Table of Contents

A Briefing Report on
the State's Compliance With Federal Securities Laws
on Municipal Securities Disclosure

December 1997

Key Points of Report

Debt-Issuing Entities in State Government Established a Process to Comply With Recent Disclosure Requirements for Municipal Bonds 1

For General Obligation Bonds, Compliance Is Covered Under an Agreement Between the Office of the Comptroller of Public Accounts and the Bond Review Board 1

For Bonds Issued by Individual Agencies and Universities, the Issuers Report Significant Progress in Complying With the New Rules 2

Substantial Compliance With Disclosure Rules Was Reported by State Bond Issuers; However, Improvements Can Be Made 3

Only Three Issuers Have Written Policies and Procedures for Compliance With Federal Disclosure Rules 3

State Bond Issuers Reported That They Rely Heavily on Hired Professionals to Meet Disclosure Requirements 3

State Bond Issuers Reported That They Generally Do Not Use Industry Guidelines and Publications to Enhance Compliance 5

Appendices

1 - Objectives, Scope, and Methodology 6

2 - Authorized State Bond Issuers and the Amount of Bonds Issued in Fiscal Years 1996 and 1997 8

3 - Disclosure Survey 9

4 - Municipal Bond Industry Organizations 13

Key Points of Report

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Overall Conclusion

The State of Texas appears to have made significant efforts to comply with Securities and Exchange Commission (SEC) Disclosure Rule 15c2-12. The State has established a process to comply with the new continuing disclosure requirements imposed by the amendments to SEC Rule 15c2-12.

Our survey of the 20 state agencies and universities authorized to issue bonds on behalf of the State indicated substantial compliance with these federal disclosure rules. However, the survey also indicated that improvements can be made in policies and procedures, reliance on hired professionals, and use of industry disclosure guidelines.

Key Facts and Findings

- The State of Texas has established a process to comply with federal disclosure requirements for municipal bonds. The Bond Review Board and the Office of the Comptroller of Public Accounts have contractually agreed to disclose annual financial information and operating data on an ongoing basis.
- Our survey of state agency and university bond issuers indicated that:
  - Although state issuers reported compliance, most issuers reported that they have no written policies and procedures for compliance with disclosure rules.
  - Issuers reported heavy reliance on hired professionals to comply with federal disclosure rules.
  - Issuers generally do not use industry guidelines or publications to enhance their compliance with disclosure rules.

Contact

Carol A. Smith, CPA, Audit Manager, (512) 479-4700

Office of the State Auditor
Lawrence F. Alwin, CPA

This project was conducted in accordance with Government Code, Sections 321.0132 and 321.0133.

Issues and Recommendations

Section 1:

Debt-Issuing Entities in State Government Established a Process to Comply With Recent Disclosure Requirements for Municipal Bonds

Debt-issuing entities within Texas state government established a process to comply with recent federal rules. In November 1994, the Securities and Exchange Commission (SEC) issued new rules for disclosure of information related to municipal bonds. Failure to comply with the November 1994 amendments to the Securities Exchange Act would have created a risk to the State's ability to use debt. The rules prohibit dealers from purchasing, selling, or making recommendations about the purchase or sale of municipal bonds unless issuers file certain information with national repositories.

> The amendments to SEC Rule 15c2-12 prohibit municipal securities dealers from purchasing or selling municipal securities unless the dealer has reasonably determined that ***an issuer*** of municipal securities or an obligated person has undertaken in a written agreement or contract for the benefit of holders of such securities to provide certain annual financial information and event notices to various information repositories. Further, the amendments prohibit a dealer from recommending the purchase or sale of municipal securities unless the dealer has procedures in place that provide reasonable assurance that it will receive promptly any event notices with respect to that security. Although the focus of the amendments was on the activities of underwriters, the SEC recognizes that **the primary responsibility for disclosure rests with the issuer.** The SEC maintains that disclosure promotes efficient markets and thereby preserves public trust in the municipal marketplace.

