

Conduit Bond Issuers

Issuers Complied With Key Bond Requirements,
but Two Joint Powers Authorities' Compensation
Models Raise Conflict-of-Interest Concerns

August 2012 Report 2011-118/2011-613



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The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

The California State Auditor presents this audit report concerning the organizational structure and significant policies and practices of three public agencies that issue conduit revenue bonds: the California Health Facilities Financing Authority (Health Financing Authority), and two joint powers authorities—the California Statewide Communities Development Authority (California Communities) and the California Municipal Finance Authority (Municipal Finance).

This report concludes that it may be helpful for the Legislature or the Fair Political Practices Commission (FPPC), as appropriate, to provide clear policy direction regarding whether contingency fees paid to private employers of consultants participating in financing decisions should be permissible under California's conflict-of-interest laws. Both California Communities and Municipal Finance are staffed entirely by private consulting firms. For their work, the consulting firms receive a percentage of the fees associated with each conduit revenue bond the joint powers authorities issue. During July 2006 through June 2011, California Communities and Municipal Finance paid their consultants roughly \$50 million and \$4.6 million, respectively. These amounts represent 59 percent of total revenues generated for California Communities and 49 percent for Municipal Finance. This method of compensation raises a concern under the Political Reform Act of 1974 (political reform act), which prohibits public officials—including consultants performing the work of public officials—from making, participating in, or attempting to influence certain governmental decisions in which they have a material economic interest. In explaining why they believe the compensation model does not violate the political reform act, consultants who advise the public entities rely on an advice letter issued by the FPPC to a different entity. However, neither the FPPC nor a court of appropriate jurisdiction have considered the applicability of the reasoning set out in that advice letter to the specific circumstances described in this audit report.

The joint powers authorities' use of consultants also raises a concern under California Government Code, Section 1090 (Section 1090). This state law prohibits public officials and employees from having a financial interest in any public contract whose formation or approval they participate in, which includes the issuance of conduit revenue bonds. Although there is some case law that suggests that consultants who contract with public agencies may be paid on a contingency fee basis for their services without violating Section 1090, no court has squarely addressed the specific question presented here and we therefore cannot reach a definitive legal conclusion.

This report also concludes that the joint powers authorities could improve their contracting practices to better ensure the services they receive are reasonably priced. The boards of directors for California Communities and Municipal Finance have not required the consulting firms staffing the joint powers authorities to compete against other firms since the joint powers authorities were formed in 1988 and 2004, respectively. By not periodically bidding out the contracts for these services, the joint powers authorities have less assurance that they are getting the best value from their consultants. However, notwithstanding the potential problems described above, during 2006 through 2011 California Communities and Municipal Finance met bond issuance requirements and generally fulfilled reporting obligations, including those established in 2010 under Senate Bill 99. Similarly, the Health Financing Authority also met these requirements.

Respectfully submitted,



ELAINE M. HOWLE, CPA
State Auditor

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Contents

Summary	1
Introduction	5
Chapter 1	
The Practices of Some Conduit Bond Issuers Raise Concerns Regarding Conflicts of Interest and Whether the Issuers Receive the Best Value From Contractors	13
Recommendations	31
Chapter 2	
The Conduit Bond Issuers Met Bond Issuance Requirements and Generally Fulfilled Reporting Requirements	33
Recommendations	45
Appendix	
Financial Information for the Conduit Bond Issuers We Reviewed	47
Responses to the Audit	
California Health Facilities Financing Authority	51
California Municipal Finance Authority	53
California Statewide Communities Development Authority	55
California State Auditor's Comments on the Response From the California Statewide Communities Development Authority	59

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Summary

Results in Brief

Many public agencies issue conduit revenue bonds on behalf of private businesses or nonprofit organizations (borrowers). Once investors purchase the bonds, borrowers use the resulting proceeds to fund projects that provide public benefits, including hospitals, affordable housing, and pollution control facilities. Because these projects further public purposes, the interest that bond investors receive is generally exempt from state and federal income tax. The public agencies that issue the bonds are not responsible for paying the investors back; rather, they merely serve as a *conduit* connecting borrowers to investors. In return for serving that purpose, the agencies charge the borrowers fees that vary depending on the size and the nature of the projects.

In this audit we evaluate whether the organizational structures and significant policies and practices of three public agencies that issue conduit revenue bonds (issuers) comply with applicable laws and other requirements. The California Health Facilities Financing Authority (Health Financing Authority) is a state entity administratively located within the State Treasurer's Office, while the California Statewide Communities Development Authority (California Communities) and the California Municipal Finance Authority (Municipal Finance) are joint powers authorities established under the California Joint Exercise of Powers Act (joint powers act). Each of these three issuers is governed by a board of directors that votes to approve issuances at public hearings.

Although we found that the compensation model of the joint powers authorities raises concerns, we cannot conclude that it violates California's conflict-of-interest laws. Unlike the Health Financing Authority, both California Communities and Municipal Finance rely wholly on private consulting firms for staff. Because the joint powers authorities pay these consulting firms a percentage of the fees associated with each conduit financing, there is a concern as to whether this practice violates the Political Reform Act of 1974 (political reform act). This act prohibits public officials—in this case, consultants performing the work of public officials—from making, participating in, or attempting to influence certain governmental decisions in which they have a material economic interest. The consultants believe that a 1993 advice letter published by the Fair Political Practices Commission (FPPC), which administers the political reform act, applies to their circumstances. If so, they have likely not violated the act. However, neither the FPPC nor a court of appropriate jurisdiction have ever considered the applicability of the reasoning set out in that advice letter, known as the *McEwen* advice letter, to the specific circumstances here.

Audit Highlights . . .

Our audit of the organizational structures and significant policies and practices of two joint powers authorities (JPAs) and the California Health Facilities Financing Authority (Health Financing Authority) highlighted the following:

- » *Although the compensation model of the two JPAs raises concerns, we cannot conclude that it violates California's conflict-of-interest laws.*
- *Public officials, including consultants performing the work of public officials, are prohibited from making, participating in, or attempting to influence certain governmental decisions in which they have a material economic interest.*
- *The two JPAs rely wholly on private consulting firms for staff and pay them a percentage of the fees associated with each conduit financing.*
- *Consultants who advise the JPAs believe that a 1993 advice letter from the Fair Political Practices Commission (FPPC) applies to their circumstances and that they have not violated laws.*
- *No court has squarely addressed the legality of this compensation model.*
- » *The two JPAs could improve their contracting practices to better ensure contractors' fees are reasonable.*
- *The two JPAs have not required their consulting firms to compete against other firms since their respective formations in 1988 and 2004, and thus, have less assurance that they are getting the best value.*

continued on next page . . .

- *Because they pay their consultants based on a percentage of the fees associated with bonds issued, JPAs risk receiving advice that may not be in their best interest.*

- » *The Health Financing Authority and the two JPAs all issue conduit revenue bonds in accordance with key federal and state laws, and substantially complied with reporting requirements.*

Moreover, given that consultants who advise public entities widely rely on the reasoning set out in the *McEwen* advice letter, it may be helpful for the Legislature or the FPPC, as appropriate, to provide clear policy direction.

The joint powers authorities' use of consultants also raises concerns under another state conflict-of-interest law. Specifically, California Government Code, Section 1090 (Section 1090), prohibits public officials and employees from having a financial interest in any public contract whose formation or approval they participate in. Because the consultants here act in the same capacity as public employees, we believe they are subject to the prohibition contained in Section 1090. Further, we believe that the consultants' role in the bond approval process constitutes participating in the formation of a contract for the purposes of Section 1090. Although there is some case law that suggests that consultants who contract with public entities may be paid on a contingency fee basis without violating Section 1090, no court has squarely addressed the specific question presented here and we cannot reach a definitive legal conclusion.

In addition, California Communities and Municipal Finance could improve their contracting practices to better ensure contractors' fees are reasonable. The boards of directors for the two joint powers authorities have not required their consulting firms to compete against other firms since the joint powers authorities were formed in 1988 and 2004, respectively. By not periodically bidding out the contracts for these services, or performing some other price comparison analysis, the joint powers authorities have less assurance that they are getting the best value from their consultant contracts. Moreover, by choosing to pay the consulting firms a percentage of the fees associated with bonds issued, the joint powers authorities create a financial incentive for consultants to recommend the approval of bond issuances. Further, they do not mitigate this financial incentive by requiring the consulting firms to disclose whether they compensate their employees in a way that is directly tied to the number or volume of bonds the joint powers authorities issue.

In evaluating the issuers' compliance with other laws and requirements, we found that the Health Financing Authority, California Communities, and Municipal Finance, all issue conduit revenue bonds in accordance with key federal and state laws. For example, the issuers ensure that the projects they finance meet state and federal requirements for tax-exempt financing related to the public benefits the projects must provide. Moreover, the issuers provide additional benefits to communities throughout the State either by distributing fee revenues to the jurisdictions in which projects are located or by contractually obligating borrowers to serve specified public purposes.

In our review, we also found that the issuers substantially complied with reporting requirements. Effective January 1, 2010, Chapter 557, Statutes of 2009 (Senate Bill 99 (SB 99)) created requirements to ensure that conduit financing providers make their activities transparent and accountable to the public by extending opportunities for participation in public meetings and by providing information about their financial activities. While the Health Financing Authority and Municipal Finance met the applicable SB 99 requirements, California Communities did not provide all necessary disclosures in its financial statements for fiscal years 2009–10 and 2010–11. However, once we alerted California Communities to this oversight, it updated its financial statements to include this information. We also found that before fiscal year 2006–07, California Communities did not prepare and file audited annual financial statements as required by the joint powers act. However, it has prepared the statements each year since that time.

In evaluating other aspects of the issuers' practices, we noted that borrowers' bankruptcies and other financial disclosures are not generally an accurate measure of an issuer's performance. We have no reason to believe that any of the issuers we reviewed are better than the others in regards to the quality of bonds they issue. We also concluded that although issuers may charge different fees for similar services, this variance is not inherently problematic because borrowers can analyze these fees and select the issuers that best meet their needs.

Recommendations

If the Legislature believes that the compensation model is appropriate whereby the private firms that employ consultants are paid a percentage of the fees associated with bond issuances, the Legislature should enact legislation that creates a clearly stated exemption from Section 1090. On the other hand, if the Legislature believes that this compensation model is not appropriate, it should enact legislation that clearly proscribes, or limits, such a model.

The FPPC should adopt regulations that clarify whether the analysis in the *McEwen* advice letter is intended to apply to the factual circumstances presented in this audit.

To be better informed about the compensation of their consultants, including any potential conflicts of interest, California Communities and Municipal Finance should require the consulting firms that staff their organizations to disclose the amount and

structure of compensation provided to individual consultants, including disclosing whether any of this compensation is tied to the volume of bond sales.

In implementing its January 2012 contracting policy, California Communities should either periodically subject existing contracts to competitive bidding or perform some other price comparison analysis to ensure that the public funds it oversees are used effectively.

Municipal Finance should follow its July 2012 policy that describes how it will select contractors and periodically review existing contractors' services and prices to ensure the public funds it oversees are used effectively.

Agency Comments

The Health Financing Authority, Municipal Finance, and California Communities concurred with our conclusions and recommendations.

Introduction

Background

Federal and state law authorize certain public agencies (issuers) to issue conduit revenue bonds that provide financing for private businesses and nonprofit organizations (borrowers) to construct privately owned projects that benefit the public.¹ Examples of these projects include hospitals, affordable housing developments, pollution control facilities, and manufacturing facilities. When bonds are issued, investors purchase them and the resulting proceeds provide capital for borrowers' projects. Borrowers are then responsible for making principal and interest payments to the bondholders. In this way, issuers act as a *conduit*, linking bond investors to organizations desiring capital for their projects. When conduit revenue bonds finance projects that benefit the public, they are generally tax-exempt, meaning the interest bond investors earn is exempt from state and federal income taxes.

The Process for Issuing Conduit Revenue Bonds

When a private business or nonprofit organization decides to pursue financing through conduit revenue bonds, it typically assembles a financial team that may include bond counsel, an underwriter, a trustee, and a financial advisor. Once the borrower has selected an issuer, the borrower's financial team provides legal and financial information and services while the issuer reviews the overall financing plan and other critical documents to ensure that the financing is in compliance with the issuer's policies. During the process, the issuer ensures that any required hearings are held to allow for public comment on project financing.

Additionally, before issuing conduit revenue bonds to finance certain types of projects, the issuer must receive approval from the California Debt Limit Allocation Committee (debt allocation committee). Federal law limits the amount of tax-exempt debt that can be issued every year in each state for projects such as affordable housing developments, pollution control facilities, and manufacturing facilities, although the amount of debt each state can issue for projects such as schools and hospitals is unlimited. Administratively located within the State Treasurer's Office, the debt allocation committee is responsible for allocating portions of California's debt limit to qualifying issuers.

¹ Although less common, conduit financing can also provide capital for public entity projects.

Once all legal opinions attesting to a bond's status have been finalized and the issuer's governing body has approved the financing, a bank or other financial institution acting as the underwriter or placement agent purchases the bond (providing that it meets their own standards) and either offers it for sale or holds it as an investment. If it offers the bonds for sale, the financial institution may sell the bonds either to the general public or to another private institution, such as a bank. The borrower receives the proceeds of the bond sale and is subsequently responsible for making interest and principal payments to the investors over the life of the bond.

The federal Securities and Exchange Commission (SEC) prohibits underwriters from purchasing or selling bonds unless borrowers, or other parties whom they designate, agree to disclose certain events that may be indicative of their ability to repay the bond investors (disclosure rule). For example, the events that must be disclosed within 10 days of occurrence include a payment default or delinquency, bankruptcy, an adverse tax opinion, a bond rating change, and a failure to provide annual financial information. The issuer is not responsible for ensuring that the borrower complies with this disclosure rule. Moreover, if a borrower fails to make bond payments, investors must seek redress from the borrower, not the issuer.²

Issuers of Conduit Revenue Bonds

Many different types of public agencies issue conduit revenue bonds in California, including state government agencies, cities and counties, and other local agencies such as housing authorities and industrial development authorities. In addition, local governments have used the Joint Exercise of Powers Act (joint powers act), which we describe in the text box, to create legally separate entities, called *joint powers authorities*, for the purpose of issuing conduit revenue bonds. The formation of a joint powers authority for this purpose can provide smaller local governments with greater access to bond market expertise than they would have if acting alone, and it can allow the joint powers authority to issue a single bond to finance small projects across multiple jurisdictions.

Joint Exercise of Powers Act

- Two or more public agencies that share common powers may form a new, legally separate government entity to jointly implement programs, build facilities, or deliver services.
- To form the new entity and specify its powers, officials from the public agencies must formally approve a cooperative agreement, referred to as a *joint powers agreement*.
- The joint powers authority must provide strict accountability of all funds and report all receipts and disbursements.

Source: California Government Code, sections 6500 through 6536.

