A Preliminary Review of the Initial Disclosure Practices of California's Conduit Borrowers

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CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

The California Debt and Investment Advisory Commission (CDIAC) provides information, education, and technical assistance on debt issuance and public fund investments to local public agencies and other public finance professionals. CDIAC was created to serve as the state's clearinghouse for public debt issuance information and to assist state and local agencies with the monitoring, issuance, and management of public debt.

Additional information concerning this report or CDIAC programs may be obtained by contacting CDIAC directly via phone (916) 653-3269, fax (916) 654-7440, e-mail (cdiac@treasurer.ca.gov) or by visiting CDIAC's website: www.treasurer.ca.gov/cdiac.

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INTRODUCTION

Federal securities laws are designed to facilitate transparency in the municipal market and ensure that issuers are providing timely and accurate information to investors not only at the time of issuance but through the life of the bonds. To gain an understanding of the disclosure practices of conduit issuers, the California Debt and Investment Advisory Commission (CDIAC) conducted a content analysis of official statements (OSs) supporting the marketing of conduit bonds issued in California between January 1, 2009 and November 1, 2014.

Generally, information disclosed prior to the sale of conduit bonds includes financial and operating data, including the financing plan for the project(s), outstanding debt, and projected revenue. Initial disclosures may also inform investors of risks outside of the financial and operating data that affects a project's viability. CDIAC identified several of these risks that were applicable across all sectors of conduit issuance and deemed them "inter-sector risks." For example, the tax-exempt status of the bond and, more specifically, the factors that influence the bond's future taxability is a risk applicable to all conduit bonds. CDIAC also identified risks that varied from sector to sector and deemed them "sector-specific" risks. For example, issuers of school bonds may disclose pending legislation that may reduce revenues and, thus, their ability to meet debt service obligations.

The standard of disclosure for all issuers is set forth in Section 17(a) of the Securities Act of 1933 and Rule 10b of the Securities and Exchange Act of 1934 (collectively the "anti-fraud provisions") and Rule 15c2-12 of the Securities and Exchange Act of 1934 (initial and continuing disclosure). Yet, as the study reveals, initial disclosures made by conduit issuers vary significantly in form and content. CDIAC found that issuers presented information concerning bondholder risks differently and issuers in one sector did not regularly discuss bondholder risks in the OS. Finally, risks specific to a sector were addressed differently across topics and over time. Risk discussions contained in the OSs of healthcare conduit issuers, for example, became increasingly quantitative from 2009 to 2014 as more information on the impact of the Patient Protection and Affordable Care Act (ACA)[1] became available.

This study is the first of its kind to take a holistic view of conduit disclosure. Because of the scope of the analysis, covering 275 OSs, it provides an understanding of differences between initial disclosure practices of conduit issuers. As a result, it helps to articulate additional questions that must be addressed to determine whether these differences are justified. The differences may be a function of issue specific factors or accepted issuer practices, or they may reveal weaknesses in the form and content of market disclosures. If it is the latter, this study and any follow-on studies may result in improved practices that ensure investors have the information they require to make informed investment decisions.

Due to the lack of guidance on the appropriate level of disclosure of industry risks, the study does not assess the quality or completeness of the OSs or espouse best practices for disclosure of such risks. Rather, by analyzing the content of OSs the study uncovers common disclosure practices among conduit issuers, both within and between industry sectors. Specifically, the study sheds light on what conduit issuers deem to be "disclosable" risks and how these risks are disclosed over time.

[1] 42 U.S.C. § 18001 et. seq. (2010).

DISCLOSURE REQUIREMENTS OF ISSUERS

The purpose of disclosure is to provide investors with sufficient information to make an informed choice as to whether to purchase the security. Issuers and borrowers of municipal securities must disclose financial and industry information to investors in compliance with federal securities regulations. The Securities Act of 1933, Section 17(a) and the Securities and Exchange Act of 1934 Rule 10b are the anti-fraud provisions applicable to the purchase and sale of municipal securities. Under the anti-fraud provisions, issuers cannot make material misstatements or material omissions of facts in offering documents provided to investors. Rule 10b-5 also extends the anti-fraud provisions to any statements made by the issuer to the municipal market.[2] Additionally, Securities and Exchange Act of 1934 Rule 15c2-12 indirectly obligates issuers to provide initial and continuing disclosure.

Initial disclosure takes the form of preliminary official statements (POSs) and OSs that are presented to investors with the bond offering. The POS is prepared by a financing team and approved by the governing board of the issuer. Generally, the OS varies only slightly from the preliminary version but for the inclusion of final pricing and financing information. The OS must contain the issuer's (or borrower's) statements about its financial condition, the terms of the securities, details about the project or program to be financed, and the sources of repayment. Additionally, the OS should explain significant risks that are likely to affect the specific sector of issuance and the particular bond at issue. Securities regulations place emphasis on materiality – if there is a substantial likelihood that a fact would be significant to a reasonable investor, it must be disclosed. Effective July 1, 2009, the Municipal Securities Rulemaking Board (MSRB) became the sole repository for filing initial and continuing disclosure information. This information is uploaded and maintained in MSRB's searchable online database, Electronic Municipal Market Access (EMMA).