Section 1-A:

For General Obligation Bonds, Compliance Is Covered Under an Agreement Between the Office of the Comptroller of Public Accounts and the Bond Review Board

At the State level, compliance with disclosure requirements is covered under an agreement between the Office of the Comptroller of Public Accounts (Comptroller) and the Bond Review Board. The contract covers information to be disclosed, procedures for updating the information, and procedures for filing the information with national and state repositories. To comply with the SEC's disclosure requirements, issuers must file certain financial and operating information in national and state repositories and update the information when needed.

> SEC Disclosure Rule 15c2-12 requires issuers to contractually undertake for the benefit of holders of securities being issued to file with national and state repositories:
>
> 1. Annual financial information and operating data of the type provided in the official statement,
> 2. Audited financial statements when available,
> 3. Notice of material events, and
> 4. Notice of failure to provide such annual financial information as agreed.

Our review of this contract indicated the following:

- The scope of information to be reported is adequate to comply with the disclosure requirements. The agreement includes the following reporting requirements:
  - The type of financial information and operating data to be provided as part of annual financial information
  - The accounting principles used to prepare financial statements
  - The date on which the annual financial information will be provided
  - Identification of each obligated person for whom annual financial information and notices of material events will be provided

- The State has designated responsibility for updating the reported information. The Comptroller's office will provide timely updates on relevant information regarding the State.

- Filing procedures are adequate to comply with the disclosure requirements. The Comptroller's office will provide audited financial statements of the State to nationally recognized municipal securities information repositories (NRMSIRs) and to the Municipal Advisory Council of Texas. The Municipal Advisory Council of Texas is designated as the state information repository (SID).

Section 1-B:

For Bonds Issued by Individual Agencies and Universities, the Issuers Report Significant Progress in Complying With the New Rules

A survey of individual agencies and universities that issue bonds indicated significant progress in complying with the new disclosure rules. Under the disclosure rules, individual agencies and universities that issue self-supporting revenue bonds are also responsible for filing certain financial and operating information in national and state repositories and updating the information when needed.

Our survey indicated that issuers are aware of the recent disclosure requirements, intend to comply with them, and had generally filed information with national and state repositories as required. In responses from 17 state agencies and universities with operational debt programs:

- 16 agencies and universities reported that they were aware of the SEC disclosure rules and intended to comply with them. One issuer was not aware of rules because it had not issued bonds since the amendments to the rule took effect in July 1995.

- 14 agencies and universities reported that they filed all relevant information with appropriate national and state repositories. The three remaining entities had not issued debt since the new disclosure rules took effect.

- Four entities that had "material events" reported that they had properly notified information repositories.
  The amount of bonds issued by state agencies and universities in fiscal years 1996 and 1997 was approximately $2.7

SEC Rule 15c2-12 requires that notice of any of the following events with respect to a given issue of securities be filed, <u>if material</u>:

1. Principal and interest payment delinquencies
2. Nonpayment-related defaults
3. Unscheduled draws on debt service reserves reflecting financial difficulties
4. Unscheduled draws on credit enhancements reflecting financial difficulties
5. Substitution of credit or liquidity providers, or their failure to perform
6. Adverse tax opinions or events affecting the tax-exempt status of the security
7. Modifications to rights of security holders
8. Bond calls
9. Defeasances
10. Release, substitution, or sale of property securing repayment of the securities
11. Rating changes

Generally, an event is "material" if it is likely that it would assume actual significance in the deliberations of a reasonable investor.

and $1.1 billion, respectively. The amount of bonds issued by each entity is listed in Appendix 2.

Section 2:

Substantial Compliance With Disclosure Rules Was Reported by State Bond Issuers; However, Improvements Can Be Made

State agencies and universities reported substantial compliance with federal disclosure rules; however, survey results show improvements can be made in the following areas:

- Written policies and procedures
- Reliance on hired professionals
- Use of industry guidelines

Section 2-A:

Only Three Issuers Have Written Policies and Procedures for Compliance With Federal Disclosure Rules

Out of the 17 agencies and universities with operational debt programs, 14 entities reported that they do not have written policies and procedures to ensure compliance with disclosure rules. Two issuers mentioned standardized written policies and procedures developed at the state level as areas for potential improvement.

