



**CALIFORNIA DEBT ADVISORY COMMISSION**

**RECOMMENDED CHANGES TO THE  
MARKS-ROOS  
LOCAL BOND POOLING ACT OF 1985**

*REPORT TO THE LEGISLATURE AND GOVERNOR*

**MATTHEW K. FONG  
State Treasurer and Chair**

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**California Debt Advisory Commission**

## **California Debt Advisory Commission**

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## INTRODUCTION

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The Marks-Roos Local Bond Pooling Act of 1985 greatly expanded the financing powers of joint powers authorities (JPAs) by adding Article 4 *Local Bond Pooling* to the *Joint Exercise of Powers* provisions of the Government Code (Division 7, Chapter 5, sections 6500 et seq.). Article 4 authorized JPAs to form *bond pools* for the purpose of consolidating the financing of several capital projects into a single bond issue, as an alternative to executing a separate bond issue for each project. Historically, the bond issuance practices of JPAs had been confined to financing regional public facilities such as water and power systems; the Marks-Roos Act ushered in a new type of JPA - the Public Financing Authority (PFA) - formed expressly for the purpose of executing debt transactions through the bond pooling mechanism, for any number of purposes. While PFAs technically constitute *joint* powers authorities, often different agencies within the same political jurisdiction band together to form a PFA (most commonly, a city and its redevelopment agency). Such PFAs are under the direct control of the city council and may execute financings for both city projects and redevelopment agency projects.

There are four main reasons why public agencies choose to finance projects through Marks-Roos bond pooling rather than conventional forms of borrowing:

- **Issuance Cost Economies.** Public agencies incur a variety of transactions costs in accessing the bond market. These expenses represent remuneration for professional services retained to assist in the planning and sale of a bond issue, most significantly the investment banking firm or firms which underwrite the bond issue and reoffer it to investors; the bond counsel firm, which offers its opinion on the tax-exempt status of the bonds; the trustee, which serves as custodian for the funds; the fiscal agent, which administers payments to bondholders; and one or more of the credit rating agencies, which assign a credit rating to the offering. Additionally, a financial advisor may be retained to direct or assist in a variety of tasks, such as preparing the official statement, structuring the issue and negotiating its pricing. What's more, the bonds themselves must be printed and advertised for sale; fees must be paid to MSRB, PSA and CDAC, and other expenses may be incurred. Insofar as some of these costs are fixed, rather than variable, bond pooling can allow for certain economies of scale in borrowing, since some costs may be incurred only once, when the bond pool is formed, rather than several times, as under a series of standalone transactions.
- **Credit Pooling.** By grouping together several credits or projects into a single bond issue, an agency may be able to improve the credit quality of its debt offering and achieve lower interest costs. This is accomplished through risk diversification and *cross-collateralization* - applying security features of one project or bond issue toward other projects or bond issues in the pool. Credit pooling is a valuable application of the Marks-Roos tool, insofar as California's public finance landscape is replete with small financing districts - assessment districts, Mello-Roos districts and redevelopment project areas - that can benefit from diversifying risk and cross-

- collateralizing security features (particularly coverage ratios and reserve funds). The most recent innovation in credit pooling is the *senior/subordinated* structure, under which a PFA pools together several Mello-Roos or assessment districts and creates a senior lien on a portion of the debt, entitling that portion to first claim on all special tax or assessment payments from all the districts. The coverage ratio on the senior lien portion of the debt is raised high enough to achieve an investment grade credit rating on what otherwise would be unrated debt. Although the junior lien debt remains unrated, the agency's composite interest cost is lower than it would be under a series of separate transactions.
- **Interest Rate Hedge.** Under current law, bond pools may have long origination periods, which means that several years may pass between the time that the bond pool is formed and its proceeds are loaned. The interest rates paid on the bonds issued to form the bond pool, therefore, can be locked-in for the duration of the bond pool, which protects the issuer against rising interest rates. Of course, the reverse also is true: the bond pool can preclude issuers from enjoying the benefits of falling interest rates. The *Hedge Bond* restrictions adopted into the Internal Revenue Code in 1989 [Section 149 (g)] require agencies to have a *reasonable expectation* that they will draw down 85 percent the proceeds of bonds issued for this purpose within five years. This restriction, along with a similar restriction on *Pooled Financing Bonds* appear to have curbed the use of Marks-Roos financing for hedging purposes.
- **Flexibility in Issuance.** Public agencies form PFAs and issue debt under the Marks-Roos Act not only for the reasons mentioned above, but also to enjoy maximum flexibility in structuring and marketing their debt obligations. Most notably, redevelopment agencies rely on the Marks-Roos Act to circumvent competitive bid requirements they face on new money issues and advance refundings (redevelopment agencies are authorized to issue current refunding bonds through negotiated sale). The amendments to the Marks-Roos legislation enacted in the late 1980s (discussed below) established the Marks-Roos legislation as a "complete and supplemental" method of issuing debt that supersedes any other conflicting provisions of law.

### Flow of Funds Can Be Complex

The flow of funds under even a relatively simple Marks-Roos bond pool can be quite complex. A PFA first must issue revenue bonds, which have come to be called *Marks-Roos* bonds, to generate funds for its bond pool. These Marks-Roos bonds are underwritten by an investment banking firm and reoffered to investors. The bond pool, in turn, is used to underwrite or acquire obligations of PFA member agencies or, in some instances, nonmember obligations. By underwriting their own debt issues, PFAs, in effect, perform the role of the investment bank. The Marks-Roos Act permits PFAs to underwrite a variety of bond, lease or loan obligations. PFAs also may refund debt, whether or not the original obligation was acquired by the bond pool. Most frequently, PFAs underwrite assessment bond and tax allocation bond issues (both new money issues and refundings). Marks-Roos revenue bonds, consequently, are not ordinary revenue

bonds supported by a dedicated revenue stream; rather, the debt service on Marks-Roos revenue bonds is paid from the separate revenue streams supporting each bond issue or obligation acquired by the bond pool. The credit of a Marks-Roos bond pool is only as strong as the credit of these underlying obligations.

### **Amendments Expand the Scope of the Marks-Roos Act**

Two amendments enacted in the late 1980s expanded the scope of the Marks-Roos Act in ways that proved to be significant in later years.

*Investments in Nonmember Securities Authorized; Competitive Bid Requirements Superseded.* AB 1496 (Peace - Chapter 481/87) authorized the financing of working capital (or short-term cash flow borrowing) and self-insurance programs through the Marks-Roos structure. This legislation, however, also included two seemingly minor amendments which proved to have more far reaching consequences. First, AB 1496 expanded the definition of "local agency" as used in the Marks-Roos Act from a party to the agreement creating the joint powers authority (or an agency or subdivision of that party) to "any city, county, city and county, authority, district, or public corporation of this state." By defining "local agency" in the broadest possible manner, this amendment paved the way for PFAs to invest in the securities of nonmember agencies - since the Marks-Roos Act permits JPAs to purchase the obligations of "local agencies." The financial press has reported that certain PFA investments in questionable nonmember securities are now under investigation by the SEC, and CDAC is also concerned about abuses of this authority (see *Issue #3: Suitability of Bond Pool Investments.*)

Second, AB 1496 specified that local agencies may sell any type of bond to a PFA on a negotiated basis, notwithstanding any conflicting provision of law. This amendment made the Marks-Roos Act more workable, since it would be difficult to operate a bond pool if a PFA had to bid for local obligations at a public sale. But by permitting any type of bond to be sold to a Marks-Roos bond pool on a negotiated basis, AB 1496 effectively subverted every competitive bid requirement in law, since PFAs are authorized to purchase every type of bond. Yet the practical significance of this loophole has been to provide redevelopment agencies greater flexibility in issuing debt through negotiated sale, as noted earlier. Though the Legislature's intent in enacting AB 1496 seemingly was not to grant redevelopment agencies additional authority to issue debt through negotiated sale, it should be noted that redevelopment agencies may have legitimate financial reasons for doing so. In particular, the timing considerations involved in an advanced refunding issues justify a negotiated sale. Also, the complexity of the projects and cash flows involved in redevelopment agency financings also may justify negotiated sale. A redevelopment agency, for example, may choose to fold one or more refundings into a new money issue, in order to conserve on issuance costs. In the view of the Commission, redevelopment agencies should enjoy the flexibility to decide whether such bond issues can be sold more advantageously through negotiated sale. As a consequence, the Commission does not recommend restricting this provision of law in the recommendations for legislation which follow.