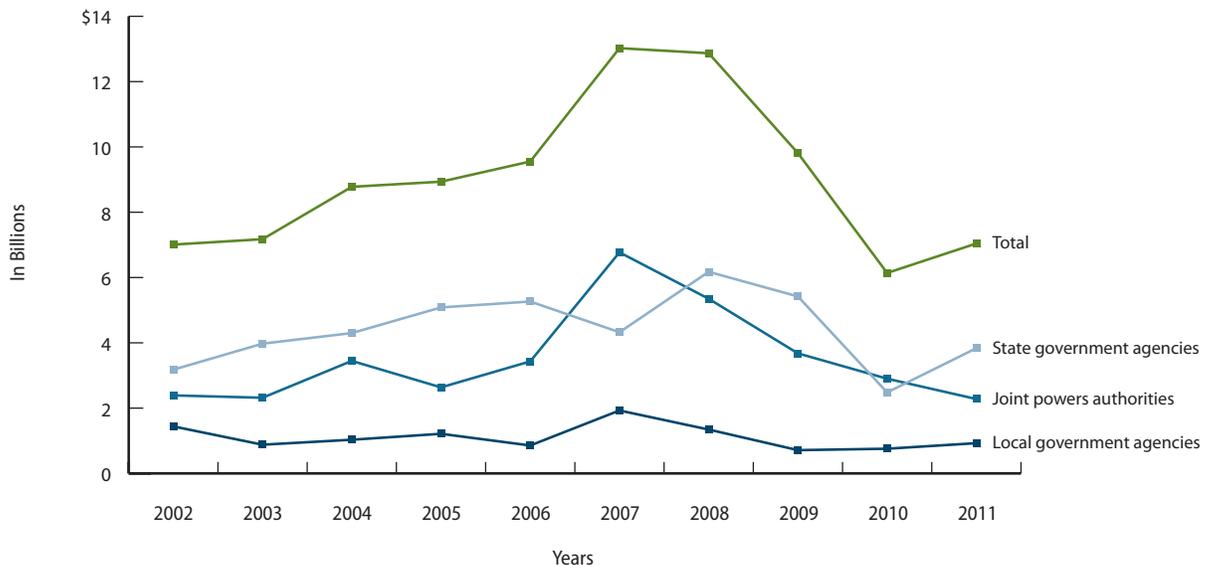
² Although conduit issuers may have variations on the general process described in this section, we confirmed that this summary is accurate for the three issuers whose compliance we reviewed.

According to the California Debt and Investment Advisory Commission (CDIAC), which publishes information on conduit revenue bonds issued within the State, 153 public agencies in California issued more than 2,600 conduit revenue bonds totaling \$90 billion from 2002 through 2011.³ Specifically, the CDIAC’s annual reports show the following:

- Eleven state agencies issued 675 bonds totaling \$44 billion (an average of \$65 million per agency).
- Twenty-two joint powers authorities issued 1,353 bonds totaling \$35 billion (an average of \$26 million per joint powers authority).
- A total of 120 local government agencies issued 651 bonds totaling \$11 billion (an average of \$17 million per agency).

Figure 1 summarizes the total annual issuance of conduit revenue bonds from 2002 through 2011, categorized by type of issuer. As the figure shows, conduit financing steadily increased from 2002 to 2007, when it peaked at \$13 billion. It then declined to nearly \$6 billion by 2010, which appears to be reflective of the recent economic recession in which borrowers demand for capital to build new projects likely decreased.

Figure 1
The Dollar Value of Conduit Revenue Bonds Issued in California
January 2002 Through December 2011



Sources: The California Debt and Investment Advisory Commission’s annual reports for 2002 through 2011. The California State Auditor did not audit the information contained in this figure.

³ Of the \$90 billion in conduit revenue bonds issued, only \$297 million was subject to state taxation and roughly \$5 billion was subject to federal taxation.

The figure also shows that local government agencies issued the lowest dollar volume of bonds, while state agencies and joint powers authorities issued higher volumes. State issuers consistently issued the highest dollar volume of conduit revenue bonds until 2007, when joint powers authorities surpassed the state agency total. Since 2007 the volume of bonds issued by joint powers authorities has steadily decreased, and state agencies have once again become the highest volume issuer of conduit revenue bonds.

To perform this audit, we focused our review primarily on three issuers. The first is the California Health Facilities Financing Authority (Health Financing Authority), which the State established in 1979 to act as its vehicle for providing financial assistance to public and nonprofit health care providers. It is one of six state agencies with the authority to issue conduit revenue bonds that the State Treasurer's Office oversees. Of the six, the Health Financing Authority has issued the highest dollar volume of conduit revenue bonds during 2002 through 2011.

In addition to the Health Financing Authority, we also reviewed the California Statewide Communities Development Authority (California Communities) and the California Municipal Finance Authority (Municipal Finance). Both are joint powers authorities that issue a high volume of conduit revenue bonds for a variety of projects. In compliance with the joint powers act, these two entities were created under agreements approved by local public agencies. California Communities was created in 1988 and, as of May 2012, its membership included more than 500 cities, counties, special districts, and other public agencies. Newer and smaller, Municipal Finance was created in 2004 and, as of June 2012, its membership included more than 150 cities, counties, and special districts.

As indicated in Table 1, the three agencies in our review issued more than \$36 billion in conduit revenue bonds from 2006 through 2011. California Communities issued the highest volume of the three.

Table 1
Conduit Bond Financings by Purpose of Financing
January 2006 Through December 2011
(Dollars in Millions)

PURPOSE OF FINANCING	CALIFORNIA HEALTH FACILITIES FINANCING AUTHORITY		CALIFORNIA MUNICIPAL FINANCE AUTHORITY		CALIFORNIA STATEWIDE COMMUNITIES DEVELOPMENT AUTHORITY		TOTALS	
	NUMBER OF FINANCINGS	AMOUNT	NUMBER OF FINANCINGS	AMOUNT	NUMBER OF FINANCINGS	AMOUNT	NUMBER OF FINANCINGS	AMOUNT
Health care	71	\$9,757	16	\$809	59	\$10,146	146	\$20,712
Education	–	–	48	1,093	49	1,448	97	2,541
Social services	–	–	7	60	11	78	18	138
Affordable housing	–	–	90	1,106	232	3,225	322	4,331
Manufacturing	–	–	16	104	8	57	24	161
Pollution control	–	–	9	645	11	767	20	1,412
Other*	–	–	3	52	34	6,734	37	6,786
Totals	71	\$9,757	189	\$3,869	404	\$22,455	664	\$36,081

Sources: Listings of conduit financings provided by each conduit bond issuer identified in the table.

* Financings in this category served a variety of purposes, such as fire protection, pension obligations, and the construction of business facilities in areas of significant economic distress.

Scope and Methodology

The Joint Legislative Audit Committee (audit committee) requested that the California State Auditor (state auditor) review the business and compensation models of two joint powers authorities—California Communities and Municipal Finance—focusing on compliance with conflict-of-interest laws, bond-issuance requirements, and reporting requirements. For comparison purposes, the state auditor performed the same evaluation for the Health Financing Authority. The audit committee’s request contained 13 separate objectives. We list the objectives and the methods we used to address them in Table 2.

Table 2
Methods of Addressing Audit Objectives

	AUDIT OBJECTIVE	METHOD
1	Review and evaluate the laws, rules, and regulations significant to the audit objectives.	We reviewed relevant laws, rules, and regulations governing the issuance of conduit revenue bonds, along with conflict of interest laws, such as the California Political Reform Act of 1974 (political reform act) and its implementing regulations and California Government Code, Section 1090. We also reviewed the Joint Exercise of Powers Act (joint powers act).
2	Determine whether the structure and significant policies and practices of the conduit revenue bond issuers (issuers) comply with the joint powers act.	<ul style="list-style-type: none"> We interviewed applicable personnel and consultants and obtained financial and other documentation to identify the organizational structures, policies, and practices of the joint powers authorities for issuing conduit revenue bonds. We reviewed the applicable joint powers agreements to identify the joint powers authorities’ powers to issue conduit revenue bonds and to evaluate their compliance with the joint powers act.

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AUDIT OBJECTIVE	METHOD
<p>3 Review the financial, personnel, and structural relationships for each issuer and its particular sponsoring entities to determine whether those relationships present a potential conflict of interest.</p>	<ul style="list-style-type: none"> • We interviewed applicable staff and consultants and obtained documentation such as contract agreements to identify the issuers' financial and structural relationships, including the procedures for selecting issuers' boards. • We reviewed the agreements between the issuers and their outside consultants to determine how the consultants participate in or influence the issuers' decisions. • We obtained each issuer's policies and procedures for complying with the political reform act and other conflict-of-interest laws, including obtaining a copy of their conflict-of-interest codes and their lists of the personnel and consultants they require to periodically disclose economic interests. • We compared each issuer's economic interest disclosures to the bonds it had issued during 2006 through 2011. • We used the eight-step analysis detailed in the political reform act to evaluate the financial, personnel, and structural relationships for each issuer.
<p>4 Determine whether the issuers are subject to the political reform act.</p>	<p>We determined the political reform act applies to each issuer we reviewed.</p>
<p>5 Evaluate the process, including oversight by board members, each issuer used when selecting and compensating bond counsel, outside consultants, and other contractual service employees to determine if that process is reasonable.</p>	<ul style="list-style-type: none"> • We interviewed personnel to identify contracting practices and obtained each issuer's contracting policies and procedures. • We identified each issuer's contracts with outside consultants and assessed the reasonableness of their selection processes.
<p>6 Review how compensation is determined for staff (or consultants working as staff) who evaluate and recommend approval of financing requests and whether the compensation creates potential conflicts of interest for those staff.</p>	<ul style="list-style-type: none"> • We interviewed applicable personnel and reviewed contracts in an attempt to identify how compensation is determined for consultants working as staff at the joint powers authorities. HB Capital Consulting, LLC, and Sierra Management Group, LLC, would not provide information regarding how they compensated individual consultants acting as staff at the California Statewide Community Development Authority (California Communities) and the California Municipal Finance Authority (Municipal Finance), respectively. • With this limitation, we obtained financial information to document the dollar amounts the consulting firms received from their respective joint powers authorities during fiscal years 2006–07 through 2010–11. • In tandem with procedures performed for audit objective 3, we evaluated compensation methods in relation to conflict-of-interest requirements.
<p>7 For the period from 2006 through 2010, review a sample of each issuer's financings to determine its compliance with applicable laws, rules, and regulations. Specifically, review the level of oversight, reporting, and transparency before and after the enactment of Senate Bill 99 (SB 99).</p>	<ul style="list-style-type: none"> • We interviewed key staff and obtained documentation to determine each issuer's policies for ensuring compliance with bond laws, rules, and regulations (bond requirements) and SB 99. • We judgmentally selected 10 conduit financings at each issuer (30 in total) to evaluate issuers' compliance with bond requirements. • Using these selections and other relevant documentation, we evaluated the issuers' compliance with relevant laws prior to SB 99 and after the enactment of SB 99.

AUDIT OBJECTIVE	METHOD
<p>8 Based on a sample of projects, review the fees charged to applicants by each issuer and compare those fees with industry standards and other conduit issuers.</p>	<ul style="list-style-type: none"> • We interviewed key staff and consultants and conducted research regarding fees charged to borrowers. We determined that no industry standards exist for the fees issuers can charge. • Using the conduit financings identified in audit objective 7, we verified whether the fees each issuer charged to borrowers agreed with its fee schedule. • We used information reported by the California Debt and Investment Advisory Commission, a state agency administratively located within the State Treasurer's Office, to select four additional high-volume conduit bond issuers for our comparison of fees.
<p>9 Examine each issuer's use of fee revenues in excess of their operating costs, including the extent to which these revenues further a public benefit.</p>	<ul style="list-style-type: none"> • We interviewed key staff and consultants to obtain relevant financial information and documentation. • Using appropriate documentation, such as audited financial statements, we identified each issuer's revenues and expenditures by category for fiscal years 2006–07 through 2010–11. • We interviewed key staff and collected documentation to identify the dollar amounts issuers distributed to charities and other organizations to enhance the public benefits associated with the projects they financed with conduit revenue bonds.
<p>10 Based on a sample of projects, review and assess the means by which issuers quantify public benefits for each project financed and the criteria each issuer's board used to determine whether to support the individual financing request.</p>	<ul style="list-style-type: none"> • We interviewed key staff and obtained documentation to determine how issuers quantify each project's public benefits and to identify the criteria their board members use to support a decision to issue bonds. • We researched applicable federal and state bond laws identifying the criteria for issuing tax-exempt bonds. • Using the conduit financings identified in audit objective 7, we verified that each project the issuers financed with conduit revenue bonds met the requirements for tax-exempt financing.
<p>11 Review the number and rate of material defaults and material events for each issuer's bond-financed projects in the past five years and how those rates compare to any industry standards and other conduit issuers.</p>	<ul style="list-style-type: none"> • We researched laws related to material defaults and material events. We determined that there is no industry standard for the rates of material defaults and material events. • We researched the type of conduit bond issuances that are subject to federal disclosure requirements and obtained applicable disclosures from a federal database. • We interviewed key staff and consultants, obtained documentation, and performed procedures to identify material defaults and material events associated with the issuers' bonds.
<p>12 Compare the business model used by each issuer to conduit financiers that perform similar duties to identify alternative models and best practices.</p>	<ul style="list-style-type: none"> • In tandem with the procedures we performed to address audit objectives 2 through 6, we developed measures for comparing the organizational structures of the issuers we reviewed. • We interviewed key staff and obtained documentation to obtain perspectives on best practices.
<p>13 Review and assess any other issues that are significant to the issuers' operations.</p>	<ul style="list-style-type: none"> • As part of our work on audit objective 1, we identified federal registration requirements administered by the Security and Exchange Commission's Municipal Securities Rulemaking Board. • We interviewed key staff and consultants at each issuer and obtained documentation to determine if the issuers complied with these registration requirements.

Source: California State Auditor's analysis of the audit objectives approved by the Joint Legislative Audit Committee.

For most audit objectives, we focused our review on the Health Financing Authority, California Communities, and Municipal Finance. However, in several of the audit objectives shown in Table 2, the audit committee asked for a comparison across the conduit finance industry. We therefore included additional public agencies in these areas of our review, such as in responding to audit objective eight.

Assessment of Data Reliability

In performing this audit, we relied upon electronic data files extracted from the information systems listed in Table 3. The U.S. Government Accountability Office, whose standards we follow, requires us to assess the sufficiency and appropriateness of computer processed information if it is used to support findings, conclusions, or recommendations. We summarize the results of this analysis in Table 3.

Table 3
Methods of Assessing Data Reliability

INFORMATION SYSTEM	PURPOSE	METHODS AND RESULTS	CONCLUSION
California Debt Investment Advisory Commission (CDIAC): California Debt Issuance database Data for the period January 1, 2002, through June 30, 2011.	To identify high volume issuers of conduit revenue bonds for the period January 1, 2002, through June 30, 2011.	The data is not used to support findings, conclusions, or recommendations.	No determination required.
State Treasurer's Office: California State Accounting and Reporting System California Health Facilities Financing Authority data for the period July 1, 2006, through June 30, 2011.	To calculate revenues and expenditures for the California Health Facilities Financing Authority Fund for the period July 1, 2006, through June 30, 2011.	We used the data to provide background information in the Appendix.	No determination required.
Municipal Securities Rulemaking Board: Electronic Municipal Market Access (EMMA) Data for the period July 1, 2009, through December 31, 2011.	To identify the number of material events associated with conduit revenue bonds issued by the California Health Facilities Financing Authority, the California Statewide Communities Development Authority and the California Municipal Finance Authority	EMMA, a federal database, is outside the jurisdiction of our statutory authority. Therefore, we did not perform a data reliability assessment.	Undetermined reliability for the purposes of this audit.