Although some issuers stated that they are informed about disclosure rules through memoranda from their bond counsel or the disclosure provisions included in the bond resolution or official statements, these documents do not usually identify important procedural elements such as responsible agency staff, internal compliance procedures, and specific time lines for compliance.

Without written policies and procedures, issuers create a risk that debt issues will not be handled consistently and effectively. Written policies and procedures also promote continuity in the event of employee turnover, changes of contractors, or other developments in the operating environment.

> The Government Finance Officers Association recommends state governments develop a formal, comprehensive debt policy. Adherence to a debt policy helps to ensure that a government maintains a sound debt position and that its credit quality is protected. A debt policy is beneficial because it enhances the quality of decisions, rationalizes the decision-making process, identifies objectives for staff to implement, demonstrates a commitment to long-term financial planning objectives, and is viewed positively by the rating agencies.

Section 2-B:

State Bond Issuers Reported That They Rely Heavily on Hired Professionals to Meet Disclosure Requirements

Our survey indicates that state agencies and universities rely heavily on contracted services of external professionals (such as financial advisors, bond counsel, and disclosure counsel) to ensure compliance with disclosure rules. All 17 issuers with operational debt programs responded that they rely or would rely on hired professionals to perform one or more of the following tasks:

- Inform the state agency or university of changing disclosure rules.
- Prepare bond offering documents.
- File relevant information with repositories.

The use of external professionals provides issuers with access to highly specialized

Issues and Recommendations

The SEC believes local and state governments can rely on hired experts, lawyers, and financial advisors, just as public companies do. That reliance, however, must be reasonable. Issuers who rely on hired experts to prepare offering documents are not relieved from their disclosure responsibilities. The SEC maintains that offering documents are issuers' documents; therefore, issuers are ultimately liable for disclosure.

Compliance with the latest federal disclosure rules is important for the State to reduce potential risks. If municipal issuers fail to meet disclosure requirements, they could face enforcement actions and private damage actions under the general anti-fraud provisions of Section 17 of the Securities Act of 1933, of the Securities Exchange Act of 1934, and SEC Rule 10b-5. In addition, failure to comply with disclosure rules could adversely affect the marketability of subsequent bond issues.

Recently, the SEC engaged in a four-year campaign to improve the municipal securities market and this campaign is expected to continue in the future. One of the primary goals of the campaign is to improve disclosure. As part of this effort, the SEC became quite active in enforcing municipal securities rules. It has taken enforcement action against alleged violators in several states. According to the SEC, its Enforcement Division has brought 20 municipal securities cases into the investigations and enforcement actions over the past three years. The involved state and local governments spent significant time and resources to defend themselves.

knowledge and skills. However, a high level of reliance on external professionals necessitates effective monitoring mechanisms and controls by issuers to ensure the quality of work performed by hired professionals.

An effective control system generally enables state entities to manage significant risks and to monitor the reliability and integrity of financial and operating information. It also allows issuers to ensure that all significant information related to their offerings is provided to the public and the investment community.

Issuers themselves are in the best position to know whether a reportable event has occurred. It is the SEC's position that regardless of who prepares offering documents, issuers are ultimately responsible for disclosure in municipal securities offerings.

We also noted that state agencies and universities contract with a relatively small number of external professionals. Contracts for the applicable 16 agencies and universities were concentrated in the hands of two financial advisors and three bond counsels. This dominance of a few external firms might result from specialization in the market to provide the necessary expertise for large state bond issues; however, it could also represent a lack of competition, which would prevent the State from obtaining services in the most cost-effective manner.

In our survey, five respondents stated that they did not use the request-for-proposal (RFP) process when procuring external professionals. They stated that such criteria as a firm's national recognition, prior experience with the firm, or referrals from other issuers were used as primary selection criteria. Although state law does not require procurement of professional services based on the RFP process, this practice is highly recommended by the Government Finance Officers Association (GFOA).