Continuing disclosure is comprised of annual reports and material events notices. According to Rule 15c2-12, an underwriter may not purchase or sell a primary offering of securities unless the issuer or borrower undertakes to provide continuing disclosure. This agreement is regularly memorialized as a covenant in the OS. The annual report consists of the issuer's financial and operating data. Material events notices are filed as specified events occur, such as bond payment delinquencies or rating changes. Rule 15c2-12 delineates the events which require the issuer or borrower to file a material events notice. Voluntary disclosure outside of the formal requirements is subject to the same anti-fraud standard.

While the SEC has not mandated the content of disclosure documents, there are resources available to issuers that provide guidance. Professional organizations and self-regulatory agencies have published guidelines and best practices regarding disclosure for use by municipal entities.[3] Some publications provide further guidance in disclosure practices for certain kinds of issues. For instance, the National Federation of Municipal Analysts (NFMA) has published recommended best practices in disclosure for housing revenue bonds and hospital debt transactions.[4]

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2 This includes any information provided outside of the offering documents. For instance, any information provided on an issuer's website relating to its financial viability or speeches made by public officials in the absence of regularly reported disclosure documents.

3 *See, e.g.*, Robert Dean Pope (GFOA), Making Good Disclosure: The Roles and Responsibilities of State and Local Officials Under the Federal Securities Laws (2001); Orrick, Herrington & Sutcliffe LLP, Disclosure Obligations of Issuers of Municipal Securities (2011); Municipal Securities Rulemaking Board (MSRB), The Conduit Issuer's Guide to Continuing Disclosures (2013).

These resources prescribe the specific information that is relevant to a reasonable investor. In particular, the disclosure guidelines published by the NFMA offer detailed guidance on the financial and operating data that should be provided as well as appendixed checklists that offer a consolidated presentation of that guidance.

Although the SEC has taken note of these resources, it has neither affirmed nor disclaimed them as definitive guides of appropriate disclosure content.[5] In the absence of declarative guidance, the SEC enforcement actions against municipal issuers for violations of disclosure requirements illuminate what practices are insufficient to meet those requirements. Recent actions reveal that an issuer's failure to disclose adequate financial information, particularly financial and operating information that may negatively affect the pricing of the bond issue, may expose it to liability for violating securities law. For instance, including misleading statements about solvency or failing to disclose liabilities in offering documents may constitute fraud.[6]

These measures were used to inform our review and analysis of the initial disclosure documents provided by issuers to the municipal market. However, neither the best practices publications nor the SEC enforcement actions provide much guidance on whether and to what extent industry risks should be disclosed. The lack of guidance on this subject may account for the non-uniformity of information provided in disclosure documents. Yet CDIAC's content analysis of initial disclosure documents does reveal some common practices.

STUDY APPROACH

To better understand conduit disclosure practices, CDIAC undertook a preliminary analysis of OSs associated with the sale of conduit revenue bonds in California between January 1, 2009 and November 1, 2014. Conduit revenue bonds are municipal bonds issued by a governmental agency whose proceeds are loaned to a borrower for purposes that are permitted for qualified private activities.[7] Generally, the purpose of conduit issuance is to allow private entities to finance projects with the same tax-exempt benefits of public agencies. Conduit authorities, such as the California Health Facilities Financing Authority (CHFFA), California Infrastructure and Economic Development Bank (I-Bank), and the California Statewide Communities Development Authority (CSCDA), assist private borrowers in financing facilities and projects that provide a public service or benefit. Conduit revenue bonds are limited obligations of the issuer payable exclusively by the borrower under a loan agreement. It is the issuer, however, that is responsible for preparing the OS.

In its analysis CDIAC identified six major sectors of conduit financing: (1) healthcare, (2) higher education, (3) K-12 education, (4) housing, (5) pollution control, and (6) theatres, museums, and the arts, including conduit revenue bonds issued by Industrial Development Authorities (IDAs),

[4] National Federation of Municipal Analysts (NFMA), Recommended Best Practices in Disclosure for Housing Revenue Bonds (2013); NFMA, Recommended Best Practices in Disclosure for Hospital Debt Transactions (2012). Additionally, the NFMA published disclosure guidelines in the early 2000s that offer guidance on higher education financings and certain pollution control financings: NFMA, Recommended Best Practices in Disclosure for Private College and University Transactions (2001) and NFMA, Recommended Best Practices in Disclosure for Solid Waste Transactions (2001).

[5] U.S. Securities and Exchange Commission, Report on the Municipal Securities Market (2012).

[6] In *SEC v. City of Miami, Florida et al.*, Case No. 1:13-cv-22600-CMA (July 19, 2013), the SEC charged the City of Miami with securities fraud for misleading investors about interfund transfers reflecting on the city's solvency. In *SEC v. State of Kansas*, Admin. File No. 3-16009 (Aug. 11, 2014) and *SEC v. State of New Jersey*, Admin. File No. 3-14009 (Aug. 18. 2010) the SEC asserted that failing to disclose unfunded pension liabilities constituted securities fraud. Additionally, the SEC filed an enforcement action against an issuer for using inflated property values to secure bonds on more favorable terms. *SEC v. City of Victorville*, et al., Case No. EDCV13-0776 (Apr. 29, 2013).

[7] March 2012 Debt Line, *Conduit Revenue Bond Spotlight*.

Joint Powers Authorities (JPAs), and State of California issuing agencies.[8] Private placements and direct loans were excluded from the study as these are not accompanied by disclosure documents such as an OS.[9] In the course of the study CDIAC noted great variance in the disclosures made by issuers carrying out a refunding, with many OSs containing little information on bondholder's risks. Therefore, CDIAC elected to exclude refundings from the analysis. Only OSs associated with new money issuance were reviewed.

