State of Vermont
Debt Management Policy

January 2019

The purpose of this document is to provide guidance on current practices as they relate to the issuance, management, continuing evaluation, and reporting on all debt obligations issued by the State of Vermont, in relationship to the overall mission and internal control standards of the State Treasurer's Office.

Mission Statement

Treasurer's Office will issue debt in compliance with state statute and in compliance with applicable federal code, at the lowest possible interest rates, in the most cost-effective manner possible while maintaining the State's high credit ratings. Such issuance must balance both immediate costs and potential future savings, while minimizing potential regulatory, economic and market risks.

Relationship to Treasury Mission and Vision

Debt service is a long-term, fixed obligation. Obtaining the most favorable rates on tax supported debt programs through timely issuance, maintenance of high credit ratings, well thought out debt structures and taking advantage, where appropriate, of refunding opportunities, directly benefits the State of Vermont and the taxpayers by saving tax dollars.

Primary Functions

This function, completed by Administrative and Treasury Operations staff, serves the state agencies and departments, bond holders, and the citizens of the state. The Treasurer's Office provides central coordination for all state-issued debt. Staff also monitors local and national bond markets, as well as financial and economic trends that impact bond issuance structures and interest rates.

Primary functions include

- Debt financing review and program administration
- Debt program administration, including compliance and continuing disclosure, investor relations, and rating agency relationships
- Issuance of bonds or other securities
- Monitoring and execution of refunding opportunities
- Debt affordability analysis and recommendations to executive and legislative branches
- Debt financing and advisory services to state agencies, authorities, boards, commissions and higher education institutions
- Technical assistance on the financial aspects of legislative proposals, impact on debt capacity, financial studies and initiatives

- Managing the long-term accounting records needed for verifying and coordinating the payment of principal and interest with the fiscal agent and initiating supporting transfers required by the bond covenants
- Managing and monitoring arbitrage compliance and computing federal rebate calculations as needed
- Monitor post-issuance compliance

In completing the above functions there is considerable interaction with Finance & Management and Buildings & General Service, the departments primarily responsible for preparing the capital budget, and with the Joint Fiscal Office. Treasury staff also works with the Financial Operations Division of the Department of Finance & Management to record debt transactions and prepare disclosures for financial presentation in the state's Comprehensive Annual Financial Report (CAFR) and the bond disclosure documents (Official Statement).

Debt Management Practices and Overview

Current Practice

Historically, the State Treasurer's Office, in conjunction with the Administration and the Legislature, has set a course of maintaining modest levels of new authorizations of long-term debt and net tax-supported debt outstanding in a concerted effort to reduce debt burdens and to free up debt capacity for future projects. The approach is as follows:

- Bond issuance is substantially lower than in the 1990s. Reduced debt issuance and continued improvement in the State's economy and financial condition have lowered State debt ratios.

- Debt guidelines were strengthened in 2004. The State maintains the highest overall ratings amongst New England states.

- Uncomplicated debt management nearly exclusively using general obligation debt.

- Vermont has taken advantage of refunding opportunities, lowering debt service costs.

- The State has a low debt burden with rapid amortization.

- The Capital Debt Affordability Advisory Committee ("CDAAC") recommended reductions in the debt recommendations of 7.0%, 8.0% and 9.9% over the past six years.

The State's primary financing vehicle has been and continues to be the issuance of General Obligation (G.O.) bonds, backed by the full faith and credit of the State of Vermont, which includes a pledge of the general taxing power for the payment of debt obligation. Interest rates on G.O. bonds are generally lower than any other form of debt financing. The State generally issues serial G.O. bonds maturing one to twenty years from issuance date, with interest due every

six months and principal due annually on the bond. The principal portions of the bonds are paid in substantially equal or diminishing installments over the term of the bond series, while the interest payments for each series decline as the outstanding principal balance is reduced.

