

PROVIDING DIRECTION
PRODUCING RESULTS

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Northland Securities, Inc.
45 South 7th St., Suite 2000
Minneapolis, MN 55402
Toll Free 1-800-851-2920
Main 612-851-5900
www.northlandsecurities.com
Member FINRA and SIPC

Meet EMMA

There have been many changes recently affecting the "continuing disclosure" requirements for issuers and how they provide their financial and operating data on an ongoing basis to buyers of their bonds. These changes, contained in the Security and Exchange Commission's (SEC) Rule 15c2-12 (the "Rule"), have been driven by a need for more transparency in the marketplace, with investors expecting easier access to information about the securities they buy, as well as more current information. With the advent of the Municipal Securities Rulemaking Board's ("MSRB") web-based Electronic Municipal Market Access (EMMA) system, there is someone "new in town" that issuers and investors are getting to know.

Since 1995, for any bond issue of more than \$1 million, issuers have had to covenant in a Continuing Disclosure Agreement to provide financial and operating data, and to provide notification of any material events that occur (including bond rating changes and bond calls for issues that are refunded). For issuers with \$10 million or less of outstanding debt, the information to be provided is "financial and operating data which is customarily prepared

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New Continuing Disclosure Requirements

- As of July 1, 2009, for new bond issues subject to "Limited Disclosure," (an exemption for issuers with \$10 million or less of outstanding debt) info must now be submitted annually by issuers (rather than only upon request).
- Disclosure info can only be submitted electronically and EMMA is the new (sole) repository for that info (<http://emma.msrb.org>).
- Although access to EMMA is free, submitters of info (issuers and their agents) must register before they will be able to post their materials.
- Issuer data now available on EMMA is easily accessible, free, and provides a much higher level of visibility for issuers of debt.
- OS's for new bond issues must now be provided in electronic format on EMMA, so OS printing costs are eliminated.

Take a Closer Look at Negotiated Sales

Many issuers operate under the assumption that all bonds should be issued through a competitive sale. The assumption is based on the belief that the bidding process creates the lowest costs by allowing market forces to set interest rates and underwriter compensation.

While many Midwest issuers subscribe to this belief, it is not the norm. In recent times, 80% of municipal bond sales nationwide have been negotiated sales. That percentage seems to be growing; according to Bloomberg, in June, 2009, only 13.9% of all municipal bond sales were done on a competitive basis. One factor in this trend is that flexibility, particularly in today's market environment, is so important in securing capital for public entities at the lowest possible cost.

It is important to understand that the world of

public finance has changed dramatically over the past 12 months. There are fewer purchasers. The recession eliminated many traditional purchasers of tax-exempt bonds including banks, bond funds and insurance companies. Bond insurance has all but disappeared. Bond insurance proliferated in recent years. Insurance opened doors to many funds and institutional investors. It also masked credit issues for many issuers. There are now zero Moody's rated "Aaa" bond insurers. The real creditworthiness of the issuer receives greater scrutiny. There is less appetite for tax-exempt obligations. Faced with large losses, many investors do not need the tax benefits created by tax-exempt bonds. New options and tools create opportunities and challenges. As part of its economic recovery plans, Congress has created new forms of municipal bonds. The

result has been a dramatic increase in the use of taxable bonds. The future likely holds more forms of subsidized and tax credit bonds.

This new and changing environment requires an intimate understanding of the investor side of the marketplace. The successful bond issue is designed around the needs of the issuer and tailored to attract the greatest investor interest. A competitive sale may not be the best means to achieve this objective for every bond issue.

Why negotiate

Negotiated sales are well suited to several scenarios:

- There is a "story" behind the bonds or the issuer that needs explaining to investors.
- Timing flexibility needs to be retained in undertaking the sale.

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Stimulus Bonds - An Update

The "stimulus plan" (the American Recovery and Reinvestment Act) brought us several new forms of municipal bonds. Build America Bonds provide the option to lower interest expense through a 35% federal reimbursement payment. Recovery Zone Economic Development Bonds offer a larger interest reimbursement (45%) on bonds for economic development projects in counties receiving an allocation. Recovery Zone Facility Bonds create the potential of bringing tax-exempt borrowing to a broad range of private development projects. More detailed information on these bond options can be found on our website www.northlandsecurities.com (Public Finance - Resources - Informational Resources). This article focuses on what we have learned from the initial months of using these new tools.