***PFA's Exempted From All Conflicting Debt Restrictions.*** Assembly Bill 1872 (Farr - Chapter 1264/89) expanded upon the 1987 amendments exempting JPAs acquiring bonds under the Marks-Roos Act from competitive bid requirements, extending this exemption to *all* conflicting provisions of law. To quote:

This article shall be deemed to provide a complete and supplemental method for exercising the powers authorized by this article...The issuance of bonds, financing, or refinancing under this article need not comply with the requirements of any other state laws applicable to the issuance of bonds, including, but not limited to, other articles of this chapter [Gov. Code Section 6587].

AB 1872 also clarified that "revenue" accruing to a JPA may consist not only of income and receipts derived from a bond purchase agreement, but also loans, installment sales agreements, and other revenue producing agreements entered into by the authority.

### **SEC Investigating Several Marks-Roos Issues**

The financial press has reported that the Securities and Exchange Commission (SEC) is investigating several Marks-Roos transactions. Notwithstanding these reports, it is the policy of the SEC to conduct its inquiries on a confidential basis, to preserve the integrity of its investigative process as well as to protect persons against whom unfounded charges may have been made or where the SEC determines that enforcement action is not necessary or appropriate. Subject to the provisions of the Freedom of Information Act, the SEC does not disclose the existence or nonexistence of an investigation unless it is made a matter of public record in proceedings brought before the SEC or in the courts.

### **CDAC's Approach**

Whether or not the SEC's investigations of certain Marks-Roos transactions result in enforcement actions, CDAC believes that ongoing allegations of abuse and concerns over the creditworthiness of certain Marks-Roos bond pools warrant reforms to the Act. The recommendations put forth in this report, which are based on research and information gathered over an extended period, are intended to curb the potential for abusive Marks-Roos financings in the future, protect the public from unwarranted and unnecessary taxes and assessments, and restore the confidence of investors in this vital form infrastructure finance.

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## ISSUE #1: RECOVERING THE COST OF ISSUANCE

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When a public agency issues debt, it does not receive the full principal amount that it borrows. The costs of issuance - underwriter's discount, bond counsel and rating agency fees, and so on - are paid from the proceeds of the bond sale. If issuance costs equal 3 percent of the bond issue, for example, the agency receives only 97 cents for each dollar it borrows (just as a bank may deduct *points* from the principal amount of a home mortgage). A bond issue therefore must be sized to include sufficient funds to pay issuance costs in addition to construction or acquisition costs, and the tax or revenue source securing the bond issue must be set at a rate sufficient to retire the entire principal amount borrowed. In this manner, the costs of issuance are amortized over the life of a bond issue.

Like other types of bonds, the costs of issuing Marks-Roos bonds are paid from the proceeds of the bond sale. But unlike other types of bonds, the costs of issuing Marks-Roos bonds cannot be recouped by setting taxes or fees at a rate sufficient to retire debt service, since a Marks-Roos bond issue in most cases is not secured by a single tax or revenue source at the time of issuance. Rather, a Marks-Roos bond issue merely raises a pool of funds that is used to acquire local obligations. The PFA therefore must distribute the costs of issuing its Marks-Roos bonds to the underlying obligations in its bond pool. There are two ways to do this: (1) charging each local obligation an administrative fee; and (2) establishing a yield differential between the Marks-Roos bonds and the local obligations acquired by the pool. A key risk in establishing a bond pool, consequently, is *oversizing* - borrowing more money than needed to meet the PFAs capital needs over the pool origination period. A PFA has no recourse for recovering issuance costs on the unused portion of its bond pool, a problem which could lead to a shortfall in funds available for debt service and possibly a default on its Marks-Roos obligations. A PFA that oversizes its bond pool, consequently, may look for alternative investments for its unused bond pool proceeds and possibly assume a relatively high degree of risk in order to generate sufficient yield to keep the pool solvent.

**Administrative Fees.** A PFA can simply charge an administrative fee for each obligation acquired by its bond pool. Article 4, Section 6588 (o) of the Government Code authorizes a PFA to "Charge and apportion to local agencies which benefit from its services the administrative costs and expenses incurred in the exercise of this article." Suppose for example that a PFA issues Marks-Roos bonds in following amount to fund five \$1 million projects in different redevelopment project areas:

## Marks Roos Bond Issuance Costs

<u>Cost of Issuance</u>	
Underwriters Discount	\$100,000
Bond Counsel	30,000
Official Statement	10,000
Printing	5,000
Fiscal Agent	2,000
Miscellaneous	<u>3,000</u>
Subtotal	\$150,000
Construction Fund	\$5,000,000
Reserve Fund	<u>500,000</u>
Bond Issue Total	\$5,650,000

To recover its costs of issuance of \$150,000, the PFA merely needs to charge an administrative fee of \$30,000 to each of the five redevelopment project areas. To do so, the PFA executes a loan agreement with each project area for \$1,130,000, to cover the costs of construction, a proportionate share of the reserve fund, and a proportionate share of issuance costs. Each project area, in turn, allocates a sufficient amount of its tax increment revenues to retire this loan over its term. This the way by which most PFAs recover their costs of issuance.

***Excessive Administrative Fees Reported.*** Despite the fact that the Government Code section cited above would seem to limit the level of administrative fees charged by PFAs to a level sufficient to recover reasonable costs of issuance and administration, CDAC has received reports of abuses of this fee authority. In one case in the spring of 1994, for example, the owners of a shopping center in an assessment district were charged \$430,000 in administrative fees in conjunction with a \$2.6 million assessment bond refunding. CDAC also has received reports that local agencies have been told by investment banking firms marketing Marks-Roos bond pools that these fees may be used to finance entire capital projects.

These types of excesses should be clearly prohibited by law. Our recommendations for curbing abuses of this fee authority are presented at the end of this section.

**Yield Differential.** The other way for a PFA to recover its cost of issuance is to establish a differential between the yield on its Marks-Roos obligations and the local obligations it acquires. Suppose that the Marks-Roos bond issue in the example above was issued at a True Interest Cost of 7 percent over a term of 20 years. Instead of charging each redevelopment project area participating in the bond pool a \$30,000 administrative fee, the PFA instead could set the interest rate on each bond pool loan at about 7.25 percent. The additional 25 basis points would generate sufficient funds to amortize the issuance cost of the Marks-Roos bonds.

Just as the fee authority of Marks-Roos bond pools has been subject to abuse, the interest rates charged by PFAs on local obligations has been a continuing source of controversy. The spread between the yield on a Marks-Roos bond issue and the local obligations acquired with the proceeds of that issue represents a source of arbitrage profits for a PFA. This spread is a source of permitted arbitrage not restricted by the federal Tax Reform Act of 1986 (which prohibited the practice of investing tax-exempt bonds proceeds in taxable instruments for the purpose of generating arbitrage profits). The opportunity to earn arbitrage profits led several small communities in the state to issue large bond pools in the late 1980s in amounts which appeared to far exceed their capital requirements for the foreseeable future. These transactions, which involved mostly small, unsophisticated issuers, were viewed as abusive by many market observers and led to the enactment of Senate Bill 2447, discussed below.