To date, the state has not utilized other mechanisms such as revenue bonds, GARVEES, tax increment financing or TIFs (these are done at the municipal level). The State's G.O. bonds are "plain vanilla"; the state does not employ the use of derivative strategies such as swaps, variable rate debt obligations (VRDO) or auction rate securities (ARS). The state does take advantage of refunding opportunities when available. A bond refunding is a procedure whereby an issuer refinances an outstanding bond issue by issuing new bonds. There are generally two major reasons for refunding: to reduce the issuer's interest costs or to remove a burdensome or restrictive covenant (generally not applicable in Vermont) imposed by the terms of the bonds being refinanced. Vermont's refunding has been related to reduction of interest costs. The proceeds of the new bonds are either deposited in escrow to pay the debt service on the outstanding obligations when due (in which case the financing is known as an "advance refunding"), or used to immediately retire the outstanding obligations. A change in 2018 occurred as part of the Tax Cuts and Jobs Act removing the most of the incentives for advance refunding bonds after 90 days from the initial issuance date (causing them to be taxable).

The State Treasurer's Office issued $106.1 million aggregate principal amount of general obligation bonds in fiscal year 2018. This included a $34.7M Series A negotiated offering of "Citizen Bonds" and $71.4M of Series B through a competitive offering in September of 2017. The average life of these bonds was 10.4 years with an overall borrowing costs of 2.48% The State's bond ratings discussed above contributed to the favorable interest rates achieved in both offerings.

For the current fiscal year (2019) the State Treasurer's Office is authorized to issue up to $108M in general obligation bonds but has not made any issuances through calendar year 2018.

A major contributing factor to Vermont's respected debt management is the work of the Capital Debt Affordability Advisory Committee (CDAAC). The CDAAC completes an annual review of the size and affordability of the State tax-supported general obligation debt, and submits to the Governor and to the General Assembly a recommendation of the maximum amount of new long-term general obligation debt that prudently may be authorized over the next two fiscal years. The estimate of the committee is advisory, but historically has been adopted by the State as a bonding limit. This legislative adherence to CDAAC recommendations is a major factor in the investment community's recognition of Vermont as a highly disciplined state in financial affairs. The CDAAC is made up of four *ex officio* members, two appointees of the Governor, and one appointee of the State Treasurer. The State Treasurer serves as chair of the committee.

Vermont currently holds a triple-A rating from Fitch, and the second highest ratings from Moody's and S&P. A triple A rating is attractive for a state because it offers a lower cost of capital to the state and favorably impacts the ratings and costs of borrowing for state agencies such as the Vermont Municipal Bond Bank, Vermont Housing Finance Authority, Vermont Economic Development Authority, and Vermont Student Assistance Corporation. As such, the Treasurer's Office is currently focused on working to restore the AAA rating across all rating agencies.

Uses of Long-term Debt Financing

According to State Statute, the Governor will submit, in addition to the general operating budget, a consolidated capital budget request for the following fiscal year, encompassing all projects that may require state general obligation debt financing, including transportation projects. Vermont uses a conservative approach to debt management. Long-term debt financing is not considered appropriate for a recurring purpose such as current operating and maintenance expenditures. The State of Vermont will use long-term debt financing only for capital improvement projects and equipment acquisitions included under the following circumstances (see 32 V.S.A. § 309, Capital Budget Report):

- General obligation debt financing is restricted to tangible capital investments, but may include the planning, design, and engineering directly associated with a tangible capital investment.

- Activities proposed through the capital plan are restricted to those capital expenses allowed under federal laws governing the use of state bond proceeds. For instance, there is a "private activity" cap associated with each bond issuance.

- Capital needs should have identified life cycles that are matched to the debt issuance. The capital budget is segmented by the expected functional life of proposed activities, and thus by a corresponding prudent use of either long-term bond issues with a customary 20-year payback period, or shorter-term bond issues with a lesser payback period can be applied.

The primary methods for paying for capital projects are out of "pay-as-you-go" dollars or through the issuance of debt. Pay-as-you-go is a term used to describe the financial policy of a governmental unit that finances its capital outlays from current revenues rather than by borrowing. The State does fund some of its capital needs, particularly through pay-as-you-go. A balance between pay-as-you-go and prudent debt is needed. The advantages of pay-as-you-go are:

- No debt is incurred by the State improving the state's balance sheet.
- Costs of construction are not burdened by interest costs.