Using these criteria, CDIAC identified 334 new bond issues to review. Of these, 32 were for higher education, 53 for K-12 education, 88 for healthcare, 130 for housing, and 31 for pollution control. The art sector, however, contained only two new money issues that met the selection criteria. As a result, CDIAC chose to drop these issues from the analysis. To produce a statistically significant sample, CDIAC randomly reviewed OSs from 275 issues distributed between the higher education, K-12 education, healthcare, housing, and pollution control sectors.[10] This sampling method allows the results to be projected to the population of all 334 new conduit issuances during the nearly six year period. Figure 1 shows the total number of issues and sample size by sector. Figure 2 shows the makeup of the reviewed sample by sector.

CDIAC employed "content analysis" in its review of OSs to determine:

- Whether conduit issuers addressed bondholder risks in their offering documents;
- The extent to which they focused on these risks in contrast to other topics presented in the OS;
- Whether there are common inter-sector risks in the OSs of conduit bond issuers;

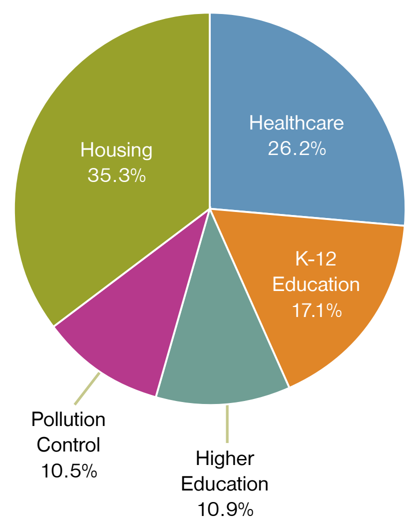
Figure 1

REVIEWED SAMPLE GROUP SIZE BY SECTOR

SECTOR OF ISSUANCE	TOTAL	SAMPLE SIZE
Higher Education	32	30
K-12 Education	53	47
Healthcare	88	72
Housing	130	97
Pollution Control	31	29
TOTAL	334	275

Figure 2

REVIEWED SAMPLE GROUP PERCENTAGE BY SECTOR



[8] Other projects may be financed through the conduit process, including airports, industrial development facilities, and power generation and transmission facilities.

[9] Private placements and direct loans are not subject to the same disclosure rules as traditionally financed bonds.

[10] The sample produced a confidence level of 95 percent with a margin of error of plus or minus 5 percent. This means that 95 times out of 100 the sample CDIAC selected from all issuers will fall within a confidence interval of plus or minus 5 percent.

- The extent to which issuers in the different sectors addressed these inter-sector risks;
- Whether there are sector-specific risks that are addressed in the OSs of conduit bond issuers;
- The level of detail provided by issuers of conduit bonds with respect to these sector-specific risks;
- Whether the level of detail of these sector-specific risks changed over time.

STUDY RESULTS

Issuers' Discussion of Bondholder Risks

Among the higher education, K-12 education, healthcare, and housing sectors, issuers nearly universally addressed (inter-sector and sector-specific) risks to bondholders within a designated section of the OS called "Bondholder's Risks." Only the OSs for pollution control conduit bonds strayed from this pattern. Approximately 14 percent of OSs for these types of bonds contained a bondholder risk discussion (Figure 3).

Figure 4 shows the average total page length and average risks section page length of all reviewed OSs by sector. When viewed as a ratio – total number of pages dedicated to the risk discussion/ total number of pages in the OS – healthcare issuers committed the greatest effort to risk disclosure in their OSs (48 percent). K-12 education, higher education (both 17 percent), and housing (13 percent) issuers were comparable. Pollution control issuers committed the least amount of the OS to risk disclosure, just 2.1 percent.

The calculation of average risk section length was based on all OSs reviewed. If the sector did not typically include a section committed to risk, such as the pollution control sector, the average section length score was low. Not committing a section of the OS to a discussion of risk does not mean that risk was not considered in the OS. Risks may have been discussed generally in other areas of the OS. The test did not assess the quality of these discussions, only whether the OS separated the discussion of risk as a stand-alone section.

Issuers' Discussion of Inter-Sector Risks

It is standard practice for issuers and borrowers to communicate comprehensive financial data, project details, and sources of repayment to investors in the OS. Yet equally important to investors is information about events that directly or indirectly impact the long-term viability of the borrower to meet its financial obligations. These