Security of Federal Payment

Perhaps the most frequent question asked by issuers considering the use of Build America Bonds (BABs) is "How do we know that the federal government will provide the money required to make the 35% interest payment?" Funding for the BAB interest reimbursement comes from a standing appropriation. This form of appropriation receives funding unless Congress takes specific action to alter the appropriation. Representatives of the Obama Administration and the Congress have gone on record stating a strong commitment to the ongoing appropriation of funds required to make BABs payments. It is important to remember that many elements of a bond issue are based on good faith in future actions. There is no guarantee that the Federal government and states will permanently exempt municipal bonds from income taxes. Most revenues needed to pay debt service are not guaranteed. The past year has also shown the vulnerability of bond insurance, once assumed to be a solid protection. The point is that few aspects of any bond issue are absolutely guaranteed. Each issuer should objectively evaluate the potential savings from BABs with the risk of future federal non-appropriation.

A Safety Net

One way to protect from the risk of federal non-payment is to include an extraordinary call provision in your issue. This provision allows the issuer to call and prepay the BABs if the federal government fails to make required interest payments. The outstanding BABs can be refunded with tax-exempt bonds. Northland has used this provision without any adverse reaction from purchasers.

Evaluate the Option

It is in the issuer's best interests to evaluate the option to use BABs for every eligible issue. Some issues may be too small or too short (in term) to produce savings over tax-exempt rates. Many issues will, however, show potential for an overall reduction in debt expense through BABs. The final evaluation of BABs must occur at the time of sale. The economics of BABs change over time as taxable and tax-exempt rates vary with market conditions. A competitive sale should allow purchasers to bid either tax-exempt or BABs. A similar evaluation should occur before pricing in a negotiated sale. Many bond issues structured using tax-exempt rates may further benefit by restructuring the maturity schedule around final taxable rates and federal interest payments. BABs may allow debt to be retired faster, lowering interest expense over the life of the bonds.

The Clock is Ticking

The ability to issue BABs and Recovery Zone Bonds is limited. Under current legislation, these bonds must be issued before the end of 2010.

BABs Plus

Think of Recovery Zone Economic Development Bonds (RZEDB) as enhanced BABs. A wide range of governmental activities will meet the criteria of promoting economic development. Most communities will have areas containing factors that allow designation of a recovery zone. The result is the ability to have 45% of interest expense paid by the federal government. If the RZEDB allocation is not adequate, the gap can be filled with BABs. Counties and cities should be discussing how to make best use of this asset.

Facility Bonds

The other type of recovery zone bonds has a narrower range of application. According to the IRS guidelines Recovery Zone Facility Bonds (RZFB) must be used:

- to finance the construction, reconstruction, renovation, or acquisition of property;
- by the taxpayer;
- for the active conduct of a qualified business;
- with substantially all use in a recovery zone.

Facility Bonds can be characterized as industrial development revenue bonds with a wider range of uses. Potential applications

include larger manufacturing (that exceed the small issuer criteria for industrial development revenue bonds), commercial, lodging, office, and health care. Since these bonds are secured by project revenues, potential projects must be creditworthy and shovel-ready.

A potential purchaser of RZFB are banks that are prepared to provide other financing for a development project. The Facility Bonds are not eligible for "bank qualified" status, but can take advantage of an often overlooked aspect of the ARRA. Banks purchase bonds that are not bank qualified and apply bank qualified-like tax treatment as long as the bonds do not exceed 2% of the bank's total assets.

Limitations to Remember

The stimulus bonds are subject to some limitations that do not apply to the typical governmental purpose, tax-exempt bonds.

- Not more than 2% of bond proceeds can be used to pay costs of issuance. Costs above 2% are paid from issuer funds.
- Interest cannot be capitalized beyond the construction period for the bond financed capital expenditures.
- The amount of capitalized interest in the bond issue cannot include the amount paid by federal reimbursement (35% - BABs and 45% - RZEDB).
- Projects financed with RZEDB are subject to federal prevailing wage rates. This requirement does not apply to BABs or RZFB.

These important differences must be considered in evaluating options and finding the lowest cost approach to each project.

Market Conditions

The spread between taxable and tax-exempt interest rates continues to support the use of Build America Bonds. Currently, the BAB equivalent rate is very attractive for maturities ten years and longer. Be aware that rates vary from week to week. Issuers should evaluate the BAB option both at the time of calling for the sale and on the actual sale date.

Negotiated Sales from Page 1

- The bonds will be placed with specific investors.

This article focuses on the timing advantages of a negotiated sale.