On the other hand, many capital projects may be delayed due to lack of resources. Recent studies completed by the Joint Fiscal office (JFO) and the Agency of Transportation (AOT) have demonstrated increased costs for repair of transportation (bridge) infrastructure when preventative work is deferred. In addition to this, if inflationary costs are higher than the interest associated with the debt, and significant economic advantages can be achieved, issuance of more debt can be a prudent decision. As noted by a recent study "Borrowing is cost-effective when the costs saved through accelerated construction, plus future project revenues, exceed the cost of interest paid on the borrowed funds." (Springer, p.4). There is also an argument to be made that borrowing provides for intergeneration equity in the sharing of the costs of new infrastructure and is a "good way to finance large public capital investments with high up-front costs that

provide benefits to users for years, even generations." (Wachs, p.9) But borrowing must also be constrained by the ability to repay the debt. This is similar to an individual's decision about personal credit card use. Future streams of revenue are needed to pay the debt.

One of the challenges over the next few years is how to manage the debt portfolio in order to achieve a proper balance between the goal of low debt ratios and the accumulating capital needs of the State. While the State must continue a disciplined approach to debt financing of public infrastructure, several self-assessment steps are currently taking place of whether Vermont's approach and policies of the past 20 years relating to debt management and infrastructure financing still make sense in light of current circumstances and remain appropriate for the future. Funding of infrastructure, especially transportation related, will become a more significant issue as traditional sources, such as motor fuel taxes, continue to be impacted by changing patterns emphasizing a reduction of reliance on oil.

Debt Characteristics

Types of Debt

Debt financing may include general obligation bonds, revenue bonds, lease/purchase as well as public improvement district bonds, and special assessment bonds. As noted above, the overwhelming method used by Vermont has been G.O. debt although some forms of revenue debt have been explored. The debt Procedures Manual provides a detailed description of the types of debt.

General Obligation Debt Structure

The following guidelines, which may be modified by the State of Vermont to meet the particulars of the financial markets at the time of the issuance of a debt obligation, describe the basic structure.

Term of the Debt: The financing will not exceed 20 years by statute. Bonds cannot be issued for a longer maturity schedule than a conservative estimate of the useful life of the asset to be financed.

Structure of Debt: Level or diminishing principal payments will be used unless otherwise dictated by the useful life of the asset(s).

Call Provisions: From an investor perspective, bonds are generally more marketable without call provisions. As a rule, investors normally prefer the certainty of a fixed maturity with no possibility of a call. On the other hand, this may inhibit the ability to take advantage of current refunding opportunities, thus reducing the debt service interest payments. To reward investors for the increased risk, callable bonds typically will carry a higher interest rate. Generally, the State strikes a balance, with bonds maturing after ten years subject to call at a redemption price of 100% of the principal amount of the bonds to be redeemed, plus accrued interest to the redemption date. This redemption price may

rise to a premium under certain market conditions such as a high interest rate environment.

Premium or Discount: State practice requires that proceeds are at least equal to the principal amount of the capital budget. Pursuant to 32 V.S.A. §954 (a), all proceeds, including any bond premium received from the issuance of debt is to be applied to the purposes for which they were authorized.

Cost of Issuance: In addition to the interest on the amount borrowed, there are additional bond related expenses including, but not limited to:

- Bond Counsel Services
- Printing of Bond Documentation
- Credit Ratings Fees
- Trustee/Paying Agent Services
- Financial Advisor Consulting Fees
- Underwriter compensation

The profits made by underwriters are referred to as the spread. The spread is the difference between the price the underwriter pays the issuer for the bonds and the price the underwriter receives from the resale of those bonds to investors. The cost of issuing the debt will be expensed in the governmental fund and allocated to the projects approved for the corresponding fiscal year. Underwriter's compensation consists of takedown, management fee, underwriting risk, and expenses, although currently spreads reflect the amounts of only takedown and expenses. The expense component is made up of costs incurred by the underwriter on behalf of the issuer. The costs for these services need to be managed, through the competitive bid process use to select underwriters and subsequent negotiation and monitoring of fees.

Budget: The budget for debt service will be the gross debt service to include interest, and principal.

Refunding of Outstanding Debt: Refunding will only be done if there is a resultant economic gain regardless of whether there is an accounting gain or loss, or a subsequent reduction or increase in cash flows.

Refunding Policy

The Director of Financial Reporting and the Financial Advisor will monitor the municipal bond market for opportunities to obtain interest savings by refunding outstanding debt. As a general rule, the present value savings of a particular refunding should meet 2%/3% tests (individual maturity/overall PV), with certain exceptions, such as the bonds to be refunded have restrictive or outdated covenants, or restructuring debt is deemed to be desirable. (The new tax law currently disallows the advance refunding of tax-exempt bonds).