The Government Finance Officers Association recommends the use of an RFP process when selecting underwriters and financial advisors because it promotes fairness and objectivity, allows the issuer to compare respondents, and helps the issuer to obtain the best price and level of service. Issuers should have a clear understanding of their needs, both transaction-specific and ongoing.

Section 2-C:
State Bond Issuers Reported That They Generally Do Not Use Industry Guidelines and Publications to Enhance Compliance

Eleven issuers responded to our survey that they do not use any published industry guidelines to ensure compliance with disclosure rules. Two of these 11 were not even aware that published industry guidelines existed. Some issuers stated that their hired professionals indirectly inform them of these guidelines.

Industry guidelines and publications provide benchmarks for effective disclosure practices. Although industry guidelines are not always uniformly applicable to every issuer, guidelines published by GFOA have received widespread acceptance.

We noted that voluntary disclosure guidelines and publications produced by NFMA (National Federation of Municipal Analysts), and NACUBO (National Association of College and University Business Officers) could be useful for state entities to obtain disclosure information regarding industry-specific sectors, including housing, colleges and universities, student loans, transportation, and health care. Appendix 3 lists contacts for these organizations.

Issuers' familiarization with various disclosure resources can enhance their knowledge and thus help them ensure the quality of work performed by hired professionals.

State agencies and universities could use training workshops to enhance their level of knowledge of federal disclosure rules. Three issuers expressed the need for education and training concerning disclosure rules.

Workshops sponsored by the state oversight/service agencies such as the Bond Review Board and the Public Finance Authority would be a good way for state agencies and universities to raise the level of their knowledge. The training can include such topics as written policies and procedures, procurement methodologies of professionals, and recommended industry disclosure guidelines.

Since agencies and universities rely on external professionals, issuer staff members may not have many opportunities to interact with other state bond issuers. In addition, issuers' geographic locations and infrequent bond issuance also limit the level of interaction between state bond issuers. Training workshops would increase interaction between state bond issuers and allow them to share information regarding good disclosure practices.

Appendices

Appendix 1:

Objectives, Scope, and Methodology

Objectives

The objectives of this project were to:

- Assess the State's efforts to comply with federal disclosure rules and regulations of municipal securities.
- Determine whether state bond issuers are aware of federal disclosure rules and whether they have established policies and procedures for compliance.
- Identify opportunities to share information regarding good disclosure practices recommended by industry organizations and used by state issuers.

Scope

The scope of the project included:

- Reviewing the State's overall arrangement to comply with federal disclosure requirements
- Surveying all 20 state agencies and universities authorized to issue bonds in statute to obtain information regarding:
  - Their awareness of federal disclosure rules
  - The existence of policies and procedures for compliance
  - The filing of relevant information with national and state information repositories
  - The extent of issuers' reliance on hired professionals in complying with disclosure rules and regulations.

  Survey responses were received from all 20 issuers.

  Out of these 20 issuers, 3 issuers provided no information because either they have not issued bonds or their debt program is not operational. In addition, 3 other entities have not issued bonds since the SEC Amendments to Rule 15c2-12 took effect in July 1995. Responses from these entities only addressed their awareness of policies and procedures to comply with disclosure rules.

Methodology

We interviewed state debt personnel at the Bond Review Board and the Public Finance Authority. We compiled and reviewed information used by these agencies to comply with federal disclosure rules and regulations at the state level.

All state agencies and universities that have statutory authorization to issue bonds were surveyed to assess the individual issuer's policies, procedures, and practices to comply with federal disclosure rules. Specifically, the survey requested information related to the disclosure policies and procedures, preparation of official statements, filing of debt information with national and state information repositories, and notification of material events.

<u>Criteria used</u>:

- Securities and Exchange Commission Rule 15c2-12
- Bond Review Board rules
- Standard auditing criteria

Fieldwork was conducted from late July through mid September 1997. The project was conducted in accordance with applicable professional standards.