Source: California State Auditor's analysis of data obtained from the entities listed in the table.

Chapter 1

THE PRACTICES OF SOME CONDUIT BOND ISSUERS RAISE CONCERNS REGARDING CONFLICTS OF INTEREST AND WHETHER THE ISSUERS RECEIVE THE BEST VALUE FROM CONTRACTORS

Chapter Summary

Payments made by the California Statewide Communities Development Authority (California Communities) and the California Municipal Finance Authority (Municipal Finance) to the consulting firms whose consultants advise the joint powers authorities raise concerns under California's conflict-of-interest laws. These joint powers authorities contract with private consulting firms to staff their organizations. Because the joint powers authorities pay these consulting firms a percentage of the revenue generated by each conduit financing, there is a question as to whether individual consultant's participation in financing decisions violates the Political Reform Act of 1974 (political reform act). There is, however, a 1993 advice letter published by the Fair Political Practices Commission (FPPC), the *McEwen* advice letter, which the consulting firms cite to support their position that their staff do not have a conflict of interest when participating in bond issuances. While we acknowledge how widely consultants who advise public entities may rely upon the *McEwen* advice letter, neither the FPPC nor a court of appropriate jurisdiction has considered whether the reasoning in the *McEwen* advice letter applies to the circumstances here. Therefore, we cannot reach a definitive conclusion regarding the consultants' compliance with the political reform act.

The financial arrangements between the consulting firms and the joint powers authorities raises an additional concern under another conflict-of-interest law, California Government Code, Section 1090 (Section 1090). This state law prohibits officers and employees of public agencies from being financially interested in any contract they enter into in their official capacity. While we believe these consultants are subject to the prohibition contained in Section 1090, no judicial decision squarely addresses the legality of the compensation model in practice here, and we cannot reach a definitive conclusion. We also reviewed the contracting practices of the joint powers authorities and found that both California Communities and Municipal Finance could improve their practices for selecting and compensating consultants and other contractors.

The Joint Powers Authorities' Use of Consultants as Staff Is Not Typical of Public Agencies

Both California Communities and Municipal Finance do not directly employ staff; instead, they rely exclusively on consultants to act as program managers and perform the work necessary to prepare conduit revenue bonds for issuance. Among the California agencies of which we are aware, this is not a common organizational structure. Additionally, the compensation method outlined in these consultants' contracts further differentiates these authorities from many other public agencies. For example, state agencies, including those that issue conduit revenue bonds, must follow state laws regarding contracting; these laws generally require agencies to define the length of time of a contract, the maximum amount to be paid under that contract, and the basis of payment (e.g., fixed amount, number of hours, or recovery of costs). In contrast, California Communities and Municipal Finance pay their contracted consulting firms a percentage of the fees charged for conduit financings. We note that California Communities disagrees with our comparison of its consultant contract to state agency contracts because it is not a state agency subject to the state public contracting code. However, we were specifically asked to compare the business and compensation models of different types of issuers—how the entities contract with consultants is one aspect of that comparison.

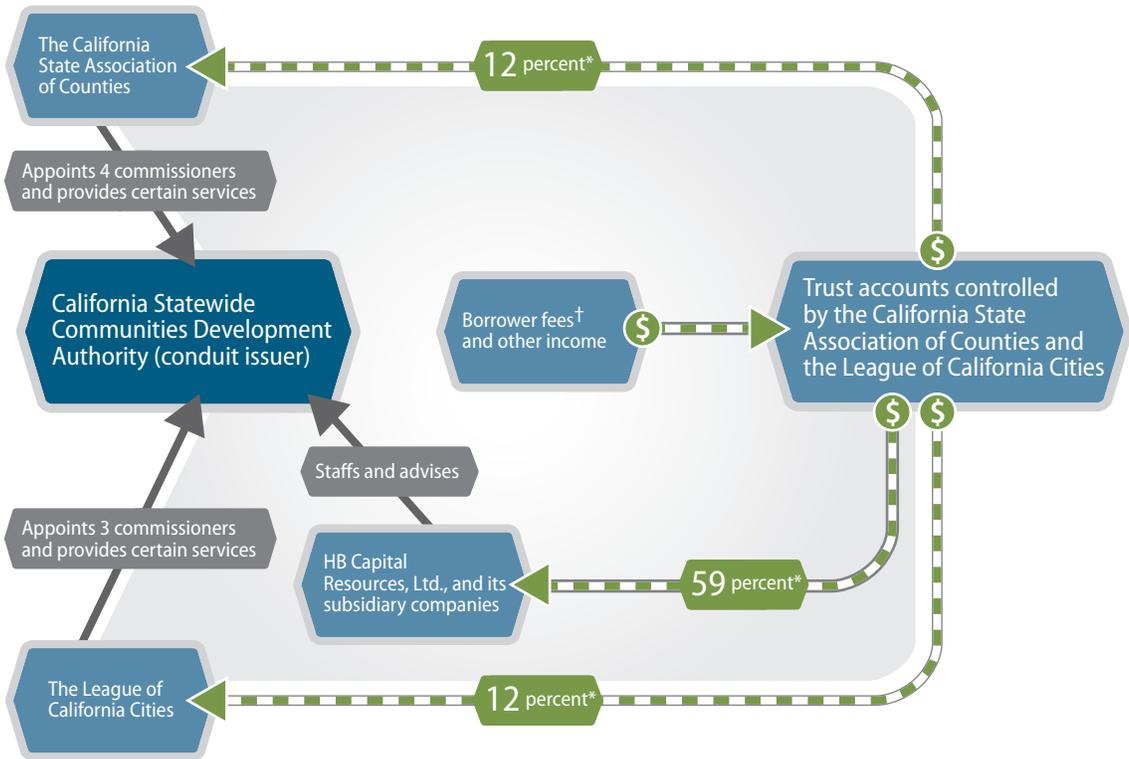
Rather than directly employ staff, California Communities contracts with HB Capital to perform consulting, advisory, and professional services.

Rather than directly employing staff, California Communities contracts with HB Capital Resources, Ltd., (HB Capital) to perform consulting, advisory, and professional services. HB Capital is involved in most aspects of the issuance of conduit financings, including working with the borrower, arranging for local governmental hearings, working with bond counsel and the underwriter, and presenting the complete financing package to the California Communities board for approval. California Communities' contract with HB Capital includes no maximum payment amounts and specifies that HB Capital has discretion over the hours it works. As compensation, California Communities pays HB Capital between 33 percent and 75 percent of the borrowers fees, depending on the type of conduit financing. As shown in the Appendix, California Communities paid HB Capital and its subsidiaries roughly \$50 million from July 2006 through June 2011, which was 59 percent of the total revenue generated by California Communities during that period.

The California State Association of Counties (CSAC) and the League of California Cities (League) co-sponsor California Communities. Specifically, these two organizations appoint California Communities' board members, the majority of whom were also paid staff members of CSAC and the League before 2009.

In fact, until that time, the executive directors of both groups served on California Communities’ board. In December 2008 CSAC and the League replaced their respective staff members on the board with local government officials due to the possibility that the previous arrangement might result in a perceived conflict of interest. As Figure 2 shows, CSAC and the League control the trust accounts holding the fees paid by borrowers; they also receive a portion of these fees. From July 2006 through June 2011, CSAC and the League each received more than \$9.7 million, or 12 percent of California Communities’ total revenue. Once HB Capital, CSAC and the League receive payment, the remaining revenue is used to pay for legal counsel and other operating costs, as shown in the Appendix.

Figure 2
 California Statewide Communities Development Authority’s Organizational Structure and Money Flow



Sources: Contracts and financial statements obtained from the California Statewide Communities Development Authority.

* The percentages shown represent the percentage of total revenue received by the applicable organizations from July 1, 2006, through June 30, 2011. Refer to the Appendix for the total revenues and expenditures during this period.

† As discussed in Chapter 2, borrowers pay a one-time fee to apply for a conduit bond issuance. They also pay a fee when the joint powers authority issues a bond to finance their project, and they pay ongoing annual administrative fees until they pay off the bond.

CSAC and the League stated that they use the fee revenues generated by California Communities to pay for the administrative and staff costs associated with their oversight responsibilities.

California Communities' financial arrangements with CSAC and the League are consistent with constitutional requirements regarding the use of public funds.

Specifically, CSAC and the League stated that they actively participate in the administration of California Communities, appoint and support its board members, market the joint powers authority to their members, work to develop programs for new financial services, and monitor the activities of California Communities for compliance with state and federal laws. Officials from both groups reported that they also use the funds to provide education and advocacy efforts, to keep member dues low, to partially offset general operating costs, and to fund programs promoting best practices in local government.

We analyzed the legality of California Communities providing public funds to CSAC and the League. Specifically, we examined whether this practice violates the provisions of the California Constitution that prohibit any public entity from making a gift of public funds. To avoid violating this prohibition, the public funds must be used for a permissible public purpose and the entity that receives the funds must offer consideration, or some value, in return for the money received. The contracts between California Communities and the two organizations require them to provide various services in return for the money they receive. Moreover, we found that the money received is required to be used for permissible public purposes.⁴ Thus, we found that California Communities' financial arrangements with CSAC and the League are consistent with constitutional requirements regarding the use of public funds.

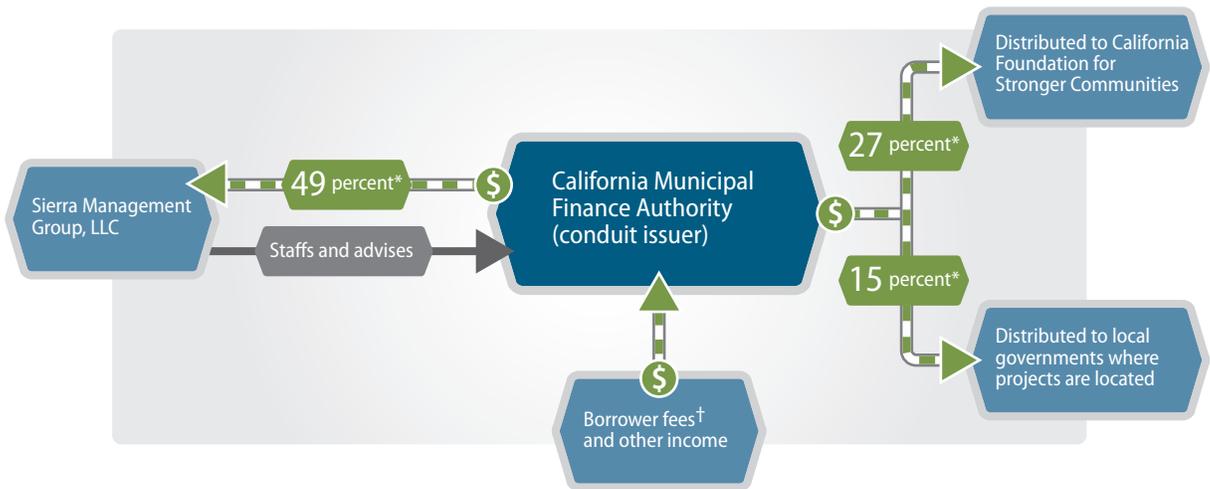
As shown in Figure 3, Municipal Finance contracts with Sierra Management Group, LLC, (Sierra Management) to manage its operations. Similar to HB Capital, Sierra Management receives a percentage of the borrowers fees depending on the type of conduit financings Municipal Finance issues. As the Appendix shows, Sierra Management received more than \$4.6 million in fees from July 2006 through June 2011, which was 49 percent of Municipal Finance's total revenue during this period.

Like California Communities, Municipal Finance is closely affiliated with a nonprofit organization. As permitted by the Joint Exercise of Powers Act (joint powers act), Municipal Finance is administered by the board of directors of the California Foundation for Stronger Communities (foundation), which was created in conjunction with the joint powers authority agreement that created Municipal Finance. Under the agreement, Municipal Finance distributes a percentage of borrower fees to the foundation to use in funding

⁴ In response to a complaint, the FPPC investigated CSAC and the League in November 2009 and found in that same month that both agencies appropriately segregate their financial activities to distinguish between revenue sources and related expenses. It did not find evidence that either agency had used public funds to make political contributions.

grants to nonprofit organizations throughout the State. Municipal Finance also distributes funds to the local cities and counties in which projects financed by conduit bonds are located. As shown in the Appendix, it uses the remaining amount for other operating costs.

Figure 3
California Municipal Finance Authority's Organizational Structure and Money Flow



Sources: Contracts and financial statements obtained from the California Municipal Finance Authority.

* The percentages shown represent the percentage of total revenue received by the applicable organizations from July 1, 2006, through June 30, 2011. The calculations exclude revenues and expenditures associated with a particular lease agreement. Refer to the Appendix for the total revenues and expenditures during this period.

† As discussed in Chapter 2, borrowers pay a one-time fee to apply for a conduit bond issuance. They also pay a fee when the joint powers authority issues a bond to finance their project, and they pay ongoing annual administrative fees until they pay off the bond.

For purposes of comparison, the organization of the California Health Facilities Financing Authority (Health Financing Authority) is more typical of a public agency in that it directly employs staff to perform its functions. Although it contracts with outside consultants to assist with the financial and legal analyses of proposed conduit financings, it hires these consultants through a competitive process and specifies in the contracts the scope of work, term dates, and maximum payment amounts. The Health Financing Authority also pays its contractors on an hourly basis, rather than paying them a percentage of the dollar value of the bonds it issues. Its board members are either elected by the public or appointed by the governor, the senate pro tem, and the speaker of the Assembly. The Health Financing Authority contracts with the State Treasurer's Office to account for borrower fees, and it uses excess funds to administer legislatively authorized grant and loan programs that benefit health facilities throughout the State. Its application and approval process for these grants and loans provides accountability to ensure appropriate use of the public funds. An additional public agency we reviewed for this audit,

the city of Los Angeles Housing Department (LA Housing), also contracts with outside consultants for financial advice and legal counsel. LA Housing hired these firms through a competitive process, and the contracts generally provide for fixed fee payments, which are contingent on the completion of a bond issuance, and vary depending on the amount of bonds sold. However, like the Health Financing Authority, LA Housing directly employs staff to oversee the issuance of conduit revenue bonds.

In contrast, the nature of California Communities and Municipal Finance's organizational structure—using private consultants as staff to review and make recommendations regarding bond transactions and then paying their employer a percentage of the fees associated with approved bond issuances—raises concerns related to the State's conflict-of-interest laws as discussed in the next sections.

Although the Answer Is Unclear, Payments to the Private Employers of Consultants to the Joint Powers Authorities Raises a Concern Under the Political Reform Act

Because California Communities and Municipal Finance are public entities, the public officials who act on their behalf must comply with certain conflict-of-interest laws. One such law is the political reform act. This act requires public agencies to adopt a conflict-of-interest code and to ensure that certain public officials complete financial disclosure statements in which they report their economic interests (interest statements). Reportable economic interests include investments, real property, sources of income, and business positions. The conduit issuers we reviewed have adopted conflict-of-interest codes as required by the political reform act, and these codes require that all board members, staff members, and designated consultants file interest statements. In our review, we determined that all persons required to file interest statements did so, and we found no disclosures that would indicate an economic interest in any approved financing.

