Speer Financial, Inc.

INDEPENDENT MUNICIPAL ADVISORS ESTABLISHED 1954

Muni Bond Newsletter

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NEW FEDERAL GIFT RESTRICTIONS ON MUNICIPAL ADVISORS

The SEC has extended MSRB Rule G-20 to municipal advisors (MAs). The rule prohibits MAs from giving or providing or permitting to be given anything or service of value in excess of $100, if such gift can be in any way viewed as related to obtaining or retaining business from a municipality or other public entity. The rule is purposefully written to be very broad and was crafted to address all forms of "pay to play/commercial bribery" between MAs and municipalities.

Some of the breadth of the rule includes provisions:

- ◊ Restricting not only direct but indirect gifts;
- ◊ Requiring that gifts must be valued at the higher of cost or market value, exclusive of tax and delivery charges;
- ◊ Including gifts not only to recipient municipalities, but their employees, agents and representatives; and
- ◊ Requiring an aggregation provision to limit multiple gifts.

The valuation provision requires that when valuing tickets for sporting or other entertainment events, the MA must use the higher of cost or face value. The aggregation provision requires the MA to aggregate all gifts given by it (and all MA employees) over the course of a year.

There are some exclusions, including occasional gifts of meals, sponsoring business functions that are recognized by the IRS as deductible business expenses, pens, notepads, and other gifts of *de minimis* value. There is also an exclusion for bereavement gifts.

The rule requires MAs to keep extensive records for all gifts. Recordkeeping alone may be one of the main deterrents to MAs providing gifts.

Municipalities and their employees should be aware of the gift restrictions on MAs and themselves as recipients of such gifts. Though this rule imposes federal restrictions on MA's, there are often additional and similar state law restrictions on municipal employees.

REFUNDING TIMING
BIRD IN THE HAND OR TWO IN THE BUSH?

Timing on when to enter into a refunding transaction can be difficult. Significant savings may be available, but there is often the question of is it enough and could it get better by waiting. One factor is that in refinancing a bond issue, refunding bond proceeds must be invested in Treasuries until the call date on the refunded issue. This often leads to "losses" in the refunding escrow through very low interest rates on the Treasury securities. This loss is known commonly as "negative arbitrage" and is calculated as the difference between earnings at the rate on the new bonds and the actual investment rate received. Refunding transactions today with call dates in 2017-2019 may be very attractive due to historically low tax exempt rates, regardless of the amount of negative arbitrage.

Patience may be a virtue but the conundrum in waiting until closer to the call date and reducing the negative arbitrage is that the rate on the new bonds may rise, wiping out the added savings. Once a target for savings is achieved, it is difficult to wait to see if things get better. There is no "correct" answer.

As your municipal advisor, we routinely run refunding scenarios and valuations of refundings. Our goal is to keep our clients informed of the possibilities, so that clients can be aware of the savings levels and discuss savings targets. While no one can foresee the future of rates, having an informed discussion of risk and reward can aid in decision making.

ILLINOIS BUDGET IMPASSE AND THE EFFECT ON LOCAL GOVERNMENTS

The State of Illinois budget impasse has had an adverse effect on local governments within the State. Local governments are having trouble preparing their budgets because they rely on revenues such as sales taxes, state income taxes, motor fuel taxes and other state funding. Local governments have had to use reserves for day-to-day operations, find other means of funding, cut expenses or in some cases, cut services and programs provided to residents. In addition, there is uncertainty as to what local governments will receive or not receive from the state in the future.

The state recently approved a stopgap budget which will provide payments for the prior year and is good for the first six months of the current fiscal year. It is uncertain as to the priority, timing and the amount of payments local governments will receive for programs and services. The state continues to operate without the implementation of a full-year comprehensive budget.

Moody's Investors Service has placed the general obligation bonds' ratings of 19 Illinois community colleges on review for a possible downgrade. This is due to the state budget impasse and its effect on revenues of the community colleges. Illinois community colleges have not received any grant distributions or state aid in almost a year. Community colleges like other local governments are faced with increased financial risks and challenges, and the risk of future cuts in state aid distributions.

Moody's Investors Service recently downgraded the credit rating of the State of Illinois from Baa1 to Baa2, two notches above non-investment grade. Standard and Poor's and Fitch have also downgraded the credit rating of the state's general obligation bonds with a negative outlook. Illinois issuers will continue to pay higher yields as a result of the financial condition of the state.