While no one really knows where interest rates will move to at a particular time, it is certain that rates WILL change. With a competitive sale, the issuer plans to sell their bonds on a particular day, often about four weeks in the future. Regardless of whether interest rates have risen or fallen, the sale takes place on that specified day and time. This approach poses a particular challenge for refunding bonds. If interest rates have risen, the issuer's refunding savings will be diminished. The issuer can cancel the sale and reschedule for a later date, but this approach is cumbersome and inflexible.

A negotiated sale provides a far more flexible approach to the market. Once initial preparations are complete (official statement written, bond rating assigned), the issue is ready for sale. The underwriter monitors market conditions for the appropriate time to issue the bonds. These conditions (such as desired savings) are often defined in advance and approved by the issuer in a "trigger resolution". As market conditions improve, the underwriter uses a pre-sale process to test the waters. If investors will not commit at the

desired rates, there is no sale to cancel. The underwriter simply tries again on another day. This process also allows the issuer to evaluate potential changes in the issue. For example, how much additional savings is derived by delaying the call date? When investor and issuer objectives are met, the underwriter commits to buy the bonds at the market levels and the transaction is completed. In the case of advance refundings, an added layer of complexity is involved because the goal is not only to achieve the lowest borrowing rate but also the highest permitted investment rate for the refunding escrow account. The combination of the two must be just right in order for the issuer to realize the desired level of savings.

An example

Northland Securities recently sold bonds for a school district to refund existing debt. The school board had passed a trigger resolution on February 17, 2009, authorizing Northland to sell the bonds when the net savings for the district reached the desired level of \$300,000. At that time, the level of savings was approximately \$222,000, based upon the current rates.

Rates fluctuated markedly over the coming months, but never staying low enough or long

enough to allow the school district to achieve the desired \$300,000 savings. On March 19, the potential savings level slipped to \$155,000! But patience and persistence paid off, and on August 11, Northland underwrote the bonds with savings of \$303,211 and a true interest cost of 2.98%. Certainly this was a case that rewarded a school district that chose to take the negotiated approach to a bond sale.

Protections for Issuers

Given today's technology, access to market information and regulatory environment, the issuance of municipal bonds is a relatively transparent process. This process is an open book in many ways. The costs, results and disclosure documents for recent comparable bond issues are available online at the click of a button. Anyone can tap into this information to easily and quickly find current market data. In addition, certain types of negotiated transactions require that an outside financial advisor review the negotiated rates and costs to see if they are in line with the market on that day.

Conclusion

We do not live in a "one size fits all" world. There is an increasing array of bond issues that will find a negotiated process as the best path to a successful sale.

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[by the issuer]....and is publicly available" and previously it needed to be provided only "upon request" (referred to as "limited disclosure"). For issuers with more than \$10 million of outstanding debt, the information must be provided annually and includes financial and operating data, as well as updates of certain information provided in the Official Statement for the issue ("full disclosure").

Effective July 1, 2009, although the type of information to be provided has not changed much, the method of providing it has. For issuers subject to limited disclosure, the information must now be provided annually, rather than only upon request. The financial and operating data "customarily prepared [by the issuer] and publicly available" would typically be the audited financial statements, but issuers must now remember each year to submit this information to a central repository. This revised requirement affects bonds issued on or after July 1, 2009.

Previously, there were four central repositories (Nationally Recognized Municipal Securities Information Repositories, or "NRMSIRs") receiving this continuing disclosure information, but EMMA has now been designated as the sole NRMSIR. Internet access to EMMA is free to all users (while access to the previous four NRMSIRs was on a subscription basis). With that ease of access comes a much higher level of transparency, and also visibility for those communities who are (or are not) providing the information they have promised to submit. Market regulatory agencies, such as FINRA (the Financial Industry Regulatory Authority) are warning investors to "be wary of bonds whose issuers are not current in their disclosure filings."

Information sent to EMMA must be in electronic format only, as prescribed by the MSRB (which means PDF files, and by January 1, 2010, the PDF files must be word-searchable, so scanned versions will not be accepted). To

submit information to EMMA, issuers will need to register with the MSRB and provide certain required information for each issue in order to submit properly. Northland currently assists over 125 issuers with their "full disclosure" needs in our capacity as a "Dissemination Agent," and we now also provide a separate service package, for an annual fee, for issuers with new "limited disclosure" obligations, including the filing of material events notices.

The good news in all of the recent changes is that Official Statements (OS's) for new issues (not just continuing disclosure reports) must also be submitted to EMMA electronically, and that means few, if any, printing and shipping costs for hard copies of OS's. Buyers of the bonds may still request a printed copy of a final OS, but they will also have immediate (and free) access to the document by going to <http://emma.msrb.org/> and searching under

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Look in the Toolbox

What's at the bottom of your toolbox? Typically, you can find things infrequently used and often forgotten. The same is true for public finance. Minnesota cities have several useful tools that often go overlooked.