Because the private firms that employ the consultants that staff California Communities and Municipal Finance become eligible to receive payment each time the joint powers authorities approve a conduit bond transaction, this presents a concern under the political reform act.

The political reform act also prohibits public officials at any level of state or local government from making, participating in making, or attempting to use their official position to influence governmental decisions in which they have an economic interest. A public official has an economic interest in a governmental decision if that decision will have a reasonably foreseeable material financial effect on one or more of the official's economic interests, unless some exception applies. Because the private firms that employ the consultants that staff California Communities and Municipal Finance become

eligible to receive payment each time the joint powers authorities approve a conduit bond financing, this presents a concern under the political reform act.

Determining whether a conflict of interest exists under the political reform act generally involves the eight-step analysis shown in the text box. The first question involves determining whether an individual is a public official. The conflict-of-interest codes adopted by both California Communities and Municipal Finance plainly recognize that some HB Capital and Sierra Management consultants participate in, or influence, the making of governmental decisions and thus perform the same duties as individuals who would be considered *designated employees*. These consultants therefore are considered public officials under the political reform act.

The second step involves determining whether the consultants are making, participating in making, or attempting to use their official position to influence a governmental decision. In the case of a conduit bond issuance that is considered and, in some cases, acted on by a joint powers authority, the members of its governing board act as the ultimate decision makers. However, designated consultants may participate in, or influence, those decisions. They do so by preparing and presenting information and analysis to the governing board members and recommending whether the board should approve the bond financing.

The third step asks whether the consultants have an economic interest that may be affected by the decision. Among other things, a public official has an economic interest in any person, such as an employer, from whom he or she has received income of \$500 or more within the previous 12 months. A public official's income includes commissions, incentive compensation, and income that has been promised but not yet received. HB Capital and Sierra Management are a source of income to the consultants who advise California Communities and Municipal Finance, respectively. As the consultants receive income from their respective employers, and their employers receive income when a bond financing is completed, they have an economic interest that may be affected by the conduit financing decisions of the joint powers authorities.

The Eight-Step Legal Analysis for Determining Conflicts of Interest Under the Political Reform Act of 1974

1. Is the individual a public official?
2. Is the public official making, participating in making, or attempting to use his or her official position to influence a governmental decision?
3. Does the public official have an economic interest that could be affected by the decision?
4. Is the economic interest directly or indirectly involved in the governmental decision?
5. What impact on the economic interest would be material?
6. Is it reasonably foreseeable that the economic interest will be materially affected?
7. Is the potential effect of the governmental decision on the public official's economic interests distinguishable from its effect on the general public?
8. Despite a disqualifying conflict of interest, is the public official's participation legally required?

Source: The California Fair Political Practices Commission's Eight-Step Process.

HB Capital has no contractual obligation to provide net income information to California Communities.

The fourth step in the analysis is determining whether the consultants' economic interest is directly or indirectly involved in the governmental decisions, and this determination is crucial to the remainder of the analysis. If the business entity in which a public official has an economic interest is directly involved in the decision before the public official's agency, a conflict of interest exists regardless of the financial effect on the business entity. For example, if a public agency approves a contract between that agency and the private employer of the consultants who advise it, that decision would directly affect the private corporation. In this case, the firm would be directly involved in the governmental decision, as it would be a party to the contract. However, if the public official's economic interest in the governmental decision is indirect, the FPPC has established materiality standards based on the net income to determine if a conflict of interest exists. The larger the private corporation's annual net income, the greater the economic effect of any one governmental decision must be in order for it to be material.

Because they are not a party to bond transactions, we believe that HB Capital and Sierra Management are not directly involved in the bond issuance decisions but instead are indirectly involved in those decisions. We therefore would need to apply the appropriate materiality standards set out in FPPC regulations to determine if a conflict of interest exists. However, we were unable to fully evaluate the potential for violating the political reform act because we have not been able to obtain net income information from HB Capital, and it has no contractual obligation to provide that information to California Communities. We do know that the payments received by HB Capital averaged \$9.9 million annually for fiscal years 2006–07 through 2010–11. However, because we do not know what HB Capital's expenses were, we could not determine its actual net income for each fiscal year we reviewed.

Depending upon its actual annual net income, HB Capital could be found to have violated the political reform act, unless the reasoning set out in the *McEwen* advice letter (discussed further beginning on page 22) applies. For a corporation whose annual net income is \$2.5 million or more, the effect of any one bond issuance would need to be \$500,000 or more in a fiscal year to constitute a potential violation. If HB Capital's annual net income was between \$750,000 and \$2.5 million, then the effect of any one bond issuance would only need to exceed \$300,000 in a fiscal year in order for it to constitute a potential violation. We determined that the amounts HB Capital received from each of the five highest dollar issuances during the past five fiscal years did not meet or exceed these thresholds. As Table 4 indicates, the highest amount HB Capital received in any one fiscal year was approximately \$200,000.

However, as we note above, we do not know HB Capital’s net income, which would be necessary to accurately evaluate potential conflicts of interest under the political reform act.

Table 4
High Dollar Projects Financed by the California Statewide Communities Development Authority

BORROWER	BOND AMOUNT	DATE ISSUED	TOTAL AMOUNT DISTRIBUTED TO HB CAPITAL IN ONE FISCAL YEAR
Kaiser Permanente	\$1,600,000,000	June 2009	\$200,690
Kaiser Permanente	500,000,000	May 2008	100,485
Catholic Healthcare West	676,250,000	April 2007	197,400
St. Joseph Health System	494,550,000	April 2007	185,737
Kaiser Permanente	473,910,000	February 2007	175,656

Sources: Unaudited accounting records and documentation such as bank statements provided by the California Statewide Communities Development Authority.

The commission chair of California Communities stated that it would not be in HB Capital’s interest to submit an inappropriate or highly speculative bond financing for approval. In his view, doing so would risk HB Capital’s and California Communities’ reputations in the market place, making it difficult for them to attract investors for their bonds. According to the chair of California Communities’ board, the interests of HB Capital and California Communities are perfectly aligned in this regard. The chair added that to the extent that a contingency fee gives an incentive for HB Capital to work harder and improve its processes to attract more business, this fee structure further aligns the interests of the joint powers authority and HB Capital. Although we appreciate the chair’s perspective, the political reform act is designed to ensure that public officials act in the public interest and not their own personal financial interests when they participate in governmental decisions.

As was the case with HB Capital, Sierra Management also did not provide us with the documentation necessary to calculate its net income, stating that it has no contractual obligation to provide this information to Municipal Finance. However, during the five-year period of our review, the gross revenues flowing to Sierra Management averaged \$920,000 per year, leading us to believe that Sierra Management had an annual net income of less than \$750,000. If this is the case, the effect of any one bond transaction would only need to be \$20,000 in a fiscal year to constitute a potential violation. The highest amount Municipal Finance paid to Sierra Management for any one financing during the five years of our review was approximately \$112,000; numerous other financings resulted in payments exceeding \$20,000 in a fiscal year. Moreover, the financial effect that the bond issuance decisions would have

on the consultant's economic interest is clearly foreseeable, as the terms of payment are spelled out in the contract between the private entities and the respective joint powers authorities. Consequently, depending on how the courts or FPPC view the applicability of the reasoning set forth in the *McEwen* advice letter, and depending on Sierra Management's actual net income, Sierra Management could be found to have violated the political reform act.

The chair of Municipal Finance's board stated that the use of a contingency fee is a customary practice in public finance and is a prudent way of limiting an issuer's financial risk because if a transaction is not completed, the issuer is not responsible for professional fees and expenses. The chair added that, based on the board's review and understanding of the public finance industry, the compensation level of Sierra Management is reasonable and commensurate with the level of service it provides. Similarly, the consulting firm that advises California Communities has observed that the trend in local government has been to use private consultants for a wide range of services historically provided by government employees. Moreover, California Communities has asserted that joint powers authorities that operate with limited budgets have found that hiring consultants with a breadth of expertise to provide management services can be more cost-efficient than retaining staff. Further, they have asserted that the advice provided in the *McEwen* advice letter provides a practical basis for ensuring that the compensation of consultants is determined in advance with full public disclosure.

The consultants are relying on a 1993 advice letter published by the FPPC to support their position that they do not have a conflict of interest when they act as staff on bond issuances.

It is important to recognize that the consultants are relying on a 1993 advice letter published by the FPPC—the *McEwen* advice letter—in support of the position that they do not have a conflict of interest when they act as staff on bond issuances. As described earlier, when a consultant participates in a governmental decision that has a foreseeable financial effect on a source of income (i.e., the private employer of that consultant), the consultant typically has a conflict of interest provided that the financial effect is deemed material under FPPC's regulations. However, under the reasoning in the *McEwen* advice letter, if the governmental entity has previously entered into a contract with a consultant or a consultant's employer that expressly allows for payment for the services to be furnished, the consultant may subsequently provide those services without having a conflict of interest.

More specifically, in the *McEwen* advice letter, the FPPC found no conflict of interest where the law firm that employed bond counsel was compensated by a city on a contingent fee basis based, in part, on the size or success of the bond issuance, as provided for in the law firm's contract with the city. In the letter, the FPPC

acknowledged that bond-issuance firms are often paid a fixed percentage of the bond-issuance amount, and if the FPPC were to prevent cities from making similar fee arrangements with their contract counsel, it “would be interjecting itself into the process of how government agencies pay individuals for services rendered.” The theory underlying the *McEwen* advice letter is that a consultant’s participation in governmental decisions subsequent to the formation of the employment arrangement does not have a financial effect on the consultant’s employer because disinterested public officials have already established the contract that sets out the services to be provided and the compensation for those services.

Both California Communities and Municipal Finance strongly believe that the *McEwen* advice letter applies to their circumstances and that their consultants do not have a conflict of interest when they present bond financing proposals to the respective authorities for consideration and action. In support of this position, the contracts between California Communities and HB Capital and Municipal Finance and Sierra Management, respectively, both contain a clearly defined scope of services and set out the manner of compensation. Both California Communities and Municipal Finance have sought outside legal counsel regarding this matter and have been advised that it is appropriate to rely on the *McEwen* advice letter. In addition, the two private firms that employ the consultants, HB Capital and Sierra Management, have also obtained legal advice on this matter and have been advised that the *McEwen* advice letter applies when they provide advice to the respective authorities. We note, however, that neither joint powers authority has sought independent legal advice on this matter directly from the FPPC based on the specific factual circumstances presented here. Given that any analysis under the political reform act is specific to particular facts, we cannot predict what the FPPC or a reviewing court would conclude. If the FPPC were to reach the same result here that it did in the *McEwen* advice letter, then the legal analysis would stop; otherwise, the remaining steps in the above analysis are necessary to determine if a violation has occurred.⁵

Neither joint powers authority has sought independent legal advice on this matter directly from the FPPC.

The Payments to the Private Employers of the Consultants to the Joint Powers Authorities Also Raise a Concern Under Another Conflict-of-Interest Law

California Communities and Municipal Finance are subject to Section 1090, which prohibits officers and employees of public agencies from having an economic interest in any contract that they enter into in their official capacity or that they participate

⁵ Steps 7 and 8 of the political reform act analysis apply only in certain limited circumstances and are not relevant here.

in entering as a member of a body or board, subject to some statutorily defined exceptions. The consequences for violating Section 1090 are severe, and a contract made in violation of that section is void. We believe the consultants of California Communities and Municipal Finance are subject to the prohibition contained in Section 1090 because they act in the same capacity as public employees.

Further, a revenue bond is generally considered to be a contract for purposes of Section 1090, so we believe that the consultants' role in the bond-approval process constitutes participation in the "making of a contract" for the purposes of Section 1090. As to whether the consultants are financially interested in bond transactions, each time they recommend bond transactions that the joint powers authority approves, their private employer becomes eligible to receive a percentage of the fees associated with the face value of the bonds in accordance with their contract with the joint powers authority. Consequently, this compensation structure could be found as serving as an incentive to recommend bonds for approval, which is the kind of conflict Section 1090 is designed to prevent.

No reported judicial decision squarely addresses the issue of whether participation by these consultants in bond issuance decisions is permissible under Section 1090.

However, no reported judicial decision squarely addresses this issue. While some of the prior cases that have analyzed whether a Section 1090 violation existed have broadly applied this prohibition, a recent appellate court decision appears to cast some doubt on whether this compensation model would be found to violate Section 1090. In *Eden Township Healthcare District v. Sutter Health* (2011) 202 CalApp.4th 208 (*Eden Township*), the court found no violation of Section 1090 when the employee did not personally participate in making the contract at issue and the contract did not result in direct financial gain for the employee, such as a change in salary, benefits, or employment status.

While the facts in that case differ from the current situation in that the consultants here do participate in the bond transaction decisions by performing reviews and recommending approval, it is unclear how a court would interpret and apply the analysis in *Eden Township*. *Eden Township* suggests that it may be necessary to demonstrate a more direct impact, such as showing that these consultants receive bonuses or commissions or that their income is tied directly to the volume of bonds they recommend that the authorities approve. Nonetheless, because the consulting firms currently have no contractual obligation to provide information that would allow us to determine whether the consultants derive such a direct benefit to the authorities and the firms did not provide it to us during this audit, we were unable to determine whether the consultants directly benefited from the bond transactions.

The attorneys who advise the joint powers authorities have also directed our attention to other court cases that they believe support their position that a Section 1090 violation is not present here. Among those cases is a 2010 California Supreme Court case; HB Capital and California Communities believe this case suggests that if a court were to consider whether a Section 1090 violation exists here, it would apply the legal doctrine that requires that laws that relate to the same subject—namely conflicts of interest—be harmonized (*Lexin v. Superior Ct.* (2010) 47 Cal.4th 1050, 1091). Based on this decision, California Communities believes that a reviewing court would essentially read the reasoning of the *McEwen* advice letter into Section 1090. Although we acknowledge that the court's decision in *Lexin* does provide some support for this position, we are not necessarily persuaded by this argument, as Section 1090 is a separate statute, with its own statutorily enumerated exceptions. Related to that, traditional rules of legal analysis require that exceptions to a statute be narrowly construed and that any exceptions to the statute must be expressly stated.

Finally, both California Communities and Municipal Finance have directed our attention to another decision, *Campagna v. City of Sanger* (1996) 42 Cal.App.4th 533 (*Campagna*). In this case, the court of appeal did not find a conflict of interest under either the political reform act or Section 1090 with respect to a contingency fee agreement negotiated by a contract city attorney between a litigation firm and the city. However, the contract city attorney had also negotiated a separate agreement with the litigation firm to receive a percentage of the litigation firm's fee as his compensation. Thus, in acting on behalf of the city, the attorney negotiated a contract that also benefitted himself and this action was held to violate Section 1090. However, the court did acknowledge that there may be circumstances where a contingency fee arrangement with a consultant does not violate Section 1090. Given the differences between the legal relationships in *Campagna* and the relationships that exist with respect to the authorities and their consultants, it is our view that *Campagna* does not apply directly to the legal question presented here. As stated earlier, until a court of appropriate jurisdiction rules on this issue or the Legislature weighs in, we believe the legality of this practice is uncertain.