Figure 3

PRESENCE OF RISKS SECTION
PERCENTAGE OF ISSUES BY SECTOR

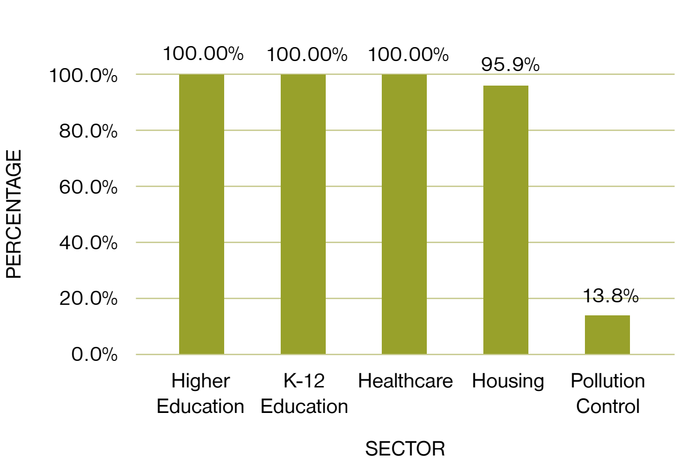
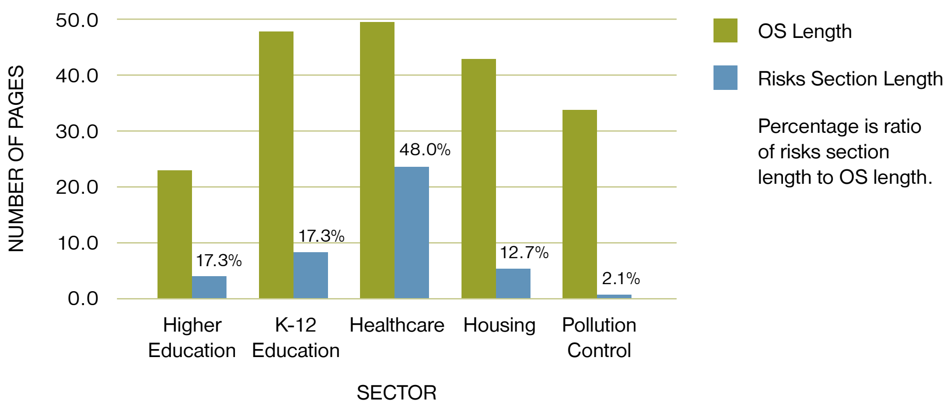


Figure 4

OS AND RISKS SECTION, AVERAGE PAGE LENGTH BY SECTOR



may be factors affecting revenues and liabilities or the demand for and utilization of the project. Event factors that posed a threat to borrowers and were applicable across all sectors were deemed "inter-sector risks." To the extent that the issuer deems these events to be material to an investor in his decision to buy the bonds the issuer must disclose them in the OS.

CDIAC identified five inter-sector risks that were consistently represented in the OSs of issuers irrespective of sector. These were:

- Tax-exemption
- Investment of funds
- Natural disasters
- Federal economic conditions
- State economic conditions

Figure 5 compares the different sectors of conduit issuance by the presence of these risks in their OSs. The importance of the tax status of the bonds and the steps required to maintain tax-exempt status (where applicable) is evident in the fact that it was discussed in every OS reviewed. The remaining risks were reported with significantly less frequency. The healthcare sector had the highest rates of conformity across issuers with respect to these inter-sector risks. That is, issuers in this sector tended to gravitate towards the same structure in their disclosures. For other sectors the variability was much greater. CDIAC did not make assumptions when a particular inter-sector risk was not discussed in any of a sector's OSs. It may have been that these factors presented no risk at all or that the risk was immaterial, but it may also be the result of industry practices that these risks are not reported.

Figure 5

OSs CONTAINING DISCUSSION OF INTER-SECTOR RISKS PERCENTAGE BY SECTOR

	HIGHER EDUCATION	K-12 EDUCATION	HEALTHCARE	HOUSING	POLLUTION CONTROL
Tax-Exemption	100.0%	100.0%	100.0%	100.0%	100.0%
Investment of Funds	51.7	10.6	77.8	33.0	6.9
Natural Disasters	51.7	42.6	95.8	35.1	6.9
Federal Economy	20.7	12.8	80.6	0.0	3.4
State Economy	3.4%	80.9%	83.3%	0.0%	0.0%

Issuers' Discussion of Sector-Specific Risks

CDIAC next focused on those risks that were unique to each sector of issuance. These risks were deemed to affect the operations of the borrower and its ability to service and repay the debt. CDIAC identified 16 "sector-specific" risks contained in the OSs of healthcare conduit issuers and three in the OSs of K-12 education conduit issuers. CDIAC was unable to identify any sector-specific risks consistently appearing in the OSs of higher education, housing, or pollution control conduit issuers.

For both the healthcare and K-12 education sectors, CDIAC noted where the sector-specific risks were disclosed and what degree of specificity was given. To assess the quality of these risk disclosures CDIAC developed a quantitative approach to rate the extent to which the disclosures provided information that would enable an investor to quantify the impact of the potential risk. CDIAC deemed a risk discussion that made the mere mention of the identified sector-specific risks as a level 1 disclosure (Figure 6). If the financial impact of an identified risk was provided, even if only in general terms, CDIAC scored it as a level 2 disclosure. If the issuer quantified the financial impact in some manner, CDIAC scored that as a level 3 disclosure. The threshold CDIAC used to determine whether a disclosure provided the financial impact of a risk was low. Essentially, any language that linked the risk to a financial impact was deemed a qualifying statement. For example, an OS that read, "The implementation of this measure will result in less funding in future years," was scored a level 2 disclosure. A higher threshold was applied in determining that an OS made mention of a quantified financial impact. For example, an OS that read, "The implementation of this measure will result in a 5% decrease in funding for the current fiscal year," was scored as a level 3 disclosure. CDIAC staff reviewed the 275 OSs and scored each of the applicable sector-specific risks using these criteria.