Limitations on Maturity

The State of Vermont normally will issue bonds with maturities of 20 years for general obligation bonds. The State of Vermont will seek to structure debt with level principal over the life of the debt. An exception to this is the Citizens Bonds issued with the longest maturity of 10 years. For the purposes of meeting the declining principal amortization requirement, however, the Citizens Bond is often deemed integrated with the preceding general obligation bond (within acceptable date period) such that the combined amortizations are equal or declining.

Statutory Limitation

Bonds are issued at the discretion of the State Treasurer with the approval of the Governor. The State has no constitutional or other limit on its power to issue obligations or incur indebtedness besides borrowing only for public purposes. The Capital Debt Affordability Advisory Committee provides a recommendation to the Governor and the legislature on the maximum amount of new long-term general obligation debt that prudently may be authorized for the next two fiscal years. Although advisory, the capital budget appropriated by the General Assembly has followed this recommendation.

Investment of Bond Proceeds

All general obligation and revenue bond proceeds shall be invested in separate bond accounts by issuance to aid in calculating arbitrage. Investments will be consistent with those authorized by existing statute and by the State of Vermont's investment policies.

Sale Process

State Statute 32 VSA § 953 states that the State Treasurer, with the approval of the Governor, may sell "bonds at such prices, in such amount, at such times and in such manner, with or without advertising the same, as he or she shall determine to be for the best interests of the state, at public or private sale."

A competitive bond offering involves bid solicitation from potential purchasers, principally underwriters. It is a public auction where the bonds are sold to the underwriter or other purchaser that offers the best bid, i.e. the lowest "true interest cost" or TIC. TIC is defined as the rate, compounded semi-annually, necessary to discount the amounts payable on the respective principal and interest payment dates to the purchase price received for the new issue securities. TIC computations produce a figure slightly different from the "net interest cost" or NIC method, since TIC considers the time value of money while NIC does not (see MunicipalBonds.com and Oregon Bond Manual). A negotiated offering differs from a competitive offering in the method used for selecting the underwriter, the role of the underwriter in the bond marketing process, and the procedures used for determining interest rates and underwriter compensation. In a negotiated offering, the underwriter is selected first, often through the solicitation of competitive requests for proposals (Leonard 1994, 15, cited in Stevens, Evaluation of Underwriter proposals for negotiated Bond Offerings, p 440). The underwriter or senior underwriter will engage in pre-sale marketing and will negotiate interest rates.

The State of Vermont will generally conduct financings, wherever feasible, on a competitive basis. However, negotiated financings may be used due to market volatility or the use of an unusual or complex financings or security structure. Retail issues such as the Citizen's bonds are done through a negotiated process. Also, bond refunding may be conducted through a negotiated process, due to complexities associated with refunding economics and escrow structuring.

In either case, there is still a competitive process, in the first case, by virtue of the auction of the bonds and in the latter case by an RFP process to select an underwriter firm or firms. The negotiated offering is structured to require the solicitation of multiple underwriter proposals and permits the state to solicit the advice of several underwriters about how to structure and price a proposed bond issue.

Either method of sale requires the preparation of an extensive disclosure document which the Treasurer's Office prepares with the Agency of Administration, Department of Finance & Management, and other department input with the assistance of outside legal counsel. Similarly, both methods of issuance require financial structuring in terms of amount, maturities, call provisions, etc. While these tasks require extensive attention, they are beyond the scope of this description. Overviews of the two methods of issuance are outlined below.

Competitive Sale

After disclosure documents are completed and structuring issues have been decided, the competitive sale process may begin. A Summary Notice of Sale is published alerting potential bidders to the date and time of the sale, approximately one week in advance of the sale date. Simultaneously, the state prints and distributes its Preliminary Official Statement that contains a detailed Notice of Sale containing the relevant aspects of the sale including precise bidding rules. At the appointed date and time, bidders submit their bids on the Official Bid Form. Recent auctions have used an on-line bidding platform developed and maintained by Parity. Bids are promptly "opened" and disclosed. As a condition of submitting a bid, bidders must provide a good faith pledge, typically 1% of the value of the bonds being offered. Approximately one week after the bid, after various legal documents are completed, including the preparation of the bonds themselves and a Final Official Statement, the bond sale closes.