Until a court of appropriate jurisdiction rules on this issue or the Legislature weighs in, we believe the legality of this practice is uncertain.

The Joint Powers Authorities Could Improve Their Policies Related to Hiring and Compensating Consultants and Other Contractors

Although generally not subject to external requirements related to their hiring of consultants and contractors, California Communities and Municipal Finance could better ensure contractors' fees are reasonable by improving their contracting practices. As discussed earlier, the organizational structure of these two joint

powers authorities are not common among public agencies. The two authorities are not subject to the State's public contracting laws regarding consulting contracts nor are they subject to any local ordinances regarding contracting that may have been adopted by their local government members. Additionally, their use of consultants as their only staff makes finding procurement best practices that are directly applicable to their organizational structures difficult. Even so, based on general procurement concepts obtained from a number of different sources as well as comparisons with other state and local conduit issuers we reviewed, we believe these joint powers authorities can adopt stronger practices to ensure that they get the best services and price from the consultants and other contractors they hire.

In guidance regarding selecting and using financial advisors when issuing municipal bonds, the Government Finance Officers Association (GFOA) recommends using a competitive process and not giving any one firm an unfair advantage. GFOA's purpose is to enhance and promote the professional management of government by identifying and developing financial policies and best practices. HB Capital disagrees with our use of this guidance related to financial advisors because it asserts that its consultants do not provide financial advice; they manage processes and ensure compliance with joint powers authority debt-issuance policies. We acknowledge that the association's best practices are not directly applicable but we believe they are at least analogous to the selection of consultants the joint powers authority uses to assist it in issuing bonds, especially those who make recommendations on whether to approve an issuance. Additionally, the California Debt and Investment Advisory Commission (CDIAC), which provides guidance to state and local debt issuers, explained in its debt issuance primer that issuers may not always need to select members of a bond financing team using a formal request for proposal; instead, it spoke to other "price control" methods like obtaining comparative price data and engaging in direct negotiation with professionals with whom the issuer has established relationships.

The best practices from these sources specifically relate to the selection of individual finance team members in a particular bond transaction; they do not necessarily contemplate the hiring of consultants to act as joint powers authority staff on a long-term basis. In guidance published on public-private partnerships, CDIAC describes important concepts to consider when selecting a long-term business partner. It describes that the process generally consists of a "best value" selection, as opposed to the "lowest bidder" process, but CDIAC consistently assumes in its advice that the selector will be using some type of formal, request-for-proposal selection process. To form a comparison, we also examined the

procurement activities of the Health Financing Authority and LA Housing. As discussed earlier, both of these entities have implemented competitive selection of their service providers.

An HB Capital consultant stated that California Communities selected HB Capital's services through a competitive process. However, given that California Communities has contracted with HB Capital since 1991, the consultant could not provide any evidence to that effect, stating that California Communities no longer maintains that documentation. The chair of Municipal Finance's board indicated that the board selected Sierra Management after a thorough search of the industry. However, the chair did not indicate that the board used a request for proposal as part of its process. Without documentation on how HB Capital and Sierra Management were selected, we cannot evaluate whether the original selections of these consultants represented best value. While both joint powers authorities periodically review the performance of these consultants, neither California Communities nor Municipal Finance has subsequently requested bids for the services the consultants provide, nor have they performed some other price comparison analysis. Instead, these private firms have acted as the long-term advisors to these joint powers authorities. This does not give other qualified consultants an opportunity to demonstrate how they might better perform the services or offer lower prices, or otherwise ensure that the joint powers authorities are using the public funds they oversee effectively.

Furthermore, to avoid the incentive for financial advisors to provide advice that might lead to the unnecessary issuance of bonds, GFOA recommends that municipalities compensate financial advisors on an hourly or retainer basis rather than on a contingency basis. However, GFOA acknowledges that financial constraints may make this difficult for many issuers. If issuers pay contingency fees, the GFOA emphasizes that issuers include provisions in their requests for proposals prohibiting any firm from engaging in activities on behalf of the issuers that produce a direct or indirect financial gain for the financial advisor other than the agreed-upon compensation without the issuer's informed consent. However, California Communities and Municipal Finance have not issued requests for proposals for the program manager functions, and we found no such provisions in the authorities' contracts with their consultants. Applying this recommendation to their contracts would provide California Communities and Municipal Finance additional assurance that their consultants act solely in the joint powers authorities' interests. In response to our review, a representative of Sierra Management stated that as a registered municipal advisor he is aware of and subject to federal securities laws and regulations that require a fiduciary obligation to place first the interests of Municipal Finance. He therefore had no objection to adding additional wording to Sierra Management's contract that reiterates this responsibility. Similarly,

Although an HB Capital consultant states that California Communities selected HB Capital's services through a competitive process, the consultant could not provide any evidence to that effect.

California Communities was originally formed as a partnership between CSAC, the League, and the founders of HB Capital; this consulting firm has served as program manager since the authority's inception.

although HB Capital's consultants are not registered municipal advisors (discussed in the next section), a representative of HB Capital also indicated that he would not object to including the provision in HB Capital's contract with California Communities.

When asked about California Communities' relationship to HB Capital, the commission chair of California Communities stated that the joint powers authority was originally formed as a public-private partnership between CSAC, the League, and the founders of HB Capital. He stated that HB Capital has served as the program manager for the joint powers authority since its inception and has developed a high degree of technical experience and knowledge in conduit financing. He also asserted that although California Communities could replace the firm, a new contractor would need to implement a compliance tracking system that was developed and is owned by HB Capital, would need time to become proficient with the joint powers authority's bond issuance policies and procedures, and would have to reestablish critical relationships. He therefore concluded that unless the commission had concerns about the performance of HB Capital, it would not be cost-effective to change consultants. The board chair of Municipal Finance expressed a similar sentiment on this matter.

The commission chair of California Communities stated that when it restructured the commission in 2008 as previously described, the new board members realized that the joint powers authority's contracts had historically not received routine, ongoing review. As a result, the new commission created an ad hoc committee to review its contracts and to generally look at how California Communities was performing. As a result of this review, the commission adopted a new contracting policy in January 2012 that specifies that no initial contract shall exceed three years or allow for unlimited two-year extensions. The policy also requires that each contract receive an annual review. The chair stated that as the commission brings contracts forward for review, it will determine whether to open them up for bid. The commission chair added that the commission also discussed opening the program manager contract for bid. However, it decided not to do so because of the potential inefficiencies previously described and because it was satisfied with the performance of HB Capital. Even so, he stated that the commission has committed to reviewing HB Capital's performance once a year and could decide to bring in a new program manager if it finds HB Capital is doing an inadequate job. Municipal Finance stated that it also reviews the performance of its contractor. However, during our audit fieldwork it did not have a board-adopted policy specifying its processes for selecting contractors or its methods for reviewing the performance of existing contractors. In July 2012 Municipal Finance's board

adopted a written policy that includes using competitive processes to identify and select contractors and evaluating the fees and expenses it is charged for consulting services.

As indicated in Chapter 2, we found little distinction in terms of compliance with pertinent regulations and reporting requirements between the issuers we reviewed. However, as indicated earlier and in the Appendix, California Communities paid HB Capital approximately 59 percent of the fee revenues it received and distributed roughly 23 percent of that amount to its two sponsoring entities while Municipal Finance paid its program manager 49 percent of its fee revenues and shared over 40 percent with its member communities and its board's charitable foundation.⁶ These data suggest that California Communities could benefit from reviewing not only the performance of its consultant staff but also the fees being paid for these services. Its January 2012 contracting policy does not address how it will examine the reasonableness of consultant fees.

Additionally, California Communities has used the same issuer's counsel since its inception in 1988 without opening the position to competitive bidding. The consultants who work for HB Capital asserted that the ongoing contract with its issuer counsel is based on a long-standing relationship and that California Communities requires continuity and specialization from its issuer counsel because of its size and history. However, giving ongoing preference to this one firm may result in higher than necessary costs for the services California Communities receives; the competition resulting from periodically bidding out the contract would provide California Communities' board with a basis for evaluating the competitiveness of the fees that its issuer counsel charges. There are likely other firms that could effectively serve as issuer counsel. For example, the State Treasurer's Office maintains a list of law firms that it has authorized to serve as bond counsel for tax-exempt financings issued through state agencies; the list, last updated in July 2011, includes 27 firms in addition to the issuer counsel California Communities uses. All of the firms on the list have met qualifications established by the State Treasurer's Office, and it seems reasonable that many could provide quality services as issuer counsel to California Communities. The commission chair stated that the California Communities' commission has had discussions regarding its long-standing contract with its issuer counsel and that

California Communities paid its program manager approximately 59 percent of the fee revenues it received, while Municipal Finance paid its program manager 49 percent of its fee revenues.

⁶ As discussed in the next section, one notable difference between the consultants for these two entities is that HB Capital has stated it is not a municipal advisor and therefore cannot provide financial advice to California Communities on the "structure, timing, terms, and similar matters" of its bonds. Sierra Management, on the other hand, employs registered municipal advisors and, therefore, can perform these functions.

it may consider conducting a competitive bidding process for this function as well as others to ensure that the joint powers authority is getting the best price and services.

While Municipal Finance's Staff Consultants Are Registered to Provide Municipal Advisory Services, California Communities' Staff Consultants Are Not

As of 2010 federal law requires that municipal advisors providing advice to governmental entities regarding municipal bonds be registered with the Municipal Securities Rulemaking Board (MSRB). The MSRB sets rules and standard requirements for the municipal securities marketplace. The registration applies to individuals and firms that provide advice regarding the structure, timing, terms, and other matters regarding municipal securities. Although the SEC has not yet finalized a definition of *municipal advisor*, a temporary registration rule has been enacted and is in effect until September 2012. The consulting firm staffing Municipal Finance and the outside consulting firms used by the Health Financing Authority are registered. In contrast, HB Capital is not registered with the MSRB.

Staff at HB Capital told us that they are not required to register with MSRB because they do not provide advice to California Communities regarding the structure, timing, terms, or other similar matters regarding the bonds that are issued. While we acknowledge that the definition of *municipal advisor* has not yet been finalized, the MSRB has provided a list to the SEC describing traditional municipal advisory activities. According to the MSRB, "this list is intended to provide a fuller understanding of the range of municipal advisory activities for which there can be little dispute as to whether those activities were intended to be covered by the [registration requirements]." Additionally, the MSRB states that "we are of the view that persons engaging in any such activities. . . must be registered as municipal advisors subject to all federal securities laws and regulations applicable to municipal advisors." We asked Sierra Management—the consulting firm staffing Municipal Finance—whether it conducts any of the activities referred to in the advice letter. Sierra Management stated that it performs at least 13 of the services described in the letter, including:

- Assistance provided to issuers and borrowers in addressing citizen concerns related to proposed projects and associated financing.
- Advice on new financial products.
- Budget planning and analysis.

- Advising issuers regarding the method of sale for particular transactions.
- Assistance in negotiation of contracts with significant financial terms.

Because it provides these and other municipal advisory services, Sierra Management is registered with the MSRB. Conversely, because HB Capital is not registered as a municipal advisor, it cannot lawfully perform a municipal advisory role unless it meets federal requirements. Depending on the final definition of a *municipal advisor* under the registration rule, HB Capital may need to register or limit its activities.

Recommendations

If the Legislature believes that the compensation model is appropriate, whereby the private firms that employ consultants are paid a percentage of the fees associated with bond issuances, the Legislature should enact legislation that creates a clearly stated exemption from Section 1090. On the other hand, if the Legislature believes that this compensation model is not appropriate, it should enact legislation that clearly proscribes, or limits, such a model.

The FPPC should adopt regulations that clarify whether the analysis in the *McEwen* advice letter is intended to apply to the factual circumstances presented in this audit.

To be better informed about the compensation of their consultants, including any potential conflicts of interest, California Communities and Municipal Finance should require the consulting firms that staff their organizations to disclose the amount and structure of compensation provided to individual consultants, including disclosing whether any of this compensation is tied to the volume of bond sales.

In implementing its January 2012 contracting policy, California Communities should either periodically subject existing contracts to competitive bidding or perform some other price comparison analysis to ensure that the public funds it oversees are used effectively.

Municipal Finance should follow its July 2012 policy that describes how it will select contractors and periodically review existing contractors' services and prices to ensure the public funds it oversees are used effectively.

As suggested by the GFOA guidance, California Communities and Municipal Finance should include provisions in their contracts prohibiting consultants from engaging in activities on behalf of the issuers that produce a direct or indirect financial gain to the consultants, other than the agreed-upon compensation, without the issuer's informed consent.

Once the SEC finalizes its definition of *municipal advisor*, California Communities should have its legal counsel review whether HB Capital should register with the MSRB.

Chapter 2

THE CONDUIT BOND ISSUERS MET BOND ISSUANCE REQUIREMENTS AND GENERALLY FULFILLED REPORTING REQUIREMENTS

Chapter Summary

The California Health Facilities Financing Authority (Health Financing Authority), the California Statewide Communities Development Authority (California Communities), and the California Municipal Finance Authority (Municipal Finance) complied with key federal and state laws regulating the issuance of conduit revenue bonds. Specifically, they ensured that the projects they financed provided at least the minimum level of public benefits necessary to meet state and federal requirements for tax-exempt financing. Moreover, our analysis found the issuers provided additional public benefits by distributing fee revenues to the community or by contractually obligating borrowers to serve a public purpose.

While the Health Financing Authority and Municipal Finance met all reporting requirements for conduit revenue bond issuers, including those in Chapter 557, Statutes of 2009 (Senate Bill 99 (SB 99)), California Communities' audited financial statements did not provide all necessary disclosures, and it did not submit an informational report for one of the financings we examined. After we notified California Communities, it resolved both of those issues.

In our review, we also noted that specific events related to conduit bonds that borrowers must report publicly do not necessarily reflect how well conduit issuers are performing, and the variance in fees that conduit issuers charge are not of particular concern because borrowers are able to select the issuers that best meet their needs.

The Issuers Met Key Federal and State Requirements for Issuing Bonds

In our review of 10 conduit financings from the Health Financing Authority, 10 from California Communities, and 10 from Municipal Finance, we found that the issuers generally complied with key federal and state laws that ensure that projects qualify for tax-exempt status. The projects we reviewed provided public benefits as state and federal law requires. Moreover, the issuers followed the mandated process for approving and issuing the bonds, including seeking public input when necessary.

As discussed in the Introduction, federal tax law provides tax-exempt status for conduit financings involving projects that generate benefits to the public. California law also identifies some types of projects that are exempt from state taxation. For instance, the California Industrial Development Financing Act (industrial financing act) states that if a manufacturing business constructs a project that increases employment opportunities, retains existing jobs, or otherwise contributes to economic development, financing of that project is in the public's interest. This declaration about job creation and economic development is designed to cover a variety of projects. For example, California Communities financed the construction of a meat processing and packaging facility for \$6.7 million in 2006. Similarly, in 2010 Municipal Finance issued a \$10 million bond to finance the construction of a food production and cold storage facility. Based on the industrial financing act, these conduit financings qualify as tax-exempt because, in addition to meeting other requirements, they created jobs and furthered the economic development of the local communities in which they were built.