Figure 6

ASSESSMENT OF DISCLOSURE LEVEL AND FINANCIAL IMPACT OF SECTOR-SPECIFIC RISKS

DISCLOSURE CONTENT	LEVEL
Discussion of a sector-specific risk	1
Discussion of risk's financial impact	2
Discussion of risk's quantified financial impact	3

HEALTHCARE CONDUIT ISSUERS' DISCUSSION OF SECTOR-SPECIFIC RISKS[11]

The healthcare sector recognized several industry risks, most notably, the Patient Protection and Affordable Care Act (ACA), which affects access to healthcare services, pricing of services, and federal payments to healthcare facilities. Additionally, California has passed legislation implementing the ACA and supplemental healthcare services in the state.

Figure 7 shows the 16 sector-specific risks that CDIAC identified for healthcare and the average score for each risk factor by year.[12] CDIAC identified three main categories of healthcare specific risks – ACA formulaic, ACA non-formulaic, and California specific.[13]

In general, the scores reflected increased disclosure of industry developments over time. The increased

[11] For purposes of CDIAC's review, the Healthcare Sector does not include data from non-hospital facilities such as senior living facilities or facilities that do not provide hospital or emergency care. Those facilities are not affected by the same healthcare industry developments and are generally not as dependent upon federal funding. For instance, the OSs for senior living facilities generally did not report on any of the sixteen sector-specific risks.

[12] *See* Appendix A for more detailed information on the healthcare risk factors.

[13] *See* Appendix B for a sample score sheet used to evaluate healthcare sector OSs. *See* Appendix C for examples of scored OSs in the healthcare sector.

Figure 7

HEALTHCARE SECTOR-SPECIFIC RISK FACTORS, AVERAGE RATINGS BY YEAR (2009-2014)

RISK FACTORS	2009	2010	2011	2012	2013	2014
ACA FORMULAIC						
Medicare market basket reductions	0.8	2.3	2.8	2.7	3.0	2.3
Medicare market productivity adjustments	0.4	1.0	2.7	1.9	3.0	1.7
Medicare disproportionate share hospital changes	1.3	2.0	3.0	2.4	3.0	3.0
Hospital-acquired conditions penalty	0.0	1.8	2.9	2.6	3.0	2.7
Readmission rate penalty	0.8	2.0	2.2	2.2	2.8	2.3
Implementation of value-based purchasing program	0.1	0.8	2.7	2.1	2.8	2.3
ACA NON-FORMULAIC						
Reimbursement for diagnosis related group	1.3	2.0	2.0	1.8	2.0	2.0
Adoption of financial assistance policy	0.5	0.8	1.9	2.0	2.0	2.0
Development of Community Health Needs Assessment	0.5	0.8	1.7	2.0	2.0	2.0
Establishment of Independent Payment Advisory Board	0.4	1.5	1.5	1.3	2.0	2.0
Integrated delivery systems	1.6	2.0	1.7	1.8	1.8	2.0
Accountable Care Organizations	0.5	1.2	1.9	2.0	2.0	2.0
CA SPECIFIC						
California Hospital Provider Fee	0.0	1.0	1.7	1.9	2.0	1.3
Establishment of California health benefit exchange	0.0	0.0	0.0	0.4	1.3	2.0
Participation in "Bridge to Reform Program"	0.0	0.0	0.0	0.4	0.8	1.3
State-run dual-eligible pilot program	0.0	0.0	0.0	0.2	0.8	1.3

disclosure of ACA implementation measures and their financial impact roughly corresponds with the timing of the development of those measures following the passage of the ACA. Most healthcare facilities depend on federal funding, and the ACA changes the distribution of federal funds. Many of the ACA's measures make federal funding contingent on certain performance measures. Other ACA measures mandate reductions in funding regardless of need or performance.

ACA FORMULAIC. Six ACA Formulaic measures were identified and these were tied to specific formulas that reduce or adjust federal funding to healthcare facilities. For instance, the ACA institutes a penalty to be levied on healthcare facilities with excessively high readmission rates for certain conditions. Medicare inpatient payments are reduced on the dollar value of preventable readmissions, with a maximum penalty of 1 percent starting in 2013 and 3 percent beginning in 2015. The established funding formula (and timeframe) provides a definitive element for borrowers to disclose in greater detail. Because a quantified financial impact can be ascertained from the formulas, these measures have a maximum disclosure level of 3. The scoring of these measures loosely follows an upward trend, peaking in 2013 and decreasing slightly in 2014. More than the other categories, the ACA Formulaic risk disclosures vary year over year. The variation may be attributed to the timing of the bond issuance, the implementation schedule of the ACA provisions, and the judgment exercised by the financing team preparing each OS.

ACA NON-FORMULAIC. Six ACA Non-Formulaic measures were identified, these measures may affect the funding a healthcare facility receives; however, there are no corresponding formulas that provide estimates for the potential change in funding. For example, one of the measures, the Establishment of an Independent Payment Advisory Board, may ultimately result in recommended reductions to Medicare cost growth. According to the ACA, those recommendations will be automatically implemented starting in 2015 absent alternative legislation. These measures may have a financial impact on healthcare facilities, but there is no known funding formula or other means to determine the extent of that impact. A quantified impact cannot be provided where it is unknown. At a maximum, these measures can only be disclosed at a level 2. These measures demonstrate an upward trend with few anomalies. Disclosure levels peak either in 2014 or earlier (2012 or 2013) and hold at that level of disclosure throughout the remaining years of this study.