Negotiated Sale

When the senior manager, the underwriting group and the State, with the assistance of the Financial Advisor, determine that market conditions are appropriate, a sale date is chosen. Interest rate scales are solicited from the underwriting group in the days prior to the sale to help determine an initial offering scale for the day of the sale. Prior to the official pricing date, a retail order period may be held to solicit smaller orders from individual investors. On the day of the sale an interest rate scale is made known to potential investors through a pricing wire. An order period is conducted lasting several hours. During the order period, orders are placed by investors through the senior manager, the co-managers and selling group. After the order period closes, the senior manager and state officials review the "book of orders." Based on the amount and distribution of orders, the senior manager and the state determine whether any adjustments to the pricing of the bonds are necessary. After the bonds are repriced, the management group checks to see whether additional orders can be obtained and/or whether initial orders are withdrawn.

Several iterations of this process may take place. When the senior manager (on behalf of the entire underwriting group) and the state agree on a price, a verbal award is made. Subsequent to pricing, an official Bond Purchase Agreement is signed between the underwriting group and the State. A good faith deposit is obtained, similar to the competitive process. On a date specified, after all legal documentation has been completed, the sale closes. The final purchase price of the bonds is wired to the State and the bonds are released, as with the competitive process.

Additional Documentation

The descriptions included above necessarily skip over a number of aspects of the issuance and sale of Vermont bonds. Extensive legal documentation of each is sale is included in the Closing Binder for each sale. These documents, many of which are required under state and federal law, or as a matter of industry practice, are prepared and reviewed in conjunction with a law firm that acts as Bond Counsel. The State Treasurer’s Office periodically selects a firm to act as Bond Counsel through a competitive RFP process.

Business Partners/Professional Services

The State of Vermont employs outside financial specialists to assist it in developing a bond issuance strategy, preparing bond documents, and marketing bonds to investors. The key players in the State of Vermont’s financing transactions include its financial advisor, bond counsel, underwriter (in a negotiated sale) and in some instances a disclosure counsel. Other outside firms, such as those providing paying agent, trustee, and/or printing services, are retained as required. A review of the primary partners is outlined below.

Bond Rating Goals

The State of Vermont will seek to maintain and, if possible, improve the current ratings in order to minimize borrowing costs and preserve access to credit.

Disclosure

The State of Vermont is committed to continuing disclosure of financial and pertinent credit information relevant to the State of Vermont’s outstanding securities and will abide by the provisions of Securities and Exchange Commission (SEC) Rule 15c2-12 concerning primary and secondary market disclosure.

Rating Agency Relations

Full disclosure of operations and open lines of communication shall be made to the rating agencies. State of Vermont staff, with the assistance of the financial advisor, shall prepare the necessary materials and presentation to the rating agencies. Credit ratings will be sought from Moody’s, Standard and Poor’s, and Fitch as recommended by the State of Vermont’s financial advisor.

Business Partners: [1]

Financial Advisor

The state's financial advisor has traditionally advised the state in structuring the issuance and sale of all bonds, notes, and other securities as well as providing assistance and analyses for other financings, including negotiating terms and drafting documents, legislation, regulations, and procedures. The financial advisor acts as a liaison between the State and bond rating agencies. In addition, the Financial Advisor is responsible, in conjunction with Treasury staff, for analyses, drafting, and presentation of the State of Vermont's Capital Debt Affordability Advisory Committee Report.

Trustee/Paying Agent

The trustee/paying agent is usually a commercial bank. Its purpose is to represent and protect the interest of the bondholders and also to act as paying agent (responsible for transmitting payments of interest and principal from an issuer of municipal securities to the bond holders). The bank provides various other services, including the maintenance of records and reconcilement.