Key Requirements for Issuing Tax-Exempt Conduit Revenue Bonds

- Applicable elected officials must approve the financing at an open, public meeting following reasonable public notice.
- The issuer's board must approve the financing at an open, public meeting following reasonable public notice.
- The borrower can use no more than 2 percent of tax-exempt bond proceeds to pay issuance costs.
- The issuer must report bond information to the appropriate federal and state agencies.
- The California Debt Limit Allocation Committee must approve the financing (if applicable).

Sources: California Government Code and the Federal Internal Revenue Code.

Federal and state laws do not specifically require issuers to quantify a conduit financing's public benefits. However, for the 30 conduit financings we reviewed, we determined that the Health Financing Authority, California Communities, and Municipal Finance ensured that the projects provided sufficient public benefit to qualify for tax-exempt status under state and federal law. Specifically, before approving the issuance of a conduit revenue bond, each issuer's board received a staff report detailing the proposed conduit financing that included a consideration of public benefits. The authorities also followed the approval process necessary for issuing tax-exempt bonds, as described in the text box. This process requires that conduit revenue bonds receive multiple approvals before they are issued.

To be eligible for tax-exempt status, the financing of projects must receive approval from applicable elected officials in open, public meetings. These meetings provide opportunities for the public to voice concerns about the financing of projects. We found that all three issuers held these meetings as required for the 30 projects we reviewed. However, one key difference between the issuers is that in order to comply with the legal requirements for financing approval, joint powers authorities such as Municipal Finance and California Communities must hold local financing approval hearings in each jurisdiction in which a project will be built. For instance, to finance

solid waste disposal facilities in multiple locations throughout the State, Municipal Finance had to obtain approvals in open meetings from 10 separate city or county governments, ranging from San Diego to the Bay Area.

In contrast, state agencies such as the Health Financing Authority, which have statewide jurisdiction, need to hold only one hearing somewhere within the State to obtain public approval. Typically, the Health Financing Authority holds this hearing in Sacramento regardless of the location of the projects involved. The agendas associated with these meetings make no mention of the availability of technology (streaming video, teleconference, etc.) designed to make these meetings more publicly accessible. For example, in 2007 the Health Financing Authority issued a bond to finance a variety of health facilities in 10 locations throughout California. The Health Financing Authority held one public hearing in Sacramento to approve the financing at all 10 locations. Although this practice meets federal requirements, improving the ability of citizens interested in a local project's financing to attend approval hearings—either in person or through technology—would allow the public a better opportunity to understand the financing of projects and voice their opinions.

Issuers must also receive approval for certain types of bonds from the debt allocation committee. As the state agency responsible for allocating portions of the annual federal cap, the debt allocation committee uses a scoring system to quantify the public benefits of proposed projects. For instance, it will give a proposed affordable housing financing a certain number of points based on its percentage of affordable units or the site's location. However, this scoring system is only used for conduit financings subject to the debt allocation committee's approval. Federal law exempts some conduit financings from the State's limit on issuing tax-exempt bonds, such as bonds funding the projects of nonprofit organization, such as hospitals and schools. We found that, when applicable, the issuers we reviewed had obtained the approval of the debt allocation committee as required.

In addition to the approvals listed in the text box, the law also contains requirements specific to certain bond categories. For example, federal tax law specifies the percentage of low-income units that must be occupied by eligible individuals in a residential rental project in order for its conduit financing to be exempt from federal taxation. In our review of five affordable housing projects for which Municipal Finance and California Communities issued conduit revenue bonds, we found that the projects had met or exceeded this requirement.

Improving the ability of citizens interested in a local project's financing to attend approval hearings—either in person or through technology—would allow the public a better opportunity to understand the financing of projects and voice their opinions.

Conduit issuers also obtain written legal opinions from bond counsel attesting to whether each bond satisfies the legal requirements for tax-exempt status. Bond investors have an economic incentive to ensure that the bonds they purchase qualify for tax-exempt status. In addition to any of their own research, they gain this assurance through the issuance process for conduit revenue bonds and through bond counsels' opinions confirming compliance with tax-exempt status requirements. With the existing scrutiny and controls in place, it is not particularly surprising that we found that the Health Financing Authority, California Communities, and Municipal Finance have issued tax-exempt conduit revenue bonds appropriately.

The Issuers Provide Additional Benefits to the State's Communities in a Variety of Ways

In addition to the public benefits that conduit bond projects must provide to qualify for tax-exempt status, all three of the issuers we reviewed provide community benefits, which we define as funds or specific activities directed towards charitable causes or other community efforts. Both California Communities and Municipal Finance distribute portions of the fee revenues generated from their conduit financings to further benefit communities within the State. Although the Health Financing Authority's authorizing statute limits its ability to fund community causes, it provides community benefits in other ways. Of the three issuers we reviewed, Municipal Finance provides the most community benefit—sharing over 40 percent of its fee revenue with its member communities or with a charitable foundation. California Communities distributes roughly 24 percent of its fee revenue to its sponsoring entities, which in turn support various education and outreach programs. The Health Financing Authority, on the other hand, provides community benefits by making loans to hospitals and health facilities in need, and requiring borrowers to provide certain community services to the public.

Municipal Finance shares a percentage of its fee revenues directly with its member communities and with the California Foundation for Stronger Communities (foundation), which supports local charities recommended by its board members and member communities. As identified in the Appendix, Municipal Finance distributed a total of \$3.9 million to community causes from July 1, 2006, through June 30, 2011, \$1.4 million of which went to its member communities and \$2.5 million to the foundation for the support of local charitable organizations.

Of the three issuers we reviewed, Municipal Finance provides the most community benefit—sharing over 40 percent of its fee revenue with its member communities or with a charitable foundation.

California Communities also distributes a percentage of its fee revenues to each of its two sponsors, the California State Association of Counties (CSAC) and the League of California Cities (League). As indicated in the Appendix, from July 1, 2006, through June 30, 2011, California Communities paid \$9.7 million each to CSAC and the League. According to CSAC and the League, this revenue allowed them to keep their members' dues low and to support a variety of education and outreach programs, including the City-County-School Partnership program, a nonprofit corporation dedicated to improving the conditions of children, families, and local communities.

In contrast to the joint powers authorities we reviewed, the Health Financing Authority's governing statutes limit its ability to provide financial assistance to charities or to fund community benefit programs. However, as part of its conditions for issuing conduit revenue bonds, it requires its borrowers to provide significant community service to the public. This includes borrowers certifying that their health facilities will be available to all persons residing or employed in the respective areas regardless of their ability to pay. In addition, the Health Financing Authority has made loans to small and rural health facilities through its Healthcare Expansion Loan Program and Medi-Cal Bridge Loan Program. Finally, Chapter 23, Statutes of 2012 (Assembly Bill 1467), which was enacted in June 2012, authorizes the Health Financing Authority to award up to \$6 million in grants to health care providers who are creatively looking for new ways to deliver health care to vulnerable populations.

In contrast to the joint powers authorities we reviewed, the Health Financing Authority's governing statute limits its ability to provide financial assistance to charities or to fund community benefit programs.

The Issuers Generally Fulfilled Reporting Requirements

The Health Financing Authority and Municipal Finance complied with recently enhanced reporting and transparency requirements for issuers of conduit revenue bonds. However, while California Communities substantially complied, it did not provide all necessary disclosures in its financial statements and failed to ensure that a required report was submitted to a state oversight entity. Upon notification, California Communities corrected both errors.

Effective January 1, 2010, SB 99 created requirements designed to ensure that all conduit bond issuers make their activities transparent and accountable to the public. Table 5 on the following page summarizes the requirements applicable to conduit bond issuers before and after the enactment of SB 99. As the table shows, one requirement of SB 99 is that issuers post key information on their Web sites, including full staff reports and the minutes of board meetings.

Table 5
Oversight, Reporting, and Transparency Requirements Before and After the Enactment of Senate Bill 99
on January 1, 2010

REQUIREMENTS	PRIOR TO SENATE BILL 99 (SB 99)		AFTER SB 99
	STATE ISSUERS	JOINT POWERS ISSUERS	ALL ISSUERS
Web site Posting			
Meeting agendas posted on Web site before board meetings*	Yes	No	Yes
Full staff reports before board meetings [†]	No	No	Yes
Minutes of board meetings [†]	No	No	Yes
Annual applications approved for conduit financing [†]	No	No	Yes
Annual audited financial statements that include all of the following:	No	No [†]	Yes
Dollar amount of fees imposed on borrowers	No	No	Yes
Dollar amount of expenditures related to the fees imposed on borrowers	No	No	Yes
Bonds the board approved that remained unsold at the end of audit period	No	No	Yes
Bonds issued during audit period and bond amounts still outstanding	No	No	Yes
Reporting			
Report of final sale for each bond submitted to California Debt Investment and Advisory Commission	Yes	Yes	Yes
Results of audited financial statements submitted to the State Controller's Office	No [‡]	No	Yes
Any amendments to an issuer's joint powers agreement filed with the State Controller's Office (if applicable)	No	No	Yes [§]
Other			
The board's adoption of bond decisions only during regular, open meetings	No	No	Yes

Sources: The California Government Code and SB 99.

* SB 99 requires the posting of agendas 10 days before meetings for state conduit revenue bond issuers and 72 hours before meetings for issuers of conduit revenue bonds that are joint powers authorities.

[†] These items were previously subject to public records act requests but issuers were not required to post them on their Web sites.

[‡] This requirement varies by state issuer. The issuer we reviewed, the California Health Facilities Financing Authority, was not subject to an annual audit.

[§] This requirement applies only to joint powers authority conduit revenue bond issuers.

In our review, we found the Health Financing Authority and Municipal Finance posted all of the financial information on their Web sites that SB 99 requires, including the mandatory elements of their audited financial statements. Further, these issuers submitted all necessary reports, such as reports on the final sale of the bonds they issued. California Communities complied with most of the SB 99 requirements; however, it did not include all necessary information in its audited financial statements. SB 99 requires financial audits of issuers' records and specifies these audits must disclose fees, expenditures, and the amount of bonds authorized but unsold. In our review of California Communities' audited financial statements for fiscal years 2009–10 and 2010–11, we found the statements did not disclose the amount of bonds authorized but unsold. We also noted that in 2009, California Communities did not submit a report of final sale to the California Debt and Investment Advisory Commission (CDIAC) for one of

the financings we reviewed, which was a requirement prior to the enactment of SB 99. After we notified California Communities, it resolved both of these issues.

The HB Capital Resources, Ltd. (HB Capital) representative at California Communities stated that not including the disclosure in the audited financial statements was an oversight by California Communities' auditor and staff. Per his request, California Communities' auditor restated the financial statements to include this information. Additionally once we brought it to his attention, HB Capital's representative acknowledged that bond counsel did not submit the report of final sale for the one financing previously mentioned. In response, he worked with bond counsel, and bond counsel subsequently filed the report in July 2012.

SB 99 does not specify when issuers must post certain information on their Web sites, nor does it state how long issuers must keep that information posted. Despite such lack of specificity, Municipal Finance promptly posted the information that SB 99 requires after the end of each fiscal year, and its Web site contains information on previous years. In contrast, we found that the Health Financing Authority did not post the list of applications its board approved for conduit financing until approximately nine months after fiscal year 2010-11 ended. Further, we could not confirm if California Communities met several SB 99 requirements in fiscal years 2009-10 and 2010-11 because it only maintains board meeting agendas and minutes on its Web site for six months. Moreover, its Web site only includes its most recent financial audit.

Before the enactment of SB 99, issuers were still responsible for providing information such as board meeting minutes, staff reports, and approved issuances to the public if an individual or organization requested it through the California Public Records Act. The California Public Records Act allows the public to inspect any California public record that is not exempt from disclosure requirements under state law. In evaluating the issuers' compliance with the requirements before the enactment of SB 99, we determined that the issuers possessed required information and therefore had the means to respond to public records requests. Because not all of the issuers we reviewed maintain a log of the public records requests to which they have responded, we did not evaluate whether they had complied with such requests in the past.

In reviewing other reporting requirements, we found that California Communities has not always completed annual financial audits, limiting the information available regarding its operations. The Joint Exercise of Powers Act (joint powers act) requires joint powers authorities to prepare and file yearly audited financial statements. Municipal Finance has prepared and posted these yearly audited

SB 99 does not specify when issuers must post certain information on their Web sites, nor does it state how long issuers must keep that information posted.

financial statements on its Web site since it was formed in 2004. However, we found that California Communities did not fulfill this requirement from the time it was formed in 1988 until 2007. The HB Capital representative for California Communities stated that it did not complete these annual financial statements because it had no assets or liabilities of its own. Specifically, as discussed in Chapter 1, the revenues generated by California Communities are held in trust accounts that its cosponsoring organizations, CSAC and the League, control. At the direction of its board, California Communities began issuing yearly audited financial statements in 2007, which provide information about the money the trust accounts receive and distribute.

Borrowers' Bankruptcies and Other Financial Disclosures Are Not Generally an Accurate Measure of an Issuer's Performance

As discussed in the Introduction, the Securities and Exchange Commission (SEC) requires borrowers that use conduit financing to disclose certain information to bond investors until they pay off their bonds. Specifically, for bonds that public investors purchase, the SEC requires disclosure in 15 categories, which it refers to as *material events*.⁷ However, the number of disclosures is not a valid measure of issuer performance since disclosing the events is the borrower's responsibility rather than the issuer's, and many material events are procedural in nature and are not associated with comprehensive industry standards.

Material Events That Do Not Necessarily Indicate Whether Bondholders Will Be Paid

- Bond calls.
- Failure to file financial information in a timely manner.
- Appointment of a successor or additional trustee, or the change of name of a trustee.
- Merger, consolidation, or acquisition.
- Bond rating changes (upgrades in particular).

Source: Securities and Exchange Commission Rule 15c-212.

The most common material events that borrowers disclose do not necessarily reflect negatively on their ability to pay off bonds. For example, we found that bond calls are the most common type of material events that borrowers report. A *bond call* refers to an instance in which borrowers pay off bonds early at a specified price, usually at or above the original value of their bonds. Many conduit revenue bonds are callable, meaning the bond contract contains provisions that allow borrowers to pay off bonds before they are due. Hence, when a borrower discloses a bond call, investors have not been harmed; they have been paid what was due to them. Further, investors who purchase callable bonds are aware that borrowers may pay off the bonds before they are due, as the bond contracts contain

⁷ This disclosure rule applies only to public bond offerings, not to bonds borrowers sell directly to one or more investors, known as *private placements*.

this information. In addition to bond calls, the text box displays other examples of material events that would not necessarily reflect negatively on the ability of borrowers to pay off their bonds.

Using the Municipal Securities Rulemaking Board's Electronic Municipal Market Access (EMMA) system, which publicly displays required disclosures, we searched for material event notices for each of the issuers we reviewed. From Municipal Finance's inception in 2004 until December 2011, we found that borrowers or their designees had disclosed 86 bond calls and seven notices of failure to provide timely annual financial information. Further, one bond rating changed from high credit quality to good credit quality, which is an indicator that bondholders could be financially harmed. It is important to note that these statistics include only the material events of public bond offerings. There are no standards for reporting events related to private placements. For example, a financial advisor representing Municipal Finance stated that he was aware of two financings by Municipal Finance in which the borrowers defaulted. Both of these financings were private placements and therefore would not have been reported in EMMA. The financial advisor added that despite the defaults, the borrowers repaid the bondholders in both of these instances. It would be difficult to systematically compare Municipal Finance, which has performed a number of private placements, with other conduit issuers.