CALIFORNIA SPECIFIC RISKS. In general, the disclosure of the four California specific risks increased over time. With the exception of the California Hospital Provider Fee, these measures complement and expand upon the ACA provisions. As with the ACA Non-Formulaic category, these measures are not tied to specific funding formulas and therefore their financial impact is not yet clear. Without knowing the financial impact, the maximum disclosure level for these measures peaks at a level 2. The California Hospital Provider Fee, enacted by the State Legislature in 2009 is unrelated to the ACA; the disclosure of this measure increased from 2009 to 2013. The remaining provisions were not implemented until mid-2012, and therefore do not appear in OSs until that time. For each of these measures, disclosure levels gradually increase over time and peak in 2014.

Generally, the analysis suggests that as more information about the ACA and state specific measures became known, disclosure of those measures increased in their frequency and degree of quantification. However, the irregularities and variances between OSs demonstrate the lack of established standards for disclosure content. Without further guidance from the SEC, it is unclear whether such variance is appropriate. Thus, the risks and degree of specificity of financial impact that are provided to investors are often left to the judgment of bond and disclosure counsel.

K-12 EDUCATION CONDUIT ISSUERS' DISCUSSION OF SECTOR-SPECIFIC RISKS

The education sector is comprised of private K-12 school facilities and charter schools. Both face a variety of risks relating to their funding and compliance obligations. Charter schools receive funding appropriated from the state budget and delays or reductions in that funding may impact a borrower's ability to meet debt service payments. Additionally, charter schools' funding may be based on enrollment numbers or test performance.

Figure 8 shows the three sector-specific risks that CDIAC identified for K-12 education and the average score for each risk factor by year.

The analysis of OSs in the K-12 education sector demonstrates a general upward trend in the disclosure of sector-specific risks with slight declines in 2012 and 2013 and a peak in disclosure levels in 2014. Throughout all of the K-12 education sector OSs, risks were disclosed at a level 2 or above. However, where not all OSs disclosed a particular risk the average disclosure level may be below a level 2. As with the healthcare sector,

Figure 8

K-12 EDUCATION SECTOR-SPECIFIC RISK FACTORS, AVERAGE RATINGS BY YEAR (2009-2014)

RISK FACTORS	2009	2010	2011	2012	2013	2014
Offsets to state apportionment	0.4	1.0	1.7	2.0	1.3	2.3
Reduction in average daily attendance funding	0.0	1.0	1.7	1.3	1.8	2.0
Compliance with No Child Left Behind	0.4	0.0	0.9	0.8	0.7	2.0

there are inconsistencies in the disclosure levels of OSs within each year and an imperfect upward trend across all years.

OBSERVATIONS & RECOMMENDATIONS

Conduit borrowing is an important part of the municipal market that provides non-governmental borrowers the ability to utilize the tax advantages of state and local agencies to finance projects that provide a public benefit. Conduit borrowers are subject to the same federal securities laws as municipal issuers, and they must provide initial and continuing disclosure materials to the municipal market. In a review of OSs, CDIAC compared the content of each of five major sectors of issuance: (1) healthcare, (2) higher education, (3) K-12 education, (4) housing, and (5) pollution control. This preliminary analysis sought to better understand the disclosure practices of conduit issuers with regard to the treatment of bondholder risks. Specifically, it intended to assess the presence of discussions of risk in the OS, including common risks, such as tax exemption, which affect the viability of all conduit borrowers, but also specific risks that apply to borrowers within a particular sector.

In a statistically significant sampling of conduit issues from five sectors CDIAC found that all but pollution control conduit issuers systematically profiled bondholder risks in their OSs. That is, only pollution control conduit issuers did not frequently structure their OSs to contain a section dedicated specifically to bondholder risk. Failing to commit a clear section of an OS to bondholder's risks arguably makes it harder for investors to decipher those potential risks and thereby make an informed investment decision. This practice by issuers of pollution control conduit bonds may warrant further research into whether disclosures provide the necessary information to adequately inform investors.

In the same statistically representative sample CDIAC found that the extent of the bondholder risks section of the OSs differed between sectors. Healthcare conduit issuers dedicated a higher percentage of the OS to this topic than did issuers in other sectors. The healthcare sector is commonly subject to industry developments and legislative action, and thus, there was significantly more content relating to such developments. This was due in large part to the passage of the ACA, which led to the implementation of many provisions affecting how federal funding is apportioned to healthcare facilities. The OSs of healthcare issuers have increasingly reported these provisions over the last six years and with greater specificity in recent years as to the financial impact of the implementation of the ACA.

CDIAC identified five risks common to most conduit bond OSs. These included discussions of tax exemption, investment of funds, natural disasters, and federal and state economic conditions. The OSs consider these topics because they provide investors information on the viability of the borrower or the project. Outside of tax exemption, which was universally reported in OSs across all sectors, conduit issuers differed with regard to their treatment of these other inter-sector risks. No conclusions were drawn from this analysis regarding the appropriateness of these risk disclosures. The inter-sector risks may be inapplicable to some borrowers or projects in these sectors, but the reason for the different treatment of these risks between sectors warrants additional investigation.

The content analysis carried out by CDIAC uncovered 16 sector-specific risks in the OSs of healthcare conduit bonds and three sector-specific risks in K-12 education conduit bonds. When rated according to the detail of risk disclosed in these OSs, CDIAC discovered that the specificity of these risk discussions varied across topics and time. Different topics allowed for more quantitative exposition than others, as evidenced by the Formulaic and Non-Formulaic ACA risks. As the impact of these different topics upon the viability of the borrower or the project became clearer, the disclosures became more specific. In general, disclosures became more quantitative over the study period. However, the upward trend of disclosure is not absolute and the reason for these inconsistencies was not determined. The general upward trend may reflect greater attention paid to disclosure by regulators and the market, in general. But it is just as easy to conclude that the changes reflect assumptions and practices common to those preparing the OSs. As a result, CDIAC draws no conclusions from the differences between the noted levels of disclosure revealed by its analysis.