***SB 2447 Yield Restrictions.*** The communities which formed PFAs and issued large bond pools during the late 1980s justified their actions on the basis of aggressive projections of growth and development. The bond pool proceeds were to be used to finance infrastructure in real estate development projects. Although many of these projects never materialized, these PFAs came in for criticism for charging excessive yields on the local obligations they did acquire with their bond pools, the costs of which were passed on to developers and residents in their communities. The interest rate differential pocketed by these PFAs was nothing more than a surreptitious tax increase, according to this criticism. The PFAs and their financial consultants, for their part, defended the interest rate differential charged by Marks-Roos pools on the grounds that communities must rely on "creative financing" to generate needed funds in the post-Proposition 13 era. Even with the interest rate differential, these PFAs maintained, their Marks-Roos pools still offered real estate developers lower cost funds than they could get from private banks.

The arguments of Mark-Roos proponents notwithstanding, the Legislature moved to restrict the arbitrage profits that could be earned by Mark-Roos bond pools. Senate Bill 2447 (McCorquodale, 1990) restricted the yields that a PFA could charge on local obligations it acquires to that of the Marks-Roos bond issue that funded its bond pool, with two notable exceptions:

- 1) The PFA can charge a higher interest rate on the bonds it purchases if the *current market yield* for that type of bond, as verified by a financial advisor or underwriter, exceeds that of the pool.
- 2) The PFA can charge a higher interest rate on the bonds it purchases if those bonds are refunding existing bonds. The interest charged on the refunding bonds can be as high as that of the bonds being refunded.

To gauge the effectiveness of the SB 2447 yield restrictions, which have been in effect since 1991, CDAC has compared the yields on assessment bonds underwritten by PFAs to those underwritten by investment banking firms for the years 1991 through 1993. More specifically, the weekly average yield for each assessment bond issue underwritten by a PFA was compared to the weekly average yield of all conventionally underwritten assessment bond issues. (Assessment bonds were chosen for this analysis because that is the type of debt most frequently underwritten by Marks-Roos bond pools; refunding bond issues, which are exempted from the SB 2447 yield restrictions, were excluded from this analysis).

**Special Assessment Bond Yield Differential  
Marks-Roos Bond Pools vs. Conventional Underwriting**

<u>YEAR</u>	<u>NUMBER OF ISSUES</u>	<u>MARKS-ROOS BASIS POINT DIFFERENTIAL</u>
1991	16	+86
1992	24	+104
1993	16	+156

This chart shows the yields on special assessment bonds issues underwritten by PFAs were higher than those underwritten conventionally by an average of 86 basis points in 1991, 104 basis points in 1992, and a whopping 156 basis points in 1993. A part of these differentials might be explained by the overall decline in interest rates during this period: To the extent that any of these PFAs issued Marks-Roos bonds prior to this decline, they would need to pass on their relatively high cost of funds. But undoubtedly, this chart demonstrates that some PFAs have charged excessive yields to generate profits in violation of SB 2447. In order to prove that an individual PFA was not in compliance with SB 2447, the yield on its local obligations would have to exceed that of its bond pool as well as the current market yield for that type of bond. Unfortunately, SB 2447 does not define *current market yield*; it merely requires that an experienced underwriter or financial advisor “certify” that the yields charged by a PFA are in accordance with current market yields.

This mysterious certification process notwithstanding, it does not appear that SB 2447 has curbed the practice of PFAs charging excessive yields on local obligations acquired by their bond pools. Ultimately, the cost of financing projects at above-market interest rates is passed on to the unfortunate taxpayers in these communities. At the end of this section, we outline our recommendations for strengthening the SB 2447 yield restrictions.

## Disposition of Savings on Assessment Bond Refundings

Refunding bond issues, as noted above, were exempted from the SB 2447 yield restrictions. PFAs can set the yield on a refunding bond issues as high as the yield on the bonds being refunded. It is not clear why SB 2447 allowed this exception to its yield restrictions. What is clear is that as interest rates fell between 1991 and 1994, many PFAs turned a tidy profit by refunding assessment bond issues at above-market interest rates. These PFAs issued Marks-Roos bonds to borrow money at low market rates and earned an arbitrage profit by acquiring assessment bond refunding issues at higher rates. These refundings essentially redirected the existing stream of assessment payments from the original bondholders to the new bondholders - the PFA - without materially lowering the assessment liens on parcels in these districts. The Refunding Bond Act of 1984 specifies only that a reassessment undertaken in conjunction with a refunding lower the assessment on each parcel in the district; in the cases described above, the assessments on parcels were reduced by a nominal amount. (The Refunding Bond Act of 1984 was of course enacted prior to the Marks-Roos Local Bond Pooling Act of 1985 and could not have anticipated this problem). Finally, some PFAs reaped an additional windfall by diverting the original bond issue's reserve fund to purposes other than retiring the assessment debt (since the refunding bonds can rely on the pool's reserve fund).

The practice of PFAs siphoning off the savings generated by assessment bond refundings appears to be perfectly legal, but in the view of the Commission, it is poor public policy. A PFA should be established for administrative convenience, it should not become a moneymaking venture that leads to a divergence in the financial interests of public finance officers and their constituents. Our recommendation for eliminating this practice is discussed below.

## RECOMMENDATIONS FOR LEGISLATION

1. **Limit Origination Period for Marks-Roos Bond Pools to 90 Days.** In the view of the Commission, virtually all of the abuses of the Marks-Roos Act that have come to light stem from *blind pools* - bond pools where the projects to be financed are not clearly identified at the time of issuance. To the extent that a PFA oversizes a blind pool, it faces the difficulties in recovering its costs of issuance described above. Moreover, because blind pools often have multyear origination periods, they offer lucrative investment contracts that have, in certain instances, been awarded noncompetitively (see *Issue #4: Fees Charged on Nonprogram Investments*). By simply shortening the origination period for Marks-Roos bonds pools, and effectively eliminating the formation of blind pools, the Legislature could go a long way toward curbing abuses of the Marks-Roos Act.

Although the *Hedge Bond* restrictions adopted into the Internal Revenue Code in 1989 have circumscribed the issuance of blind pools under the Marks-Roos Act, these restrictions have not completely shut down this practice. In fact, there is evidence that blind pools may be staging a comeback in California. A recently proposed blind pool

financing was structured to include premium bonds to pay issuance costs up front, as required by federal law, the debt service on which was to be paid with income generated by a guaranteed investment contract scheduled to run until the proceeds could be loaned out. While this financing supposedly was structured to comply with the letter of federal law, the origination of these bond pool proceeds ultimately would be sensitive to interest rate movements, which would conflict with other provisions of federal law. This particular financing ultimately was withdrawn from the market, but the Commission is concerned about the potential for similar blind pools coming to market in the future.

In the view of the Commission, the record of abusive blind pool transactions under the Marks-Roos Act, coupled with the potential for future abuses, calls for immediate corrective action. Toward that end, *the Commission recommends that the origination period for Marks-Roos bond pools be limited to 90 days.* Furthermore, any proceeds that were to be loaned but are not loaned within this 90 day period must be used to redeem the authority bonds within 270 days of the date of their issuance. These restrictions would apply only to Marks-Roos bonds issued to fund bond pools for the purpose of acquiring local obligations; they would not apply to Marks-Roos bonds issued to directly fund construction projects, or to Marks-Roos bonds issued by redevelopment agencies in lieu of tax allocation bonds.