Using EMMA, we also examined the material events that California Communities' borrowers reported. In this instance, we found that the database was particularly difficult to use because the exact name of the joint powers authority was typed differently by those reporting into the system. Additionally, the sheer volume of financial records listed—over 1,700—prevented us from identifying all material events. However, based on a review of 104 records (roughly the same number as from Municipal Finance), we found 23 bond calls, two notices of failure to provide timely annual financial information, and five rating downgrades. In the records we reviewed, we did not find any bankruptcies or defaults. For the bonds that California Communities issued between August 2004 and December 2011, the joint powers authority is aware of one instance in which a borrower did not repay a bondholder and another financing in which a borrower filed bankruptcy but is attempting to restructure the debt with bondholders.

A review of approximately 100 records on EMMA related to Health Financing Authority's borrowers found 28 bond calls or related events, three notices of failure to provide timely annual financial information, 24 rating changes (16 downgrades, eight upgrades), one merger, and one change in trustee. EMMA also shows that the Health Financing Authority had one instance in which a borrower

The Municipal Securities Rulemaking Board's Electronic Municipal Market Access system includes only the material events of public bond offerings. There are no standards for reporting events related to private placements.

We found that the three issuers we reviewed fulfilled their obligations to issue the bonds in a manner that was transparent and compliant with key federal and state requirements.

filed bankruptcy. In this instance, a third-party insurer redeemed the bonds earlier than scheduled by paying the principal and interest owed as of the redemption date.

Based on our review, and in consideration of the limits of available data, we have no reason to believe that any of the issuers we reviewed are better than the others in regards to quality of the bonds they issue. Each has issued bonds for which the borrowers either failed to fully repay investors or disclosed circumstances that caused risk to investors. The conduit issuers' responsibilities include reviewing the overall financing plan and other critical documents, such as borrowers' project plans.

Bondholders—many of whom are sophisticated institutional investors— receive information necessary to understand the risks of conduit revenue bonds. These bonds clearly indicate that they are not backed by the full faith and credit of the State or any other local government agency. If a borrower fails to make these payments, investors must seek redress from the borrower, not the issuer. Consequently, it is incumbent upon the investors to evaluate the risks associated with each project. The conduit issuers are responsible for ensuring that the process of issuing these bonds is transparent so that investors can identify risks. As indicated earlier in this chapter, we found that the three issuers we reviewed fulfilled their obligations to issue the bonds in a manner that was transparent and compliant with key federal and state requirements.

Market Competition Plays a Large Role in Determining the Fees Conduit Bond Issuers Charge

The Health Financing Authority, California Communities, Municipal Finance, and other public agencies that issue conduit revenue bonds charge fees to cover the costs of their services. For example, issuers typically require potential borrowers to pay a fee to apply for conduit financing. If an issuer approves a potential borrower's application and subsequently issues a bond, the borrower typically needs to pay an issuance fee, which is based on a percentage of the face value of the bonds. For the issuers we reviewed, this percentage ranged between .05 percent and .25 percent. Further, for every year until the borrowers pay the bonds off, issuers generally require them to pay an annual fee based on a percentage of the outstanding principal of their bonds. For the issuers we reviewed, this percentage typically ranged between .015 percent and .12 percent, depending on the purpose of the financing.⁸

⁸ In addition to these fees, borrowers are responsible for paying other fees including those to the California Debt Limit Allocation Committee, the California Debt and Investment Advisory Commission, and its financial team. As mentioned earlier in the Introduction, a financial team can include bond counsel, an underwriter, a trustee, and a financial advisor.

While conduit bond issuers' fees have similar components, the total amount they ultimately charge borrowers can vary widely. We compared the posted fees of six high-volume issuers in the State to determine how much each would charge to issue conduit revenue bonds for a variety of purposes. Some issuers only issue bonds for single purposes. For example, the Health Financing Authority issues bonds to finance hospitals and health facilities only, and the city of Los Angeles Housing Department issues bonds to finance multifamily housing construction only. Consequently, if an issuer did not issue bonds for the purposes we compared, we did not include that issuer in our analysis. Our fee comparisons may not be precise because several factors determine exact fees associated with specific projects, including the credit rating of the bonds and the cumulative amount of bonds issued for a borrower.

In Table 6 we compare the fees a nonprofit corporation would expect to pay to receive \$86 million in tax-exempt conduit financing to construct a hospital or health facility. The table shows that fees can vary widely depending on the issuer. In this case, the borrower would pay the least in the first year if the Association of Bay Area Governments (ABAG) issued the bond, followed by the Health Financing Authority. However, because of variations in how they charge annual fees, over a 30-year period the borrower would pay the least if it used the Health Financing Authority, followed by Municipal Finance.

Table 6
A Comparison of Fees for Issuing a Conduit Revenue Bond to Finance a Nonprofit Hospital or Health Facility

CONDUIT REVENUE BOND ISSUER	\$86 MILLION NONPROFIT HOSPITAL OR HEALTH FACILITY						
	APPLICATION AND ISSUANCE FEES	ANNUAL FEES (FIRST YEAR)	OTHER FEES	TOTAL FEES			
				IN YEAR 1	AFTER YEAR 10	AFTER YEAR 20	AFTER YEAR 30
Association of Bay Area Governments	\$25,000	\$0*	\$8,000	\$33,000	\$123,000	\$223,000	\$323,000
California Health Facilities Financing Authority	43,000	15,050		58,050	170,925	248,683	276,275
California Municipal Finance Authority	98,500	12,900		111,400	208,150	274,800	298,520
California Statewide Communities Development Authority	73,000	25,800		98,800	292,300	425,600	472,900

Sources: Issuers' fee schedules.

Note: We based our calculations on the assumption that the financing involved a first-time borrower, and that the project is a private health facility with annual gross revenues of \$2.5 million or more. We also assumed that the bonds have a 30-year term, are unrated, and have principal payments that are evenly distributed throughout the 30-year period.

* Association of Bay Area Governments' annual fees are calculated as a percentage of the original value of the bonds, not to exceed a maximum of \$10,000. The first year's annual fee is included in the issuance fee.

Affordable housing is another category that receives a large volume of conduit financing. In Table 7, we compare the fees a private developer would expect to pay for conduit financing to build a \$10 million multifamily housing project. For this project, a borrower would pay the least in the first year if ABAG issued the bonds, followed by Municipal Finance. Over a 30-year period, the borrower would pay the least if it used Municipal Finance.

Table 7
A Comparison of Fees for Issuing a Conduit Revenue Bond to Finance a Multifamily Affordable Housing Project

CONDUIT REVENUE BOND ISSUER	\$10 MILLION MULTI-FAMILY AFFORDABLE HOUSING PROJECT						
	APPLICATION AND ISSUANCE FEES	ANNUAL FEES (FIRST YEAR)	OTHER FEES	TOTAL FEES			
				IN YEAR 1	AFTER YEAR 10	AFTER YEAR 20	AFTER YEAR 30
Association of Bay Area Governments	\$15,000	\$0*	\$8,000	\$23,000	\$104,000	\$194,000	\$284,000
California Municipal Finance Authority	21,250	8,000		29,250	89,250	133,250	173,250
California Statewide Communities Development Authority	25,000	12,000		37,000	127,000	202,600	277,600
City of Los Angeles Housing Department	28,000	12,500	3,000	43,500	156,000	281,000	406,000

Sources: Issuers' fee schedules.

Note: We based our calculations on the assumption that the project involved a for-profit developer that was a first-time borrower. We also assumed that the bonds were unrated, the face value of the bonds did not change between the construction phase and permanent financing, and the project included more than 75 units.

* Association of Bay Area Governments' annual fees are calculated as a percentage of the original value of the bonds, not to exceed a maximum of \$10,000. The first year's annual fee is included in the issuance fee.

Although not shown in the tables, we also compared the fees issuers would charge for a \$36 million conduit revenue bond to construct a pollution control facility. Over a 30-year period, California Communities would charge \$215,400, Municipal Finance would charge \$347,500 and California Pollution Control Financing Authority would charge a one-time fee of \$72,000 to a small business and would charge a one-time fee between \$72,000 and \$309,600 to a large business. In addition, we compared the fees associated with a \$6 million bond for a manufacturing facility. Over a 30-year period, California Infrastructure and Economic Development Bank would charge \$31,500, Municipal Finance would charge \$110,900, and California Communities would charge \$118,000.⁹

According to a general manager representing California Communities, market competition plays a large role in pricing, but other factors such as the costs associated with attending public hearings and board meetings, performing the varying amount of work necessary to issue bonds for different purposes, and ensuring

⁹ The ABAG does not issue bonds for pollution control or manufacturing facilities.

ongoing compliance monitoring all come into consideration. A financial advisor from Municipal Finance and the executive director of the Health Financing Authority agreed that the market and operating costs are the primary factors they consider when setting their fees.

Borrowers are private entities that select the issuer that best suits their needs. In doing so, they are likely to consider the fees the issuer charges as well as other factors such as the issuer's application process, bond sale process, and customer service responsiveness. We have no reason to believe that the private entities that use conduit financing cannot adequately identify the issuers that best suit their needs. Although there are no industry standards for issuers fees, any such standardization appears unnecessary. The market drives the fees issuers charge; borrowers may simply avoid conduit issuers attempting to charge more than they want to pay.

Recommendations

To provide more accessible venues for citizens to understand the financing of projects and to voice their opinions, the Health Financing Authority should either hold local approval hearings in each jurisdiction in which a project will be built or create a cost-effective technological solution (streaming video, teleconference, etc.) to provide more public accessibility.

To ensure that all issuers of conduit revenue bonds make their activities sufficiently transparent to the public, the Legislature should consider amending state law to provide deadlines for issuers to post the information SB 99 requires on their Web sites and to specify how long issuers must keep this information posted.

We conducted this audit under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives specified in the scope section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,



ELAINE M. HOWLE, CPA
State Auditor

Date: August 23, 2012

Staff: Benjamin M. Belnap, CIA, Project Manager
David J. Edwards, MPPA
Joshua K. Hammonds, MPP
Bradford S. Hubert, MBA
Amber D. Ronan

Legal Counsel: Donna L. Neville, Associate Chief Counsel

IT Audit Support: Benjamin Ward, CISA, ACDA
Kim L. Buchanan, MBA

For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255.

Appendix

FINANCIAL INFORMATION FOR THE CONDUIT BOND ISSUERS WE REVIEWED

Table A.1 shows California Statewide Communities Development Authority’s (California Communities) revenues and expenditures from July 1, 2006, through June 30, 2011. As discussed in Chapter 1, California Communities paid HB Capital Resources, Ltd., and its subsidiaries roughly \$50 million in compensation, which is 59 percent of the total revenue it earned. California Communities paid \$9.7 million to both the California State Association of Counties and the League of California Cities.

Table A.1
A Summary of the California Statewide Communities Development Authority’s Revenues and Expenditures July 1, 2006, Through June 30, 2011

Revenues	Totals
Application and issuance fees*	\$25,363,864
Annual administrative fees	58,247,080
Investment income	974,020
Total revenues	\$84,584,964
Expenditures	
HB Capital Resources, Ltd., and its subsidiaries’ fees	\$49,633,054
Distributions to the California State Association of Counties	9,731,493
Distributions to the League of California Cities	9,731,493
General administration expenses	2,283,762
Legal fees	540,736
Deposits returned and other†	9,763,099
Total expenditures	\$81,683,637

Sources: Audited financial statements for fiscal years 2006–07 through 2010–11.

* Application and issuance fees were not separately identified in the issuer’s audited financial statements; hence they are combined in the table.

† A consultant for the California Statewide Communities Development Authority (California Communities) explained that the authority often requires borrowers to deposit issuance fees in advance for bond issuances requiring an allocation of the debt limit from the California Debt Limit Allocation Committee as discussed in the Introduction. California Communities returns this deposit to the borrower if the borrower withdraws its application before the authority applies for volume cap. California Communities also returns any excess deposit to the borrower.

Table A.2 on the following page summarizes California Municipal Finance Authority’s (Municipal Finance) revenues and expenditures for the same period. As discussed in Chapter 1, it paid Sierra Management Group, LLC more than \$4.6 million in fees, which is

49 percent of the revenue it earned during this time.¹⁰ Municipal Finance distributed \$1.4 million to its member communities and \$2.5 million to various charitable organizations.

Table A.2
A Summary of the California Municipal Finance Authority's Revenues and Expenditures
July 1, 2006, Through June 30, 2011

Revenues	Totals
Application fees	\$535,000
Issuance fees	4,676,781
Annual administrative fees	4,108,736
Investment income	63,301
Services	66,000
Other income*	2,191,250
Total revenues	\$11,641,068
Expenditures	
Sierra Management Group, LLC fees	\$4,600,617
Charitable contributions	2,508,745
Distributions to member communities	1,403,730
Other consultants' fees	166,049
General and administrative expenses	88,293
Advertising	63,164
Interest expense*	2,191,250
Total expenditures	\$11,021,848

Sources: Audited financial statements and information from the California Municipal Finance Authority's (Municipal Finance) accounting system.

* Municipal Finance entered into an agreement in 2004 under which it leased solid waste disposal vehicles and related equipment, which were financed with bonds, to a waste management company for 10 years. In its financial statements, it recorded revenue from the lease as other income and the payments made to bondholders as interest expense.

Table A.3 shows the California Health Facilities Financing Authority Fund's revenues and expenditures from July 1, 2006, through June 30, 2011. As discussed in Chapter 1, the California Health Facilities Financing Authority (Health Financing Authority) directly employs staff to perform its functions, unlike the two joint powers authorities we reviewed. Health Financing Authority is not presently authorized to contribute money to charities or otherwise distribute funds for community benefit.

¹⁰ In this calculation we excluded from revenues the roughly \$2.2 million of other income shown in Table A.2, which is associated with a lease agreement and is offset by the interest expense also shown in Table A.2.

Table A.3
A Summary of the California Health Facilities Financing Authority Fund's
Revenues and Expenditures
July 1, 2006, Through June 30, 2011

Revenues	Totals
All fees*	\$9,330,444
Interest income	1,249,690
Investment income	33,625
Other income	7,611
Total revenues	\$10,621,370
Expenditures	
Salaries and benefits	\$4,845,401
Operating expenses and equipment	715,154
Consultants and professional services fees	
Internal	1,306,659
External	579,714
Legal fees	
Internal	621,453
External	141,271
Total expenditures	\$8,209,652

Source: California State Auditor's (state auditor) analysis of data provided by the State Treasurer's Office from the California State Accounting and Reporting System (CALSTARS). Please refer to the Introduction's Scope and Methodology for the state auditor's assessment of CALSTARS' data reliability.

* The State Treasurer's Office did not consistently identify its revenue by the type of fee it received in CALSTARS. Hence, all of the California Health Facilities Financing Authority Fund's fees are reflected in one category.

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(Agency response provided as text only.)