The work was performed by the following members of the State Auditor's Office:

- Denise F. Wieler, MPA (Project Manager)
- Hugh Ohn, CPA (Assistant Project Manager)
- Claudia Cabello
- Worth S. Ferguson, CPA (Quality Control Reviewer)
- Carol A. Smith, CPA (Audit Manager)
- Deborah L. Kerr, Ph.D. (Audit Director)

Appendices

Appendix 2:

Authorized State Bond Issuers and the Amount of Bonds Issued in Fiscal Years 1996 and 1997

State Agencies (10)	Fiscal Year 1996 Bonds	Fiscal Year 1997 Bonds
Texas Department of Agriculture	$0	$0
Texas Department of Economic Development	$0	$0
Texas Department of Housing and Community Affairs	$242,930,540	$269,240,000
Texas Higher Education Coordinating Board	$75,000,000	$0
Texas Low-Level Radioactive Waste Disposal Authority [a]	$0	$0
Texas Turnpike Authority[b]	$446,411,475	$0
Texas Veterans Land Board	$315,491,889	$97,930,000
Texas Water Development Board	$279,564,956	$385,000,000
The Comptroller's Office/Bond Review Board	$0	$0
Texas Public Finance Authority (on behalf of):	$66,435,000	$123,405,000
Texas Dept. of Criminal Justice	$312,940,000 [c]	
Texas Department of MHMR		
Texas National Guard Armory Board		
Texas National Research Lab. Commission		
Texas Parks and Wildlife Department	$9,665,000	
Texas State Technical College		$11,660,000
Texas Youth Commission		
Colleges/Universities (10)		
Midwestern State University [a]	$4,035,000	$5,850,000
Stephen F. Austin State University [a]	$7,725,000	$0
Texas A&M University System	$267,880,000	$64,795,000
Texas Southern University [a]	$0	$15,090,000
Texas State University System	$4,415,000	$11,220,000
Texas Tech University	$0	$78,665,000
Texas Woman's University	$24,000,000	$0
University of Houston System	$0	$5,150,000 [d]
University of North Texas	$15,000,000	$8,230,000
The University of Texas System	$594,680,000	$0
	$2,666,173,860[e]	$1,076,235,000

[a] Effective September 1, 1997, authority to issue bonds for these entities was moved under the Texas Public Finance Authority by House Bill 1077, 75th Legislature.

[b] This entity is no longer considered a state agency. The authority to issue bonds has been transferred to the Texas Deportation of Transportation, which has not issued any bonds to date.

[c] This number represents the total amount of bonds issued for the Texas Department of Criminal Justice, the Texas Youth Commission, and the Texas Department of Mental Health and Mental Retardation.

[d] This bond issuance occurred after our survey was completed.

[e] This amount differs from the amount in the *Comprehensive Annual Financial Report* because this amount: (1) includes the amount of bonds issued by the Texas Turnpike Authority after their year end (December 31, 1995), and (2) does not include accretion on compound interest and capital appreciation bonds.

Appendix 3:
Disclosure Survey

State Auditor's Office
Survey of State Bond Issuers' Compliance with SEC Disclosure Rules

Question	Answer	Performed by
I. Disclosure Policies and Procedures		
1. Are you aware of the recent Securities and Exchange Commission's disclosure rules for municipal securities (Amendments to the Rule 15c2-12)?		
2. What is your agency's overall policy related to compliance with the SEC disclosure rules?		
3. How do you ensure your agency's compliance with the SEC disclosure regulations?		
4. Do you have written policies and procedures to address these disclosure requirements including material events? If yes, please provide a copy of these policies and procedures.		
5. Do you use any published industry guidelines to ensure compliance?		
6 How do you stay informed of the changes in disclosure rules?		
7. Do you internally address the disclosure requirements or do you hire outside experts?		
8. If you hire outside counsel or consultants to address the disclosure requirements, what specific procurement criteria do you use in selecting them?		
9. Do you have any suggestions to improve the State's compliance with SEC disclosure rules?		