Restricting the bond pool origination period to 90 days represents a fundamental policy shift in the Marks-Roos Act. The 90 day limit would diminish the potential for achieving issuance costs economies through the Marks-Roos Act, since PFAs no longer could consolidate capital project financings scheduled for multiple year period into a single Marks-Roos bond issue. In addition, the 90 day limit would simply eliminate interest rate hedging through Marks-Roos bond pools - to the extent that this practice already is not prohibited by the federal *Hedge Bond* restrictions. But in the view of the Commission, the issuance cost savings and other purported benefits of issuing blind pools under the Marks-Roos Act have proved illusory. Many of the small local agencies led down this path have incurred much higher costs than if they had simply executed separate bond transactions for each capital project they ultimately needed to finance. Moreover, those agencies now enmeshed in federal investigations face the prospect of long-term damage to their reputations in the bond market. The Commission recommends a 90 day limit on Marks-Roos bond pool origination periods to eliminate abusive practices and restore investor confidence in this form of finance. The 90 day limit would not circumscribe the issuance of Marks-Roos bond pools for credit pooling purposes in any meaningful way. In the view of the Commission, credit pooling is the most useful application of the Marks-Roos Act and should be maintained for the benefit of public agencies in this state.

2. **Limit Administrative Fees Charged By PFAs.** The Commission recommends that the Marks-Roos Act be amended to clearly limit the levels of administrative fees charged by PFAs. These fees should be set a rate sufficient to recover, but not exceed, the costs of issuing Marks-Roos bonds and the cost of administering bond pools. The fee levied on each local obligation should not exceed that obligation's proportionate share of these costs. Furthermore, the level of these fees should be

disclosed to CDAC and the municipal market (see *Issue #5: Ongoing Disclosure Requirements*).

- 3. Restrict Yield Differentials to 100 Basis Points; Extend Restriction to Refunding Bond Issues.** The SB 2447 yield restrictions enacted into the Marks-Roos law have not been effective and should be substantially strengthened. In the view of the Commission, a small yield differential may be justified as a mechanism for apportioning the cost of funding a common reserve fund to diverse credits in the pool. By permitting a small yield differential, the stronger credits in the pool do not have to subsidize the weaker ones. But insofar as the *quality spread* between tax-exempt credits is a function of changing market conditions, it is difficult to establish the parameters of a reasonable yield differential with precision. In most cases, a yield differential of less than 25 basis points should be adequate for this purpose, but occasionally a greater spread may be necessary. Despite the difficulty of pinpointing a reasonable yield differential, the Marks-Roos law should do so: Our experience with the SB 2447 yield restrictions should teach us that allowing discretion in determining market yields is an invitation for abuse.

After much consideration, *the Commission recommends that the yield differential between Marks-Roos revenue bonds and local obligations acquired with the proceeds of these bonds be limited to 100 basis points.* The use of a yield differential should be restricted to the apportionment of common costs, such as the costs of issuance and funding a reserve, to pool participants. The reserve fund along with its interest earnings ultimately should be used to retire bonds (assuming that any draws on the reserve are replenished). *This yield restriction should be extended to refunding bond issues, as well.* The purpose of allowing a yield differential of up to 100 basis points is not to sanction arbitrage profits up to a point, but rather to allow PFAs the flexibility to apportion common costs when quality spreads are significant.

- 4. Restrict Amounts Received by PFAs to Identified Purposes.** In order to keep PFAs from exploiting the permissible yield differential of up to 100 basis points for the purpose of generating arbitrage profits, the Commission recommends that amounts received by a PFA from the purchase of local obligations be restricted to identified purposes. Specifically, the Commission recommends that *at least 95 percent* of the receipts by an authority from bonds of a local agency purchased by the authority shall be used (i) to pay principal, interest, redemption prices or fees for credit enhancement on bonds of the authority used to acquire bonds of local agencies, (ii) to pay or reimburse administrative costs of the bonds of the authority used to acquire those bonds of the local agency, (iii) to pay or reimburse a local agency for principal, interest or redemption price on bonds of that local agency, or (iv) to establish or replenish reasonable reserves for the payment of debt service on authority bonds. By restricting the use of authority receipts in this manner, it would not be possible for a PFA to generate significant profits by exploiting the permissible yield differential.



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## **ISSUE #2 : CONFLICTS OF INTEREST IN FINANCIAL ADVISORY RELATIONSHIPS**

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The Marks-Roos Act provides the legal authority for public agencies to establish Public Financing Authorities (PFAs) and form bond pools for the purpose of underwriting their own bond issues, a function normally delegated to investment banking firms. But public agencies, of course, are not investment banks - most agencies lack the expertise required to independently execute complex financial transactions such as the underwriting of new securities issues. This lack of expertise tends to be more pronounced in smaller communities, due to their staffing constraints and more limited exposure to the financial markets. Since many Marks-Roos bond pools have in fact been formed in smaller communities, it follows that the public finance officers in these communities have relied heavily on outside financial professionals for advice on key decisions related to the formation and administration of these pools.

Because bond pooling can involve far more numerous and complex financial transactions than required under conventional forms of borrowing, the financial advisors retained to administer these pools may encounter conflicts of interest that do not normally arise. The potential for a conflict of interest arises whenever a financial advisor stands to benefit financially from a course of action that it recommends to its public client. For example, conflict of interest would occur if a broker/dealer, serving as financial advisor to a PFA, were to sell securities from its own inventory to that PFA's bond pool. The broker/dealer's role as financial advisor - to negotiate the lowest price possible for the securities - would directly conflict with its financial interest as seller of the securities - to receive the highest possible price. A similar conflict-of-interest would occur if the financial advisor to a PFA were to earn a commission on the sale or purchase of securities to or from a bond pool. The opportunity to earn commissions might lead the financial advisor to recommend unsuitable bond pool investments to the PFA, or result in the PFA paying too much for otherwise appropriate investments. In light of the influence of the financial advisor on key bond pool decisions, it is imperative that the financial advisory relationship be free from any conflicts of interest.

### **Existing Law and Regulations**

The Marks-Roos legislation itself, as noted in the Introduction, does not identify or prohibit any conflicts of interest in the practices of financial advisors retained to administer Marks-Roos bond pools. But other provisions of state law, as well as regulations of the Municipal Securities Rulemaking Board (MSRB), restrict the activities of financial advisors generally, and these restrictions are relevant to Marks-Roos financings. Specifically, Government Code Section 53691 and MSRB Rule G-23 both prohibit a broker, dealer, or municipal securities dealer that has a financial advisory relationship with respect to a new issue of municipal securities from directly *or indirectly*

underwriting that issue on a negotiated basis [emphasis added]. In other words, the same firm cannot serve as both underwriter and financial advisor on the same negotiated bond sale. This prohibition is intended to preclude a financial advisor from using its influence over its public client to direct underwriting business to itself. In the absence of this prohibition, moreover, a single firm operating in the dual role of underwriter and financial advisor would face an obvious conflict of interest in pricing a negotiated bond sale. As underwriter, the firm would have a direct financial interest in paying the lowest price possible for the bond issue; yet as financial advisor, the firm would have the responsibility of getting the highest price (and lowest yield) possible on the bond issue. Normally, these competing interests are reconciled through negotiations between the underwriter and financial advisor. The *give and take* of these negotiations would of course be missing if the same firm were to, in effect, negotiate the terms of the financing with itself - resulting in more *give* than *take* for the public borrower.

