.g. ownership, leases, management contracts, other beneficial use arrangements)
- Private business use means use in a trade or business carried on by any person other than an exempt entity for its exempt purpose
- An exempt entity is any state or local governmental entity (501(c)(3) entities are not exempt entities)
- Exceptions
  - General Public Use
  - Short Term Use
  - Incidental Use
  - Safe Harbors – Management Contracts
What is Arbitrage?
- Earning more interest from your bond proceeds than the interest you are paying on the bonds
- Requirement to pay rebate every five years after date of issuance if there is Arbitrage (maybe)

Rebate Exceptions
- Under certain circumstances you may be able to keep the extra interest earned
  - Small Issuer exception (issue less than $5 million in a year)
  - Six month exception (Spend 100% in 6 months)
  - 18 month exception (15% in 6 months, 60% in 12 months, 100% in 18 months)
  - 24 month exception (10%, 45%, 75% & 100% in 6, 12, 18 & 24 months)
Questions? Thank you!

Patrick McGow
Principal and Practice Group Leader
Miller Canfield
Phone: 313-496-7684
Email: mcgow@millercanfield.com

Robert J. Bendzinski
CIPMA, President
Bendzinski & Co.
Phone: (313) 961-8222
Email: rbendzinski@bendzinski.com