State Auditor's Office
Survey of State Bond Issuers' Compliance with SEC Disclosure Rules

Question	Answer	Performed by
Answer the questions in the Sections II, III, and IV only if your agency issued bonds during fiscal years 1996 and 1997.		
II. Filing with Repositories		
1a. Did you or your designated agent file your agency's fiscal years 1996 and 1997 bond issuances with national and state repositories? 1b. If yes, what are the dates of your filings and the names of the national and state repositories? 1c. List the specific information or documents you filed with the repositories.	Filing <u>Date</u> / Name of <u>Repository</u> / <u>Bond Issuance</u>	
2. Where do you obtain information about the new repositories recognized by the SEC?		
3. Does your agency have internal staff to perform filing or do you rely on outside entities? 3b. Identify internal and/or external people involved.		
4. After filing, does your agency receive an acknowledgment (e.g., a receipt) from the repositories? If yes, attach a copy.		
5a. Are there barriers which make filing of bond information with the repositories difficult. 5b. What might make the filing requirements easier to adhere to?		

State Auditor's Office
Survey of State Bond Issuers' Compliance with SEC Disclosure Rules

Question	Answer	Performed by
III. Official Statements		
1. How do you ensure compliance with the Official Statement content requirements of the SEC rules?		
2. Do you use any industry guidelines in complying with the Official Statement disclosure rules?		
3a. Who prepares the official statements? 3b. Is the information used in the official statements prepared internally or by external experts?		
4. How do you ensure the accuracy of information contained in the official statements?		
5. Who informs you of changes to the Official Statement rules and regulations?		
6a. Do you believe there is consistency in official statements among various state agencies and universities? 6b. If not, how do you think this can be accomplished?		
7. Do you think there might be a more effective way for the State or individual agencies to comply with the Official Statement rules and regulations?		

State Auditor's Office
Survey of State Bond Issuers' Compliance with SEC Disclosure Rules

Question	Answer	Performed by
IV. Material Events		
1. Are you aware of the SEC's guidelines for material events related to municipal bonds issued?		
2a. Is your agency's definition of material events consistent with the SEC guidelines? 2b. Do you use any other guidelines or clarifications in defining material events?		
3. How are material events usually identified within your organization?		
4. What do you do if material events occur related to your bond issuances?		
5. Have any material events occurred which related to the bonds issued by your agency? Please list them.	Material Event — Date of Occurrence — Bond Issuance	
5b. Were the repositories notified of these material events?	Notice Date — Name of Repository — Bond Issuance and Event	
6. How might the State or individual agencies better comply with the material event requirements of the SEC?		

Appendices

Appendix 4:
Municipal Bond Industry Organizations

Bond Buyer (a daily news publication)
One State Street Plaza
New York, NY 10004
(800) 982-0633
http://www.bondbuyer.com

Bond Market Association (formerly Public Securities Association)
40 Broad Street
New York, NY 10004
(212) 809-7000
http://www.bondmarkets.com

Government Finance Officers Association (GFOA)
180 N. Michigan Avenue, Suite 800
Chicago, IL 60601
(313) 977-9700
http://www.gfoa.org

Municipal Securities Rulemaking Board (MSRB)
1818 N. Street, NW, Suite 800
Washington, DC 20036-2491
(202) 223-9347
http://msrb.org

National Association of Bond Lawyers (NABL)
1761 South Naperville Rd., Suite 105
Wheaton, IL 60187
(630) 690-1135
http://www.nabl.org

National Association of College and University Business Officers (NACUBO)
2501 M Street, NW, Suite 400
Washington, DC 20037
(202) 861-2500
http://www.nacubo.org

National Association of State Auditors, Comptrollers and Treasurers (NASACT)
3560 Iron Works Pike
Lexington, KY 40578
(606) 244-8175
http://sso.org/nasact/nasact.htm

National Federation of Municipal Analysts (NFMA)
P.O. Box 14893
Pittsburgh, PA 15234
(412) 341-4898
http://www.nfma.org

Securities and Exchange Commission (SEC)
Office of Municipal Securities
450 Fifth Street, NW
Washington, DC 20549
(202) 942-7300
http://www.sec.gov