When a series of bond issues are underwritten through a Marks-Roos bond pool, the conflicts of interest that may arise in the underwriter/financial advisor relationship are somewhat different. The pattern evidenced in CDAC data - more than 50 cases since 1988 - is for a community first to form a public financing authority (PFA) and issue Marks-Roos bonds without the benefit of a financial advisor, then to retain the underwriting firm as financial advisor on subsequent bond pool transactions. It is not clear whether the restrictions outlined above contemplated this type of arrangement. If a financial advisory contract is not in place at the time the Marks-Roos bonds are issued, presumably no overt violation of state law or MSRB regulations occurs with respect to that issue (even though the PFA, acting without the benefit of a financial advisor, obviously relies on the underwriter for advice on the structuring and marketing of the Marks-Roos bond issue). If, however, a financial advisory contract was in place at the time the Marks-Roos issue was *refunded* by the same firm, a strong case could be made that a violation had taken place. Moreover, the underwriter of a Marks-Roos bond issue may be thought of as *indirectly* underwriting subsequent bond pool investments if it holds any portion of the Marks-Roos issue at the time those investments take place. A bond pool, after all, consists of borrowed money, and the lenders of that money - the Marks-Roos bondholders - indirectly own the bond pool portfolio.

Whatever the applicability of the federal and state regulations outlined above to Marks-Roos financings, the Commission believes that Marks-Roos Act itself should clearly identify and prohibit any conflicts of interest that might compromise the financial advisory relationship of a PFA. The relevant question for the Legislature to consider is whether the underwriter of a Marks-Roos bond issue has any continuing financial interest in the bond pool that might compromise the advice it offers under a financial advisory contract.

## Underwriting Role Compromises Financial Advisory Relationship

On the surface, the fact that a PFA and the underwriter of its Marks-Roos bond pool have *different* financial interests does not necessarily imply a *conflict* of interests that would compromise a financial advisory relationship between the two. After all, the PFA and the underwriter share a mutual interest in maintaining the financial integrity of the bond pool, if for different reasons. The PFA wants to make timely principal and interest payments on its Marks-Roos obligations simply to honor its commitments and maintain its good name in the financial markets. The underwriter of the Marks-Roos bond issue, by contrast, has a direct financial interest in those debt service payments as long as it owns any of the bond issue. If, for example, the underwriter of a Marks-Roos issue were to hold any of those bonds as dealer inventory, the advice it would offer under a financial advisory contract would affect the value of its own investment. But even if the underwriter successfully reoffers the entire Marks-Roos bond issue to investors, as is usually the case, the underwriter still has an indirect financial interest in those bonds, insofar as its underwriting business depends upon the continuing demand of its investor clients for the securities that it underwrites and reoffers. Saddling investors with shaky Marks-Roos bond issues might be bad for business.

In a well-structured Marks-Roos bond pool, the financial interests of a PFA and its bondholders may never conflict in a way that would compromise the underwriter of those bonds in the role of financial advisor to that PFA. But if the underwriting firm exercises poor judgment in sizing and structuring the Marks-Roos issue, and the bond pool subsequently encounters financial difficulties, this financial advisory relationship could be compromised. The financial advisor might feel compelled to recommend actions to gloss over its underwriting mistakes and/or protect its investor clients, possibly at the expense of the PFA. Specifically, there are three problematic bond pooling practices that appear to be more prevalent when the same firm operates in the dual role of underwriter of a Marks-Roos bond issue and financial advisor on subsequent bond pool investments:

- **Excessive Yields and/or Administrative Fees on Local Obligations.** As discussed in *Issue #1: Recovering the Costs of Issuance*, PFAs have two options for recovering the transactions costs associated with issuing Marks-Roos bonds: (1) charging an administrative fee on each obligation acquired by the bond pool; and (2) establishing a yield differential between the Marks-Roos bond issue and each obligation acquired by the bond pool (in accordance with the restrictions imposed by SB 2447). As part of its marketing effort, an underwriting firm may convince a public agency that establishing a Marks-Roos bond pool will generate a significant revenue stream for the community. These revenue projections, however, may depend more on the level of administrative fees and/or the yield differentials established for bond pool obligations than on any issuance cost economies or risk diversification benefits derived from bond pooling. Or, after the bond pool is formed, the underwriter/financial adviser may persuade the PFA to charge exorbitant administrative fees and/or yield differentials to compensate for the financial liabilities arising from bond pool oversizing or other underwriting errors.

- **Questionable Refunding Activity.** Commission staff has received complaints concerning questionable refundings of Marks-Roos bond issues and/or local obligations acquired by bond pools. In certain cases, the investment contract for bond pool proceeds reportedly did not run to the nonorigination call date, creating a reinvestment problem that necessitated a refunding of the Marks-Roos issue. Other bond pools have been structured with a mismatch in cash flows between the Marks-Roos issue and the local obligations acquired by the bond pool, again necessitating refunding. Certain assessment bond issues have been refunded by bond pools to provide relief to real estate developers responsible for debt service payments (by reassessing delinquencies into the principal amount of the borrowing and diverting reserve funds to the bond pool). Finally, CDAC has received complaints that some Marks-Roos issues have been refunded primarily to generate underwriting fees without providing significant present value savings to the PFA or taxpayers.
- **Unsuitable Bond Pool Investments.** As discussed in *Issue #3: Suitability of Bond Pool Investments*, a PFA that oversizes its bond pool may look for alternative long-term investments in order to recover its costs of issuance. Though both the PFA and its underwriter/financial advisor ideally would like to acquire creditworthy obligations, such obligations may not generate sufficient yield to cover the PFA's cost of funds; consequently, the PFA may accept a high degree of risk in return for yield.

An independent financial advisor, with no direct or indirect financial stake in bond pool transactions, would be less likely to recommend any of the questionable practices outlined above. An independent financial advisor, cognizant of the fact that excessive administrative fees and/or yield on bond pool acquisitions of local obligations may violate provisions of the Internal Revenue Code and state law, would have no reason to put its professional reputation at risk by recommending this course of action. Nor would an independent financial advisor recommend the refunding of obligations merely to generate underwriting fees. Finally, an independent advisor would not recommend that a PFA acquire unsuitable bond pool investments simply to generate yield and prop up a shaky bond pool; instead, he or she likely would recommend that the PFA negotiate with its bondholders if necessary to find an acceptable resolution to the bond pool's cash flow problems.

Additionally, by separating the underwriting and financial advisory functions in Marks-Roos bond pools, a community is more likely to retain an independent financial advisor *before* reaching the momentous decision to form a bond pool. The financial advisor then will be in the position to help the community decide whether this course of action makes sense financially. If so, the financial advisor can negotiate the terms of the Marks-Roos issue with the underwriter on behalf of the PFA, reducing the likelihood that the bond pool will be oversized or otherwise structurally flawed. This, in turn, should eliminate the incentive for finance professionals to engage in any of the questionable practices outlined above.

## RECOMMENDATIONS FOR LEGISLATION

1. **Prohibit the Underwriter of a Marks-Roos Bond Issue from Serving as Financial Advisor or Investment Advisor on Bond Pool Investments.** In the view of the Commission, a fundamental conflict of interest arises when the same firm operates in dual role of underwriter and financial advisor on related bond pool transactions. If the underwriter of a Marks-Roos bond issue holds any of these bonds as dealer inventory, the advice it offers under a financial advisory contract directly affects the value of its own investment. If the underwriter successfully reoffers the bonds to investors and the bond pool subsequently encounters financial difficulties, the firm may recommend actions to cover up its underwriting mistakes and protect its investor clients, possibly at the expense of its financial advisory client. *The Commission recommends that the Marks-Roos law be amended to prohibit a broker, dealer, or municipal securities dealer that underwrites a Marks-Roos bond issue from serving as financial advisor or investment advisor on bond pool investments.*

For purposes of this legislation, the term *financial advisor* is defined as “any person, firm, or organization that engages in financial services and receives remuneration for the advice and other assistance it provides a public client.”

2. **Require a Written Financial Advisory Contract.** The Commission recommends that the Marks-Roos law be amended to require that a PFA and its financial advisor enter into a written contract prior to the delivery of financial advisory services. The contract should clearly specify the range of services that will be delivered and the entire compensation to be paid to the financial advisor.