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MSRB RULE G-42 TAKES EFFECT

On June 23, 2016, the Municipal Securities Rulemaking Board's (MSRB) Rule G-42 went into effect on the duties of non-solicitor municipal advisors (MA). Rule G-42 establishes the core standards of conduct for MAs .

Rule G-42 creates certain standards of conduct relating to the fiduciary duty owed by the MA to its municipal entity clients. These standards of conduct include the Duty of Care and the Duty of Loyalty.

The Duty of Care includes:

* **The MA having knowledge and expertise needed to provide particular advice to a client**
* **Inquiring with the client about information that is relevant to making a recommendation of a financing or any advice for a certain course of action**
* **Having a basis for which to provide the advice to the client**

The Duty of Loyalty includes:

* **That the MA deal honestly and in good faith with the client**
* **Putting the client's interests ahead of all other interests, including the MA's own financial interest**
* **Not engaging with a client if the MA cannot manage their conflicts of interest in a way that allows them work in the best interests of their client**

Only MAs have a fiduciary relationship to their municipal clients in a securities transaction. While other parties have acted on many of these notions over the years, the SEC and MSRB make clear the responsibilities MAs owe to their municipal entity clients.

Municipalities will be seeing more formal contracts and disclosures from MAs, as Rule G-42 requires documentation of the MA relationship with clients. This must be done in writing, dated and delivered upon or promptly after the relationship is established. Information in the documentation includes:

* **Scope of services to be performed and the fees charged**
* **Disclosures of conflicts of interest**
* **A detailed description of any legal disciplinary events, as well as the location of the MA firm's form MA and forms MA-I that are filed with the SEC**
* **Limitations to the scope of engagement**
* **The means of terminating the relationship**

For the full text of Rule G-42 or a more complete summary of the rule, please visit www.msrb.org.

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DID THE IRS PROPOSE POLITICAL SUBDIVISION RULES THAT AFFECT YOU?

On June 6, 2016 the Internal Revenue Service (the "IRS") held a public hearing seeking comments on their proposed rule change to what types of political subdivisions may issue tax-exempt municipal securities in the future. Many large industry leaders spoke at this hearing, including GFOA's President Elect, Patrick McCoy, Director of Finance for the New York City Metropolitan Finance Authority. The IRS heard overwhelming disapproval and was urged by many to withdraw the proposal, re-evaluate and re-submit a proposal of change.

The proposed new rule requires a three prong test in determining whether a political subdivision is eligible to issue tax exempt municipal securities. The prior rule used only a two prong test, so an additional determining factor was added in this proposal. Under the proposal a political subdivision must meet these three factors in order to issue tax-exempt securities: 1) it must exercise sovereign powers, 2) serve a governmental purpose and 3) (newly added) be governmentally controlled.

Many opponents to the proposal believe that there are many types of political subdivisions across the country that provide vital services. Those same opponents don't necessarily agree with the concept that new rules may curb abuse of the use of tax-exempt securities being issue in some cases. But the argument heard from those opponents is for the IRS to let individual states decide on their own laws about what constitutes a political subdivision, as they have done in the past.

Not much has been said from the IRS following their June 6, 2016 public hearing on these proposed rule changes. If this could affect you, please continue to follow the IRS on future decisions related to this proposal.

BOND INSURANCE PAST AND PRESENT

The municipal Bond insurance industry has changed significantly the Great Recession. Four bond insurance companies have dropped out of the industry due to significant rating downgrades or withdrawals. There have also been mergers and new participants. None of the remaining municipal insurance providers are currently rated AAA. The two active insurance companies are Assured Guaranty and Build America Mutual Assurance Company (BAM). Both are rated in the AA category by S & P Global Ratings. National Public Finance Guarantee Corp., an affiliate company of MBIA (NPFG), has had its S & P rating raised to the low AA category and has begun to write new policies.

Although use of insurance is currently increasing, it is only approximately 5% of the new issue market, down from 57% of the new issue market in 2005.

Recently BAM has been requiring that the issuers provide all notices and other information they are obligated to provide under their Continuing Disclosure Agreements to the insurance company, so please review your insurance commitments and keep this requirement in mind when preparing your annual disclosure documents.