Depository Trust Corporation (DTC)

DTC is a securities depository and a national clearinghouse, registered with the SEC that provides immobilization, safekeeping and book-entry settlements in corporate and municipal securities. It is a user-owned company. Trustees and paying agents make a single interest and principal payment per maturity to DTC, and DTC distributes those payments to participating banks and securities firms for the benefit of their clients. (Source: California Debt and Investment Advisory Commission, Debt Issuance Primer Handbook)

Underwriter (Investment Banker)

The underwriter is a broker/dealer or investment banking organization that purchases and resells the bonds on behalf of the issuer with the intent of making a profit. In a competitive sale, the issuer is responsible for the planning and design of the bond offering. The issuer solicits sealed bids from competing underwriters for the purchase of bonds. The issuer (State), with the assistance of the financial advisor, plans the amount, structure and other parameters of the sale independent of the underwriter. In a negotiated sale, the underwriter takes on a more active role with the timing and pricing and is usually engaged at the beginning of the bond issuance cycle. The underwriter then purchases the bonds on terms mutually agreeable to the issuer and underwriter. In the Vermont model, an RFP is issued to solicit underwriters.

Syndicate

A group of underwriters organized for the purposes of sharing the risks of underwriting the issue, obtaining sufficient capital to purchase an issue and broadening the distribution channels of the

(1) See various sources including: KUTAK ROCK LLP, Housing Bond Basics, OREGON STATE TREASURY, MUNICIPAL DEBT ADVISORY COMMISSION, BOND MANUAL, California Debt and Investment Advisory Commission, Debt Issuance Primer Handbook

issue to the investing public. One of the underwriting firms will be designated as the syndicate senior manager or lead manager to administer the operations of the syndicate.

Bond Counsel

Every municipal security must be reviewed by a lawyer or law firm known as bond counsel. The legal opinion is an authorization of the debt and covers two main issues:

- It ensures that the bonds are legal, valid and binding obligations of the issuer.
- It verifies the tax status of the debt; that is, whether interest on the bonds is exempt from federal income taxes (as well as state and local taxes in some cases).

Investors will not buy municipal bonds unless there is an opinion of a recognized law firm to the effect that the bonds are validly issued and the interest on the bonds is tax-exempt. Bond counsel also should be experienced with all aspects of structuring a financing and should advise the issuer and the underwriter on the legal aspects of the bond issue.

State Economist

This individual provides economic and demographic data for the Official Statement and for rating agency presentations, and the CDAAC report.

Underwriter's Counsel

An attorney or law firm retained to represent the interests of an underwriter in connection with the purchase of a new issue of municipal securities. The duties of underwriter's counsel may include review of the issuer's bond resolution and documentation on behalf of the underwriter; review of the accuracy and adequacy of disclosure in the official statement; preparation of the agreement among underwriters, Contract of Purchase and/or the official statement; assisting the underwriter in meeting the underwriter's due diligence obligation; and delivery of a due diligence opinion.

Credit Rating Agencies

These include Moody's Investors Service, Inc., S&P Global and Fitch Investors Service. Rating agencies appraise, analyze and monitor the credit quality of a bond issuer. These firms provide credit ratings for use by retail and institutional investors to gauge the credit risks inherent in the bond issue. The fee for the rating service is paid by the issuer and based on the issue size, type, and complexity.

Office of the Attorney General

This Office provides a review of contingent liabilities including legal proceedings against the state as part of disclosure to bond holders. They work with the bond counsel.

Department of Finance & Management, Auditor of Accounts, Secretary of State, Agency of Administration, other State Agencies and Departments.

Provide the financial statements and financial and demographic information necessary to enable the preparation and filing of bond documents and continuing disclosure and/or approve documents as to form.

Financial Operations Division, Department of Finance & management

Monitors, projects, and controls expenditures on capital projects funded through bonds issued by the Treasurer. Provides information for the State's official Statement (see below).

Bond Arbitrage Compliance Consultant

Calculates the rate of return on proceeds from bond issuances that have been invested and provides reporting to ensure compliance with IRS arbitrage rebate rules. Also advises on projected spend downs and project swaps as it relates to arbitrage rebate compliance.