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## ISSUE #3: SUITABILITY OF BOND POOL INVESTMENTS

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Public Financing Authorities (PFAs) issue Marks-Roos bonds for the purpose of financing a program of capital improvements for the benefit, primarily, of PFA member agencies. PFAs typically do not fund construction and acquisitions costs directly from the proceeds of a Marks-Roos bond sale; instead, a bond pool is established for the purpose of underwriting local obligations which fund these projects. (The local obligations - bonds, leases and loans - acquired by Marks-Roos bond pools are called *program investments*.) The issuers of Marks-Roos bonds, therefore, may be thought of as investors as well as issuers of municipal securities. In light of their status as investors, PFAs should be entitled to the protections against fraudulent and deceptive business practices afforded other investors under federal securities laws and industry regulations. But since bond pool investments are not channeled through the retail securities market, existing investor protections may either not apply to Marks-Roos bond pools or not be enforced. The Marks-Roos Act, consequently, should incorporate a level of investor

protections for PFAs sufficient to ensure that bond pool proceeds are invested in securities suitable for public funds.

### **Antifraud Provisions of Federal Securities Law**

Municipal securities transactions, though exempted from the registration, reporting and regulatory requirements of federal securities laws, are subject to the antifraud provisions of the key federal securities laws - the Securities Act of 1933 [Section 17] and the Securities Exchange Act of 1934 [Section 10(b)]. In general, these provisions impose liability for failure to disclose material information in connection with securities offerings. The most significant antifraud provision relevant to state and local government securities transactions, Rule 10b-5, promulgated by the SEC under Section 10(b), prohibits fraudulent actions and material misrepresentations and omissions by any person in connection with purchases and sales of securities. Securities brokers and dealers that violate these laws may be subject to SEC enforcement action and possible criminal and civil penalties. The National Association of Securities Dealers (NASD), charged by Congress in the 1975 Securities Act amendments with enforcing the rules of the Municipal Securities Rulemaking Board (MSRB) and securities laws generally, also may take disciplinary action. Finally, the State Department of Corporations licenses securities brokers and dealers in California and may revoke a license if state securities laws are violated.

In a typical bond pool underwriting of a new securities issue, where the PFA consists of a city and its redevelopment agency, the requirement for full disclosure of material information may not be particularly meaningful, since the same public officials serve as the governing board for the both the buyer (the PFA) and the seller (the redevelopment agency) of the local obligation (the PFA is required, in effect, to disclose information to itself). The legal requirements for full disclosure become more relevant when a PFA consists of a number of different member agencies (for example, a statewide pool), since the PFA may not be in possession of all information material to the acquisition of member agency obligations. But the requirements for full disclosure become most important when a PFA purchases nonmember securities for its pool. For the reasons discussed below, PFAs with oversized bond pools may look to acquire nonmember securities in order to recoup the costs of issuing the Marks-Roos bonds that funded their bond pools. Such PFAs may need to acquire relatively high yielding securities in order to cover their cost of funds (the true interest cost of their Marks-Roos bond obligations). It is axiomatic that higher yielding securities entail a higher degree of risk; therefore it is imperative that these risks be fully disclosed to the prospective purchaser - the PFA. (The financial press has reported that the failure to disclose material information related to bond pool investments in nonmember securities is at issue in at least one of the Marks-Roos transactions under investigation by the SEC.)

Insofar as the antifraud provisions of federal securities laws already pertain to all municipal securities transactions, it is not clear that the Marks-Roos Act needs to be strengthened in this regard. In terms of protecting of public issuers against fraudulent and deceptive business practices, what really is needed is consistent enforcement of

existing law, rather than additional statutory restrictions. The SEC historically has undertaken enforcement action with respect to municipal securities transactions only sporadically: It is not unusual for a pattern of abuses to appear before an investigation is initiated, or for a period of years to pass before a questionable transaction is investigated. The NASD and State Department of Corporations are even less aggressive in their municipal enforcement and disciplinary efforts; these agencies are more likely to follow up on SEC enforcement actions than to initiate investigations. Finally, local district attorneys have the authority to enforce state securities laws, but typically they lack the resources and expertise to do so. In the view of the Commission, the abusive Marks-Roos transactions which have come to light thus far point to deficiencies in the enforcement of existing state securities laws, as well as the need to strengthen the Marks-Roos Act itself. Yet if the legislative recommendations included report ultimately are to be effective, they must be enforced.

### **Suitability of Investments**

Investors in municipal securities are protected not only by the antifraud provisions of federal securities laws, but also by MSRB Rule G-19, which requires that securities brokers and dealers make *suitable* recommendations to their customers. Specifically, Rule G-19 requires brokers and dealers, prior to recommending the purchase, sale or exchange of a municipal security, to develop a knowledge of the customer's financial background, tax status, investment objectives and any other similar information and have reasonable grounds to believe, based upon this information, that any recommendation it makes concerning the purchase, sale or exchange of municipal securities is suitable for the customer. Rule G-19 is one of the "fair practice" rules of the MSRB (Rules G-17 through G-35). The somewhat paternalistic tenor of these rules implies a vulnerability of investors in their business relationships with securities brokers and dealers. By prohibiting fraudulent and deceptive business practices, these rules seek to protect the public interest and promote a fair and open market in municipal securities.

The suitability requirement imposed by Rule G-19 serves as a point of reference for evaluating the judgment exercised by the financial professionals who assist PFAs in the development and administration of Marks-Roos bond pools. It is not clear whether Rule G-19 specifically applies to the underwriters, financial advisors and other consultants that assist PFAs in designing their bond pool portfolios, but clearly, the advice offered by these professionals should be held to the suitability standard. Specifically, there are two areas in which the suitability standard is particularly relevant: (1) the development of investment criteria for bond pools; and (2) the investment recommendations made by financial professionals to PFAs. The investment criteria developed for Marks-Roos bond pools should be suitable for the investment of public funds, as should be the investment recommendations of underwriters, financial advisors, brokers and dealers. Suitability really is a higher standard than full disclosure, since the disclosure of risk does necessarily make it acceptable.

## **Investment Criteria**

The investment criteria developed for Marks-Roos bond pools identify the types of local obligations eligible for acquisition and specify minimum standards of creditworthiness for these obligations. Investment criteria are most important for bond pools with long origination periods, where all of the local obligations to be acquired are not identified at the time the Marks-Roos bonds are issued. In such cases, prospective buyers of the Marks-Roos issue look to these criteria to gauge how the bond pool portfolio ultimately will take shape. To the extent that the local obligations to be acquired are identified in the Marks-Roos offering documents, prospective buyers of the Marks-Roos issue can of course evaluate these obligations (and projects) directly.

Even though Marks-Roos bond pools are formed to underwrite bonds and other obligations of PFA member agencies, the trust indenture for a Marks-Roos bond issue may permit bond pool investments in nonmember obligations. The trust indenture may require that an agency join the PFA in order for its obligations to be eligible for acquisition by the bond pool (though it is not clear that PFAs always adhere to this requirement). The language in the trust indenture identifying permissible bond pool investments is reprinted in the Official Statement for the Marks-Roos bond issue, and usually looks something like this:

The bonds are being issued pursuant to the Constitution and the laws of the State of California, and particularly the Marks-Roos Local Bond Pooling Act of 1985 (the “Act”), constituting Article 4 (commencing with Section 6584), Chapter 5, Division 7 , Title 1 of the Government Code of the State, and an indenture between the Public Financing Authority and the [trustee], to provide funds to finance, refinance or reimburse the costs of land, buildings, equipment and other capital improvements of the [PFA member agencies], for whose benefit the program has primarily been designed, or for any other cities, municipal agencies and special districts located in the State (collectively “Local Agencies”) and to make deposits in various funds authorized in the Indenture (the “Program”).