California Health Facilities Financing Authority
915 Capitol Mall, Suite 590
Sacramento, CA 95814

July 25, 2012

Elaine M. Howle, State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Re: California Health Facilities Financing Authority
Bureau of State Audits Report No.: 2011-118 – Conduit Bond Issuers

Dear Ms. Howle:

Thank you for the opportunity to review and respond to the draft copy of your report on Conduit Bond Issuers.

We appreciate the time, diligence and superior communication invested by your audit team over these past several months. We also appreciate the report's acknowledgement of the Authority's efforts since 2007 to reinvigorate its presence in the conduit finance market for hospitals and health systems.

We attach our comments to your recommendations and will work quickly to integrate the letter and spirit of those recommendations into our operations.

Please contact me anytime to further explore or discuss our comments.

Sincerely,

(Signed by: Barbara J. Liebert)

BARBARA J. LIEBERT
Executive Director

Attachment

CHFFA Response to Bureau of State Audits Draft Report 2011-118July 25, 2012

Recommendation #1

To provide more accessible venues for citizens to understand the financing of projects and voice their opinions, the Health Facilities Financing Authority should either hold local approval hearings in each jurisdiction in which a project will be built or create a cost-effective technologic solution (streaming video, teleconference, etc.) to provide more public accessibility.

Authority Response:

The “local approval hearings” mentioned in the recommendation relate to the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”) hearings required by the Internal Revenue Service for the issuance of tax-exempt bonds. As the audit points out, the Authority complies with this federal requirement. The Authority’s TEFRA public hearings provide reasonable public notice for every Authority bond transaction covered by the TEFRA requirements. The joint powers authorities are comprised of local governments and, therefore, must hold TEFRA hearings in the local communities where projects are located. In contrast, the Authority is a statewide office with statewide jurisdiction and a single statewide constituency.

Additionally, before projects seek bond financing from the Authority, they already have completed several levels of local-government approval. This multi-layered process provides members of the community numerous opportunities – at public hearings – to learn about the projects, ask questions about them or raise objections to them. This local project-approval regime includes CEQA reviews, planning commission meetings, zoning hearings, and other licensing, land use and permit processes.

Though the Authority satisfies federal TEFRA requirements, the Authority and its chairman, Treasurer Lockyer, welcome BSA’s well-considered recommendation to improve public access to TEFRA hearings. Under the current State Treasurer’s direction, the Authority, along with the other finance authorities chaired by the Treasurer, previously made a commitment to increasing transparency and public access to information related to their work. The State Treasurer’s Office sponsored SB 99, which imposed new transparency and reporting requirements on all conduit finance authorities in California. All of the boards, commissions and authorities chaired by the Treasurer now post comprehensive information regarding their activities online, in many cases dating back at least 10 years.

To implement this recommendation, Authority staff already has started to assess available options, including their costs and the accessibility they provide. We look forward to implementing this recommendation and providing another opportunity for local residents to comment on projects in their communities.

Recommendation #2

To ensure that all conduit revenue bond issuers make their activities sufficiently transparent to the public, the Legislature should consider amending state law to provide a deadline for issuers to post on their websites the information SB 99 requires and to specify how long issuers must keep this information posted.

Authority Response

The Treasurer will sponsor and support legislation to implement this recommendation. And whether or not the Legislature amends state law to provide deadlines for posting SB 99 information and specify how long issuers must keep the information posted, the Authority will set two policy objectives: post SB 99-related information within 30 days after it becomes available; and keep it posted for at least five years.

(Agency response provided as text only.)

California Municipal Finance Authority
2111 Palomar Airport Road, Suite 320
Carlsbad, CA 92011

July 27, 2012

Ms. Elaine M. Howle
State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, California 95814

Re: Bureau of State Audits Report 2011-118

Dear Ms. Howle:

Thank you for the opportunity to review and comment on the audit report. The California Municipal Finance Authority ("CMFA") appreciates your staff's extensive work in collecting information and analyzing the many complex factors that encompass conduit bond financing in the State of California. We appreciate the recommendations of the Bureau of State Audits ("BSA") and will look to the audit report as we continue to improve our operations and service to the State of California.

As the BSA discovered during this audit process, the CMFA assists local governments, non-profit organizations and private enterprises with the issuance of taxable and tax-exempt financings aimed at improving the communities within the State of California. The CMFA's approach of granting its revenues from operations to municipalities and 501(c)(3) non-profit organizations is unlike any other issuing agency in the State of California. This approach enables the CMFA to double our mission impact through:

- Facilitating the financing of qualified economic and community development projects that build our neighborhoods and provide employment opportunities; and
- Supporting, through charitable contributions, the many different locally based, non-profit organizations that touch the lives of California residents.

Since 2004, the CMFA has donated over **\$5.5 million** to 225 locally based non-profit entities throughout the State of California (a representative list of these organizations can be found at www.cmfa-ca.com/resources/Charitable%20Allocation%206%208%2012.pdf). No financing agency in the United States has granted more charitable dollars directly to local governments and 501(c)(3) non-profit organizations than the CMFA.

The CMFA strives to maintain an operating structure that promotes substantial public benefits at the lowest possible cost. The Board of Directors is comprised of municipal finance experts and career public servants with over 100 years of public service, leading the CMFA on a volunteer basis. Consistent with the Government Finance Officers Association (GFOA) guidelines, our Board of Directors has a primary responsibility to make every effort to ensure that the services desired by applicants to the CMFA are being produced effectively and efficiently. To that end, our public-private partnering and engagement of Sierra Management as an independent financial advisory firm to administer the financing programs of the CMFA enables us to deliver

to our applicants and borrowers unparalleled service, expertise and professionalism without burdening financially the CMFA. As a registered municipal advisor under the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), Sierra Management owes the CMFA a fiduciary obligation to place first the interests of the CMFA, which is the highest standard of duty owed to an issuing authority.

We also emphasize that the CMFA operates without the use of any tax-payer dollars or tax-payer support. The burdens placed on all tax-payers for increasing public pension and retirement benefits, among other liabilities, the costs of which are not applicable to the CMFA. Each CMFA transaction is completed without obligating the State of California, any political subdivision or any individual tax-payer of the State of California for any aspect of a CMFA financing, including the repayment of any debt obligation issued by the CMFA. In essence, the financings of the CMFA attempt to maximize public benefits to the State without the overhead or liabilities evident in other conduit issuers.

We will make every effort to act on the recommendations made by the BSA and have already put in place measures to implement some of the recommendations found in this report.

I want to express our appreciation to the management and staff of the BSA for their professional efforts in conducting this audit.

Sincerely,

(Signed by: Gordon J. Lee)

Gordon J. Lee
Chair, Board of Director

(Agency response provided as text only.)

California Statewide Communities Development Authority

July 27, 2012

Elaine M. Howle, State Auditor*
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, California 95814

Re: California Statewide Communities Development Authority ("California Communities")
Bureau of State Audits Report No.: 2011-118 – Conduit Bond Issuers

Dear Ms. Howle:

On behalf of California Communities, thank you for the opportunity to review and respond to the Bureau of State Audits draft report No: 2011-118 on Conduit Bond Issuers (the "Report"). A summary of our comments to the Report's recommendations is included in the enclosed attachment.

We greatly appreciated the professionalism, thoroughness and integrity that your audit team displayed throughout the past several months. Their observations and the recommendations included in your report will be helpful to us taking action and making changes where necessary that ensure any concerns identified are properly addressed. We seek every day to make California Communities the best run and most responsive conduit bond issuer in the country, and we intend to use the independent feedback from your report to make it better still.

We're very proud of California Communities' positive 24 year track record of facilitating low cost financing to build community infrastructure, provide affordable housing, create jobs, and make access available to quality healthcare and education. As the audit report indicates in Chapter 2, California Communities provides benefits to communities throughout the State, and we look forward to continuing to be a valuable economic development tool to local governments across California.

If you have any questions, please don't hesitate to contact me at (925) 933-9229

Sincerely,

(Signed by: Larry T. Combs)

Larry T. Combs
Chair of the Commission
California Statewide Communities
Development Authority

Enclosure

* California State Auditor's comments begin on page 59.

Chapter 1 Recommendation #1:

"If it believes that the compensation model whereby the private firms that employ consultants are paid a percentage of the fees associated with bond transactions is appropriate, the Legislature should enact legislation that creates a clearly stated exemption from Government Code, Section 1090. On the other hand, if the Legislature believes that the compensation model whereby the private firms that employ consultants are paid a percentage of the fees associated with bond transactions is not appropriate, it should enact legislation that clearly proscribes, or limits, such a compensation model."

California Communities Response:

California Communities agrees with this recommendation. California Communities refers to the statement made by the Bureau of State Audits (BSA) in the "Results in Brief" section of the Report which states, *"Although we found the compensation model of the joint powers authorities raise concerns, we cannot conclude that they violate California's conflict-of-interest laws."* Our Commission is highly focused on transparency and accountability to our member public agencies, borrowers, and the entire investment community, and to ensuring that California Communities' operating model complies with all laws and regulations, including those related to conflicts of interest. As the Report points out, both California Communities and HB Capital have been advised by counsel that the structure of the relationship between both organizations is in full compliance with all applicable conflict-of-interest laws.

- ① Understanding that California Communities has not violated any conflict-of-interest laws, it does appreciate the concern raised by the BSA and will work at the request of the Legislature to clarify Government Code 1090 to respond to this concern.

Chapter 1 Recommendation #2:

"The Fair Political Practices Commission should adopt regulations that clarify whether the analysis in the *McEwen* advice letter is intended to apply to the factual circumstances presented in this audit."

California Communities Response:

California Communities agrees with this recommendation. California Communities will work as requested with the Fair Political Practices Commission to provide clarity on the factual circumstances presented in the audit.

Chapter 1 Recommendation #3:

"To be better informed about the compensation of their consultants, including any potential conflicts of interest, California Communities should require the consulting firm that staffs its organization to disclose the amount and structure of compensation to individual consultants, including disclosing whether any of this compensation is tied to the volume of bond sales."

California Communities Response:

- ② California Communities agrees with this recommendation. California Communities' current contract with HB Capital runs through May, 2014 with the option to provide a notice of non-renewal in May, 2013. When entering into further contracts with consulting firms that provide staff to California Communities, the Commission will work with legal counsel to address this recommendation. California Communities has

been informed by HB Capital that individual employee compensation is not tied to the volume of California Communities' bond sales.

Chapter 1 Recommendation #4:

"In implementing its January 2012 contracting policy, California Communities should either periodically competitively bid existing contracts or perform some other type of price comparisons. It should use these price comparisons to ensure that the public funds it oversees are used effectively."

California Communities Response:

California Communities agrees with this recommendation. As part of the annual review process required by the January 2012 contracting policy, the California Communities Commissioners will look at all aspects of service provision, including pricing.

Chapter 1 Recommendation #5

"As suggested by the GFOA guidance, California Communities should include a provision in its contracts stating that, but for the agreed-upon compensation specified in their contract(s), consultants are prohibited from engaging in activities that produce a direct or indirect financial gain to the consultants without its informed consent."

California Communities Response:

California Communities agrees with this recommendation. California Communities does refer to the Government Finance Officers Association (GFOA) and California Debt Investment Advisory Commission (CDIAC) best practices for contracting and entering into public-private partnerships. For all future contracts the prohibition language outlined above will be included.

③

Chapter 1 Recommendation #6

"Once the SEC finalizes its definition of municipal advisors, California Communities should have its legal counsel independently review whether HB Capital should register with the MSRB."

California Communities Response:

California Communities agrees with this recommendation. HB Capital has previously consulted with the Securities and Exchange Commission (SEC) on this matter and the SEC has determined that under the temporary rule, HB Capital employees providing services to California Communities are not required to register as municipal advisors.

④

Chapter 2 Recommendation

"To ensure that all conduit revenue bond issuers make their activities sufficiently transparent to the public, the Legislature should consider amending state law to provide a deadline for issuers to post on their websites the information Senate Bill 99 requires and to specify how long issuers must keep this information posted."

California Communities Response:

California Communities agrees with this recommendation. California Communities fully supported Senate Bill 99 and worked closely with the Legislature to ensure that its provisions were enacted. We will work with the Legislature on any necessary amendments.

California Communities would further suggest (if the BSA have not already addressed in another section of the report we have not seen) that in order to ensure all conduit issuers make their activities and projects transparent to the public, all hearings for approval of the projects being financed be publicly noticed and held in an open public hearing in the local jurisdiction where the project resides. As the Report indicates, joint powers authorities such as California Communities conduct the required public hearings at the local agency, whereas the state issuers only hold the hearing in Sacramento regardless of the location of the project. Making this change would ensure ultimate accountability at the local level, where the people of California actually live with the projects that are financed by conduit bond issuers.

Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE CALIFORNIA STATEWIDE COMMUNITIES DEVELOPMENT AUTHORITY

To provide clarity and perspective, we are commenting on the California Statewide Community Development Authority's (California Communities) response to our audit. The numbers below correspond to the numbers we have placed in the margin of California Communities' response.

California Communities states it is understood that it has not violated any conflict-of-interest laws. However, as our report indicates, we were unable to reach a definitive legal conclusion on this issue. On page 23 we note that California Communities has not sought independent legal advice regarding its compliance with the Political Reform Act of 1974 (political reform act) directly from the Fair Political Practices Commission (FPPC) based on the specific factual circumstances presented in the report. Given that any analysis under the political reform act is specific to particular facts, we cannot predict what the FPPC or a reviewing court would conclude. Further, on page 24 of the report we state that California Communities' compensation structure to the private consulting firm that staffs its organization could be found as serving as an incentive to recommend bonds for approval, which is the kind of conflict California Government Code, Section 1090, is designed to prevent. On that same page, we note that no reported judicial decision squarely addresses this issue, and until a court of appropriate jurisdiction rules on this issue or the Legislature weighs in, we believe the legality of this practice is uncertain.

①

California Communities states that it agrees with our recommendation that it require the consulting firm that staffs its organization, HB Capital, to disclose the amount and structure of compensation to individual consultants, including whether any of this compensation is tied to the volume of bond sales. However, its response suggests that it does not intend to implement the recommendation until after its current contract with HB Capital expires in May 2014. We believe that California Communities should address the recommendation as soon as possible in order to be better informed about the compensation of its consultants, including any potential for conflicts of interest.

②

California Communities states that it agrees with our recommendation to include a provision in its contracts prohibiting consultants from engaging in activities on behalf of the issuers that produce a direct or indirect financial gain to the consultants other than the agreed-upon compensation without the issuer's informed

③

consent. However, its response suggests that it does not intend to implement the recommendation in its current contracts. We believe that California Communities should address the recommendation as soon possible, including amending its contract with HB Capital at its first opportunity to include this provision.

④

California Communities overstates the position of the Securities and Exchange Commission (SEC) on this matter. HB Capital was not able to demonstrate to us that the SEC had determined that HB Capital employees did not need to register under the temporary rule. Further, we spoke with an SEC representative who stated that the SEC did not conclude that HB Capital's activities complied with federal securities law, or other applicable rules and regulations. Rather, the representative stated that, because the definition of a municipal advisor had not been finalized, the SEC provided HB Capital its standard "no action" letter in which the SEC reaches no conclusion on a matter being reviewed.

cc: Members of the Legislature
Office of the Lieutenant Governor
Little Hoover Commission
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press