Because CDIAC merely surveyed the content of OSs, the study did not account for unreported risks that warrant disclosure. The study cannot conclusively state whether the content of OSs was sufficient or not. However, the content analysis highlighted inconsistencies between disclosures currently made by issuers across different conduit sectors and over time within sectors. To the extent that consistency allows investors to evaluate investment alternatives, more uniformity in disclosure documents should be encouraged. CDIAC recognizes that there is a lack of clear guidance on the appropriate level of disclosure of risks, especially sector- and project-specific risks. By revealing the disclosure practices of conduit issuers CDIAC hopes to encourage discussion by and among issuers and finance professionals to identify opportunities to achieve greater uniformity.

Appendix A

ACA FORMULAIC MEASURES

MEDICARE MARKET BASKET UPDATES. Medicare market basket reductions refer to the Medicare payment rates to hospitals that are adjusted annually to account for the "market basket" of estimated cost increases. The ACA required automatic reductions in the "market basket" of .25% for 2010 and 2011 and calls for reductions ranging from .1%-.75% for each fiscal year through 2019.

MEDICARE MARKET PRODUCTIVITY ADJUSTMENTS. Medicare market productivity adjustments begin in fiscal year 2012 and adjust the "market basket" based on national economic productivity statistics. The estimated effect is a 1% additional annual reduction to the "market basket."

MEDICARE DISPROPORTIONATE SHARE HOSPITALS (DSH). Medicare disproportionate share hospitals (DSH) supplemental Medicare payments are reduced by 75% starting in 2014. Medicaid DSH allotments to each state will also be reduced.

HOSPITAL-ACQUIRED CONDITIONS PENALTY. Beginning in fiscal year 2015, there will be a 1% reduction in Medicare inpatient payments to hospitals in the top 25% nationally for frequency of certain hospital-acquired conditions.

READMISSION RATE PENALTY. Medicare inpatient payments will be reduced based on the dollar value of hospital's percentage of excess preventable Medicare readmissions, with a maximum penalty of 1% in 2013 and 3% beginning in 2015.

IMPLEMENTATION OF VALUE-BASED PURCHASING PROGRAM. Beginning in fiscal year 2013, Medicare inpatient payments will be determined in part on the basis of value-based payments made to hospitals that meet certain performance standards. Inpatient payments are reduced by 1% progressing to 2% by 2017. Reductions may be offset for some facilities that meet or exceed quality standards by incentive payments beginning in 2013.

ACA NON-FORMULAIC MEASURES

REIMBURSEMENT FOR DIAGNOSIS-RELATED GROUP. Hospitals receive inpatient payments for treating Medicare patients based on their treatment or condition, commonly referred to as diagnosis-related groups (DRGs). DRGs are subject to reduction per the ACA as well as federal budgetary allotments. However, the actual cost of care may exceed the DRG rate, and there is no guarantee that the rate will cover those costs.

ADOPTION OF A FINANCIAL ASSISTANCE POLICY. The ACA mandates new requirements for hospitals to maintain tax-exempt status. Under these new requirements, hospitals must adopt and implement a financial assistance policy.

DEVELOPMENT OF A COMMUNITY HEALTH NEEDS ASSESSMENT. Hospitals must conduct a community health needs assessment every three years and implement a strategy to meet those needs in order to maintain tax-exempt status.

ESTABLISHMENT OF THE INDEPENDENT PAYMENT ADVISORY BOARD (IPAB). The Independent Payment Advisory Board (IPAB) is directed to make recommendations to reduce Medicare cost growth. These recommendations will be automatically implemented in 2015 absent alternative legislation and may lead to diminished reimbursement to facilities.

INTEGRATED DELIVERY SYSTEMS. The ACA authorizes alternative payment programs for Medicare that incentivize integrated delivery systems consisting of affiliations with physician groups and independent practice associations.

ACCOUNTABLE CARE ORGANIZATIONS (ACOS). The ACA establishes the Medicare Shared Savings Program to encourage the coordination of care through the formation of Accountable Care Organizations (ACOs).

CALIFORNIA SPECIFIC MEASURES

CALIFORNIA HOSPITAL PROVIDER FEE. The California Hospital Provider Fee resulted from legislation enacted in 2009. It assesses fees on hospitals to draw down federally matched funds. Recent legislation extended the program to December 31, 2016.

CALIFORNIA HEALTH BENEFIT EXCHANGE. The California Health Benefit Exchange is "Covered California." Enrollment opened on October 1, 2013 for coverage starting on January 1, 2014.

BRIDGE TO REFORM. The "Bridge to Reform" program consists of forty-seven of California's fifty-eight counties implementing the ACA's expansion of Medicaid in advance of the federal deadline.

DUAL-ELIGIBLES PILOT PROGRAM. California's dual-eligibles pilot program aims to combine the separate services of Medicare and Medicaid for people eligible for both programs. The program started implementation in January 2014.