Under the Act, Local Agencies may become eligible to participate in the Program and thereafter, the Authority may acquire such Local Agencies’ bonds, certificates of participation, general obligation bonds or tax allocation bonds, lease-purchase agreements, Special Tax Bonds, Assessment Bonds and other evidences of indebtedness. The authority may only acquire Local Obligations which are (a) Assessment Bonds or Special Tax bonds with not less than 3:1 MAI appraised value or assessed value-to-lien ratio issued by Local Agencies in the State of California, or (b) other Local Obligation rated “Baa” or better by Moody’ Investors Service or “BBB” or better by Standard and Poor’s Corporation or by Fitch Investors Service, Inc.



At first glance, this language suggests that the PFA has established fairly strict investment criteria for its bond pool: all land-secured debt (Mello-Roos and assessment bonds) must achieve a 3:1 value-to-lien ratio, and all other debt must be investment grade. But there are several reasons why these investment criteria ultimately may not protect the bond pool against bad investments. First, a 3:1 value-to-lien ratio only serves as an indicator of creditworthiness to the extent that it is based upon a reasonably accurate appraisal and, historically, there has been a great deal of disparity in the quality of appraisals undertaken to establish value-to-lien ratios. At least one Marks-Roos bond pool has purchased a Mello-Roos bond issue with a value-to-lien ratio in excess of 3:1 only to find, after initiating foreclosure proceedings, that the land securing the bond issue was virtually worthless. Fortunately, the quality and uniformity of these appraisals should be improving: Since January 1994, any local agency initiating proceedings to form a CFD must first adopt a set of standards for use in its appraisals. (To assist local agencies in this regard, CDAC has published the document *Appraisal Standards for Land-Secured Financings*). Also since January 1994, the minimum 3:1 value-to-lien ratio is a legal requirement for Mello-Roos bond issues. Though neither requirement applies to assessment bonds, the Commission advises local agencies to hold all land-secured debt to the same standards.

Even if a Mello-Roos or assessment bond issue achieves a legitimate 3:1 value-to-lien ratio, based upon a conservative appraisal, it still might not be a good investment, for any number of reasons. A more thorough credit analysis would look at the concentration of property ownership in the district: If ownership is highly concentrated and a major owner falls delinquent in tax or assessment payments and subsequently files for bankruptcy, the courts likely would consider the delinquent parcels to be part of the developer's bankruptcy estate and impede judicial foreclosure proceedings. Additionally, a thorough evaluation of land-secured debt must look at coverage ratios, reserve funds, capitalized interest accounts, the legal and financial structure of the partnership or corporation developing the district, as well as any number of subjective criteria that are impossible to quantify.

With respect to other types of local obligations, the requirement for an investment grade credit rating serves as a solid indicator of creditworthiness, provided that this criterion is incorporated into the trust indenture and the PFA adheres to it. This is not to say that bond pools should never underwrite noninvestment grade securities; in fact, the most recent innovation in Marks-Roos financing, the *senior/subordinated* structure mentioned in the Introduction to this report, offers a way for local agencies to achieve an investment grade credit rating on previously unrated debt by segregating a portion of this debt into a Series A tranche, with a senior lien on all revenues generated by the pool, and a Series B, with a junior lien. The added coverage of the senior lien qualifies the Series A bonds for an investment grade credit rating. Though the Series B bonds remain unrated, the PFAs composite interest rate is lowered. Nonetheless, it is difficult to develop meaningful investment criteria for noninvestment grade securities; ultimately, agency staff and their financial consultants must exercise sound judgment in designing these types of pools.

Finally, investment criteria do not necessarily offer a safeguard against *mixing credits* in a bond pool. Though not illegal, this practice tends to negate any interest cost advantages of bond pooling, since the interest rate on a Marks-Roos bond issue will reflect the *weakest link* in the bond pool. In one case that we are aware of, a strong COP issue that would have achieved an “A” rating on its own was mixed in with several tax allocation and assessment bonds of lesser quality, along with a questionable industrial development bond issue (issued to fund a fledgling auto mall). As a consequence, the PFA wound up paying a much higher interest rate on the COP issue than necessary (the COP issue eventually was refunded to generate substantial present value savings).

### **Investment Recommendations**

The investment criteria developed for Marks-Roos bond pools, no matter how comprehensive, can never address all of the tangible and intangible factors that distinguish a good investment from a bad one. The discussion above, for example, points out that the value-to-lien ratio is just one - albeit crucial - criterion for evaluating the creditworthiness of land-secured debt. But it is not possible to quantify and specify criteria for all the credit risks of land-secured debt. The credit ultimately depends upon the success of the development project, which can be assessed more accurately by the subjective judgment of an experienced market participant than by a quantitatively-oriented marketing study. Even though the credit analysis of land-secured debt certainly is quirkier and less suited to quantitative analysis than other debt instruments, no investment criteria is airtight. Ultimately, a PFA depends upon the sound judgment of its financial advisor and other professionals. It is this advice that must be held up to the suitability standard of MSRB Rule G-19.

The suitability standard is most germane in cases where a PFA *oversizes* its bond pool - or issues more Marks-Roos bonds than necessary to meet the capital needs of PFA member agencies - and faces a choice between calling (redeeming) the bonds prior to maturity, or finding an alternative investment for the funds. If a suitable investment can be found, the latter option may be preferable, since it provides a means of recouping the issuance costs of the Marks-Roos bonds (remember, the PFA must pay the costs of issuance - underwriting and bond counsel fees, etc., - on all of the Marks-Roos bonds it issues, whether or not it ultimately finds a need for the funds). If the PFA is *unable* to recoup the costs of issuance on the entire bond pool, it may face a shortfall of funds when the call date arrives, since it will not only have to redeem all of the nonoriginated bonds in the bond pool, but also pay a call premium. The nonorigination call date could, therefore, trigger the default of the Marks-Roos bond issue.

Although the PFA would have an interest in acquiring only creditworthy obligations for its pool, this goal may be undermined by simple mathematics. The Marks-Roos bond pool itself consists of borrowed money, capitalized at interest rates that reflect the *weakest link* in the bond pool investment portfolio. To attract investors, a Marks-Roos bond offering issued to fund a bond pool of noninvestment grade securities will have to offer relatively high yields (in accordance with the *risk-reward* relationship of finance). Facing such a high cost of funds, a PFA is not likely to be in a position to compete

favorably with investment banks for the underwriting business of non-PFA agencies. Only the most risky of bond issues may offer yields high enough for the PFA to cover its costs of funds. It is imperative that a PFA not be advised to accept an unreasonable degree of risk in its investments as part of a desperate strategy to keep its bond pool solvent. In such cases, Marks-Roos bondholders would be better served by a negotiated settlement to a default that returns as much of their principal as possible, rather than losing additional amounts in an ill-advised gamble.

## RECOMMENDATIONS FOR LEGISLATION

1. **Investment Criteria.** The Commission recommends that the Marks-Roos Act be amended to require that the investment criteria for bond pool investments be clearly delineated in the offering documents for a Marks-Roos bond issue. These criteria should specify the types of obligations eligible for acquisition by the bond pool and minimum standards of creditworthiness. These criteria should be as detailed as reasonably possible.

The Commission recognizes that limiting the origination period for Marks-Roos bond pools to 90 days would of course diminish the significance of Investment Criteria relative to the situation under current law (see *Recommendation 1: Limit the Origination Period for Marks-Roos Bond Pools to 90 Days* under *Issue #1: Recovering the Costs of Issuance*). Under such a short origination period, virtually all local obligations or projects to be funded through a bond pool would need to be identified at the time of issuance. Nonetheless, clearly delineated Investment Criteria would provide prospective investors with a succinct analysis of the risks in the bond pool portfolio according to objective criteria - even if all of the local obligations or projects were identified at the time of issuance. And in the event that all of the obligations or projects are not identified at the time of issuance, these Investment Criteria would provide prospective investors with their only clue as to how the bond pool portfolio ultimately will take shape.