Special Service District

A special service district is a tool for funding both improvements and services to commercial districts. The statute (Minnesota Statutes, Section 428A.01 - 428A.10) has many uses, allowing each city to determine the nature of special services. Typical improvements include utilities, parking, streetscape, and parks. Other applications to consider include transit facilities and alternative energy systems. Services can be any activity to maintain improvements and serve the properties in the district. Services already provided to the properties through the city's general fund must be provided at a higher level. The revenue to pay for the improvements and services comes from a service charge. This charge can function like a property tax. It can also be tailored around other factors (front footage, lot area, building size) to better allocate costs. The service charge can be collected through the property tax system. The city can issue general obligation bonds to finance the improvements. Using this tool involves a unique process. The city must be petitioned by property owners to hold the hearings needed to establish the district and impose the service charge. These actions are subject to veto by the property owners before final adoption.

Housing Improvement Area

The housing improvement area is a cousin of the special service district. It is a tool for making improvements to owner-occupied housing. The housing improvement area was designed to help financially troubled townhome and condominium associations make needed reinvestment. The statute (Minnesota Statutes,

Section 428A.11 - 428A.20) allows cities to undertake any form of improvement including streets, roofs, HVAC, and parking. This tool has the potential for use in existing single-family neighborhoods. Property owners could create an area to preserve open space, enhance a park, or rehabilitate utility systems. The revenue to pay for the improvements comes from a "fee". This fee may be a property tax or may be allocated using other factors. The city may issue general obligation bonds to finance the improvements. The creation of a housing improvement area is subject to petition and veto provisions similar to the special service district.

Combining Improvements

Most cities have used Minnesota Statutes, Chapter 429 to levy special assessments and issue bonds to pay for public improvements. The key to issuing bonds is assessing at least 20% of the improvement costs. The statute allows different projects to be combined into a single improvement for the application of this 20% test. For example, a water and sanitary sewer project that is 100% assessed can be formally combined with a 0% assessed storm sewer project. Bonds can be issued so long as the total assessment exceeds 20% of the combined improvement cost. There are procedural requirements, so plan ahead and be sure to get guidance from financial and legal advisors.

Equipment Certificates

Cities and counties can finance capital equipment through the issuance of equipment certificates (capital notes). The advantage of this approach is the creation of a debt levy that is not subject to levy limits. In 2005, the maximum term for equipment certificates was extended from five to ten years.

Equipment certificates can be both a funding tool and an investment. Some cities may be

able to issue equipment certificates and then purchase them as investments. The only "hook" is that the debt must be a general obligation and rated "A" or better to meet the statutory criteria for eligible investments. This form of "private placement" has several advantages:

- Costs of issuance are less than a conventional issuance.
- Interest is paid to the issuer and not an investor.
- The levy moves outside of levy limits.

For additional protection, the issuer could also sell the certificates on the secondary market, if needed.

Tax Abatement

Tax abatement began as an alternative to tax increment financing and has evolved into a versatile tool for both economic development and capital investment. One of the statutory objectives of tax abatement is to "provide or help acquire or construct public facilities". Neither the annual abatement levy nor a levy for abatement bonds are subject to levy limits. In 2008, the Legislature expanded the maximum total abatement from 10% of the percent of the current levy to 10% of net tax capacity.

Conclusion

Any evaluation of new tools should consider:

- Defining funding objectives. It is hard to know if a tool is useful, without criteria to measure the outcome and compare the options.
- Planning ahead. Investing time in exploring the potential application of different tools will lead to the best approach and leave flexibility for implementation.

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the issuer's name. The lower issuance costs from eliminating the printing and shipping of OS's was already being reflected in issues that sold in July.

There are still more changes being advanced by the SEC and the MSRB, including tighter notification periods for material events (10 days within occurrence, rather than 10 days within knowledge that an event happened), and shorter time spans for when audited financial statements should be provided

(120 days after the end of the fiscal year – currently only voluntary). Although some of these proposed changes may be challenging for issuers to comply with, they are being supported by investors and analysts in the marketplace, who are used to a different level of information from the corporate investments they purchase, and they reflect a movement toward a more global marketplace, even for municipal bonds.

The information in this newsletter is based on sources believed to be reliable, but does not purport to be complete and is not warranted by Northland Securities, Inc.