Appendix B

STANDARDIZED SCORE SHEET

ISSUER & PROJECT NAME	CDIAC NO.	REVIEWER

OFFICIAL STATEMENT CONTENT	Y/N	PAGE NO.
LENGTH OF OFFICIAL STATEMENT		
LENGTH OF OS (EXCLUDING APPENDICES)		
LENGTH OF "BONDHOLDER'S RISKS" SECTION		
COMMON CHECKPOINTS		
TAX-EXEMPT STATUS		
INVESTMENT OF FUNDS		
NATURAL DISASTERS		
FEDERAL ECONOMY		
STATE ECONOMY		
ACA CHECKPOINTS		
MEDICARE MARKET BASKET REDUCTIONS		
Any mention of financial impact		
Quantified projection of financial impact		
MEDICARE MARKET PRODUCTIVITY ADJUSTMENTS		
Any mention of financial impact		
Quantified projection of financial impact		
MEDICARE DISPROPORTIONATE SHARE HOSPITAL PAYMENTS		
Any mention of financial impact		
Quantified projection of financial impact		

OFFICIAL STATEMENT CONTENT	Y/N	PAGE NO.

ACA CHECKPOINTS CONT'D

HOSPITAL-ACQUIRED CONDITIONS PENALTY		
Any mention of financial impact		
Quantified projection of financial impact		
READMISSION RATE PENALTY		
Any mention of financial impact		
Quantified projection of financial impact		
IMPLEMENTATION OF VALUE-BASED PURCHASING PROGRAM		
Any mention of financial impact		
Quantified projection of financial impact		
REIMBURSEMENT FOR DIAGNOSIS RELATED GROUP		
Any mention of financial impact		
Quantified projection of financial impact		
ADOPTION OF FINANCIAL ASSISTANCE POLICY		
Any mention of financial impact		
Quantified projection of financial impact		
DEVELOPMENT OF COMMUNITY HEALTH NEEDS ASSESSMENT		
Any mention of financial impact		
Quantified projection of financial impact		
ESTABLISHMENT OF INDEPENDENT PAYMENT ADVISORY BOARD		
Any mention of financial impact		
Quantified projection of financial impact		
INTEGRATED DELIVERY SYSTEMS		
Any mention of financial impact		
Quantified projection of financial impact		
ACCOUNTABLE CARE ORGANIZATIONS		
Any mention of financial impact		
Quantified projection of financial impact		

CALIFORNIA CHECKPOINTS

CALIFORNIA HOSPITAL PROVIDER FEE		
Any mention of financial impact		
Quantified projection of financial impact		
ESTABLISHMENT OF CALIFORNIA HEALTH BENEFIT EXCHANGE		
Any mention of financial impact		
Quantified projection of financial impact		
PARTICIPATION IN "BRIDGE TO REFORM" PROGRAM		
Any mention of financial impact		
Quantified projection of financial impact		
STATE-RUN DUAL-ELIGIBLES PILOT PROGRAM		
Any mention of financial impact		
Quantified projection of financial impact		

Appendix C

EXAMPLES OF HEALTHCARE INDUSTRY OFFICIAL STATEMENTS

OFFICIAL STATEMENT CONTENT	PROVIDENCE HEALTH & SERVICES 2014 SERIES B		SUTTER HEALTH 2013 SERIES A		CATHOLIC HEALTHCARE WEST 2012 SERIES C	
	INCLUSION	PAGE NO.	INCLUSION	PAGE NO.	INCLUSION	PAGE NO.
LENGTH OF OFFICIAL STATEMENT						
Length of OS (excluding appendices)	✓	58	✓	51	✓	64
Length of “Bond Risks” Section	✓	34	✓	32	✓	27
COMMON CHECKPOINTS						
Tax-Exempt Status	✓	44	✓	41	✓	56-59
Investment of Funds Risk			✓	45	✓	60
Natural Disasters	✓	48	✓	44	✓	59, 60
Federal Economy	✓	17	✓	21	✓	34
State Economy	✓	17, 33, 35	✓	28	✓	45
ACA CHECKPOINTS						
Medicare market basket reductions	Level 2	19	Level 3	23	Level 3	41
Medicare market productivity adjustments	Level 2	19	Level 3	24	Level 3	41
Medicare disproportionate share hospital payments	Level 3	19	Level 3	24	Level 3	41, 44
Hospital-acquired conditions penalty	Level 3	20	Level 3	24	Level 3	41
Readmission rate penalty	Level 2	20	Level 3	24	Level 2	41
Implementation of value-based purchasing program	Level 2	19	Level 3	23	Level 3	41
Reimbursement for diagnosis related group	Level 2	32	Level 2	25	Level 2	43
Adoption of financial assistance policy	Level 2	20	Level 2	41	Level 2	40, 56

Development of Community Health Needs Assessment	Level 2	25	Level 2	41	Level 2	40, 56
Establishment of Independent Payment Advisory Board	Level 2	20	Level 2	22	○	-
Integrated delivery systems	Level 2	21	Level 2	36	Level 2	51
Accountable Care Organizations	Level 2	21	Level 2	37	Level 2	52
CALIFORNIA CHECKPOINTS						
California Hospital Provider Fee	○	-	Level 2	26	Level 2	44
Establishment of California health benefit exchange	Level 2	21	Level 1	23	○	-
Participation in “Bridge to Reform” program	Level 2	22	Level 1	23	○	-
State-run dual-eligibles pilot program	Level 2	22	Level 1	23	○	-

CDIAC

CALIFORNIA
DEBT AND
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