2. **Suitability of Investment Recommendations.** The Commission recommends that the Marks-Roos Act be amended to require financial advisors, underwriters, brokers and dealers, prior to recommending a bond pool investment to a PFA, to have reasonable grounds to believe that the investment is suitable for the bond pool.
3. **Prohibited Investments.** The Commission recommends that the Marks-Roos Act be amended to prohibit the underwriter of a Marks-Roos bond pool, or the financial advisor or investment advisor to a Marks-Roos bond pool, from selling to that bond pool any security or obligation issued by a state or local government from its dealer inventory or that it underwrote or otherwise placed on behalf of another client.

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## **ISSUE #4: FEES CHARGED ON NONPROGRAM INVESTMENTS**

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The underwriter or financial advisor on a Marks-Roos bond issue typically arranges for the investment of idle pool funds and the reserve fund in guaranteed investment contracts or other interest bearing securities that offer sufficient liquidity. These investments are incidental to the primary purpose of the bond pool - the underwriting of long-term bonds or other obligations (usually of PFA members) - and are referred to as *nonprogram investments*. Nonprogram investments include (1) guaranteed investment contracts executed either for idle bond pool funds (pending the origination of long-term program investments), debt service funds, reserve funds or other funds, (2) all other reserve fund investments, and (3) the sale of open market securities to refunding escrows. The trust indenture for the Marks-Roos bond issue should specify permitted nonprogram investments.

An underwriting firm typically will charge a fee for arranging nonprogram investments for the issuer; a financial advisor may charge a fee or include this service as part of its financial advisory contract. The Commission is concerned about the level of fees or commissions charged on nonprogram bond pool investments. Many PFAs are inexperienced issuers and do not have a strong sense as to what constitutes a reasonable fee or commission on nonprogram investments - if they are aware at all that they are paying these fees as part of the purchase price of these securities. Such issuers are, of course, vulnerable to overcharging whenever they issue debt, not just when they form Marks-Roos bond pools. But the charging of excessive fees and commissions on nonprogram investments appears to more of a problem in Marks-Roos bond pools than in the municipal market generally due to the inexperience of many PFA officials with issuing debt, coupled with the fact that many PFAs are not represented by a financial advisor at the time nonprogram investment decisions are made. In addition, a substantial portion of many bond pools sit idle for multiyear periods, presenting the opportunity for lucrative investment contracts. As a result, many PFAs have awarded nonprogram investments on a noncompetitive basis, raising serious questions over the amount of fees and commissions that were paid on these investments. There also have been instances where nonprogram investments were awarded to a guaranteed investment contract provider that was wholly owned by the underwriter of the Marks-Roos bond issue.

### **RECOMMENDATIONS FOR LEGISLATION**

Recent changes in federal tax law, effective July 1, 1993, appear to have addressed the most abusive and noncompetitive business practices identified above. Federal law now requires competitive bidding on all guaranteed investment contracts purchased with the proceeds of federally tax-exempt municipal securities. Additionally, federal law now requires that the purchase price of government securities sold to issuers of federally tax-exempt municipal bonds be certified as the fair market value of those securities by the seller. This certification requirement applies principally to the sale of government

securities to reserve funds and refunding escrows. The Commission is concerned, however, that unsophisticated local agencies may be persuaded to issue Marks-Roos bonds on a taxable basis in order to circumvent the competitive bidding and fair market value certification requirements, which apply only to federally tax-exempt municipal securities. For that reason, the Commission recommends the following amendments to the Marks-Roos Act.

- 1. Require Competitive Bidding for Guaranteed Investment Contracts.** The Commission recommends that the Marks-Roos Act be amended to require that a PFA solicit at least three bids on all guaranteed investment contracts purchased with the proceeds of a Marks-Roos bond issue, whether or not the interest on that bond issue is exempt from federal and state income taxation. This restriction would apply to the purchase of guaranteed investment contracts for reserve funds, debt service funds, or any other purpose.
- 2. Require Certification of the Fair Market Value of Government Securities Sold to Marks-Roos Bond Pools.** The Commission recommends that securities dealers that sell government securities to Marks-Roos bond pools be required to certify that the purchase price of such securities is equal to the fair market value of those securities. This requirement would apply the sale of government securities to bond pool reserve funds and refunding escrows and any other funds or accounts. This requirement should apply whether or not the interest on the Marks-Roos bond issue is exempt from federal and state income taxation.
- 3. Disclose Commissions and Fees on all Nonprogram Investments.** The Commission recommends that the Marks-Roos Act be amended to require PFAs to disclose to investors all fees and commissions paid on nonprogram investments. (This information is included on the recommended CDAC reporting requirement discussed in *Issue #5: Ongoing Disclosure Requirements*.)

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## **ISSUE #5: ONGOING DISCLOSURE REQUIREMENTS**

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One area of particular concern for investors is the lack of information available on Marks-Roos bond pools. This information void affects both the initial purchasers of reoffered Mark-Roos bond issues, who wish to keep up on the status of their investments, and prospective purchasers in the secondary market. For instance, one might suspect that the drop-off in real estate activity over the past few years has adversely affected Marks-Roos bond pools established to facilitate development; or that the decline in interest rates between 1991 and 1994 might have posed a reinvestment problem for certain bond pools, but there simply is not sufficient information available to confirm or deny these suspicions.

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While the recently adopted amendments to SEC Rule 15c2-12 on continuing disclosure requirements may improve the situation in some cases, it is questionable whether this change will fully address the information needs that have been identified. In the Commission's view, a strong argument can be made in favor of more stringent disclosure requirements for Marks-Roos bond pools, similar to that imposed on Mello-Roos bonds sold after January 1, 1993. Many of these pools have long origination periods, and are sensitive to movement in interest rates. The investment portfolios of other pools may wind up bearing little resemblance to the investments specified in the original Marks-Roos bond offering documents. For these reasons, the Commission makes the recommendation below.

## **RECOMMENDATIONS FOR LEGISLATION**

The Commission recommends that a reporting requirement be established for Marks-Roos bond pools that would be similar in form and substance to the one now required for Mello-Roos Community Facilities Districts. PFAs would be required to submit the information specified below on an annual basis for both their outstanding Marks-Roos obligations and the local obligations in their bond pools. In addition, the Commission recommends that PFAs be required to notify the Commission within 10 days of any default or draw on its reserve fund. The Commission would publish this information in an annual report. These requirements would apply only to Marks-Roos bond pools formed to acquire local obligations; they would not apply to bonds issued under the Marks-Roos Act to fund a single project. For example, these reporting requirements would not apply to bonds issued by redevelopment agencies under authority of the Marks-Roos Act, in lieu of tax allocation bonds, to fund single projects.

### **Marks-Roos Bond Yearly Fiscal Status Report**

#### **Marks-Roos Bond Information:**

1. The principal amount of bonds outstanding.
2. The balance in the reserve fund.
3. Costs of issuance, including any ongoing fees.
4. Total amount of administrative fees collected.
5. Interest earnings and terms of all nonprogram investments.
6. Commissions and fees paid on nonprogram investments.

### Local Obligation Information

1. The principal amount of bonds outstanding.
2. Delinquency rates on all obligations.
3. Balance in capitalized interest accounts.
4. Administrative fees charged to each local obligation.

### **Marks-Roos Draw-On Reserve Fund and Default Report**

1. A Marks-Roos bond issue or local obligation debt service payment is missed.
2. Funds are withdrawn from a reserve fund to pay principal and interest on the Marks-Roos bonds or any local obligation in the bond pool.