Disclosure and Post Issuance Debt Management

Municipal securities are exempt from the disclosure regulations generally applied to corporations in both the Securities Act of 1933 and the Securities Exchange Act of 1934. Municipal securities, however, are subject to the anti-fraud provisions of the acts and related rules (Olson, 2007), specifically, section 17(a) of the 1933 Act, Section 10(b) of 1934 Act, and SEC Rule 10b-5. Rule 10b-5 states that it is unlawful "to make an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." As the issuer of the bonds, the State has the responsibility to assure the accuracy and completeness of information provided to the potential investors. Issuers such as the State must also comply with SEC Rule 15c2-12. It is an SEC rule under the 1934 Act "setting forth certain obligations of underwriters to receive, review and disseminate official statements prepared by issuers of most primary offerings of municipal securities." (MSRB Web site)

The State issues a preliminary and final Official Statement (OS) in connection with its bonds. The Official Statement is one of the most critical documents produced by the bond team. The OS document discloses material information on a new issue including the purposes of the issue, how the securities will be repaid, and the financial, economic and demographic characteristics of the State. Investors, analysts and rating agencies may use this information to evaluate the credit quality of the securities. Federal securities laws generally require that if an official statement is used to market an issue, it must fully disclose all facts that would be of interest to potential investors evaluating the bonds. The OS also includes a statement that there have been no material misstatements or omissions by the issuer with respect to the issue, and that no facts have become

known which would render false or misleading, any statement which was made. Appendix 2 B identifies the key players and responsibilities in producing this document. While the State employs consultants and bond counsel to assist in this task, the ultimate responsibility for the document rests with the State.

After the bonds are issued the State has continuing obligations to bondholders including:

- Payment of principal and interest on their securities
- Compliance with IRS code relative to arbitrage earnings, private use, useful life and the tax-exempt status of the bonds; and
- Continuing disclosure to bondholders about material events that affect the status of the bonds including arbitrage and tax compliance.

The obligation to pay the debt service is straightforward and covered in the Procedures Manual. A risk map with a brief overview of the process and a summary of the procedures is included in the Appendix to this document. The emphasis of this review is IRS and continuing disclosure, which lead to extensive risk management considerations for bonds.

The primary IRS code applicable to tax-exempt bonds are the Federal Tax Reform Act of 1986 as incorporated in the U.S. Treasury Internal Revenue Code (IRC) sections 103 and 141 through 150. While there are many criteria, the most common issues relate to private use, arbitrage, and useful life. Section 103 of the Code indicates that an "arbitrage bond" under Section 148 will not be tax-exempt. "The basic arbitrage rule is that a municipality may not invest the proceeds of a tax-exempt note or bond in such a manner so that the yield on the invested funds exceeds the interest rate being paid on its borrowing by more than .125%. If this rule is violated and the municipality does not qualify for an exception to this rule, its borrowing will be an "arbitrage bond" and consequently will not be tax-exempt under Section 103 of the Code. An arbitrage bond would include any bond issue for "which any portion of the proceeds is reasonably expected, at the time of issuance, to be used to acquire higher yielding investments, or to replace funds which were used to acquire higher yielding investments." (Shannon, et. al, 2007) As such, the issuer will not be able to take advantage of the below-market interest rates that are typically available to municipal borrowers." (VLCT, 2005) This should be distinguished from an unintentional generation of arbitrage earnings. Intent factors into the determination of "arbitrage." If projects fall behind schedule, there may be an arbitrage "rebate' to the IRS but not necessarily a determination that an arbitrage bond exists. In these cases, there are safe harbors such as spend down exemptions and there are certain requirements for tracking the arbitrage rebate. Intentional arbitrage would, however, affect the status of the bonds.

In addition to arbitrage, another requirement is that the bonds issued must be for a public, not private use, generally bridges, schools, infrastructure used by the general public. There are, however, private uses that have a public benefit; pollution related clean-up, affordable housing, etc. Private use and private debt service of the bond cannot exceed 10% of the issue (5% on certain loans). [2]Another issue is continued private use. For instance, a building constructed using bond funds for a public use may not generally be resold for private use, although the "change in use" provisions do provide for certain remedies. In addition, bonds may not exceed certain useful life criteria for the underlying capital assets.

[2] See also separate discussion of Private Activity Bonds and cap in the Appendices to the Procedures Manual.

At the time of issuance, disclosure of material facts is made. Issuers such as the State have a continuing obligation for disclosure. This is required by SEC Rule 15c2-12 as stated by the MSRB:

> "Under Rule 15c2-12(b)(5), an underwriter for a primary offering of municipal securities subject to the rule currently is prohibited from underwriting the offering unless the underwriter has determined that the issuer or an obligated person for whom financial information or operating data is presented in the final official statement has undertaken in writing to provide certain items of information to the marketplace. Rule 15c2-12(b)(5) provides that such items include: (A) annual financial information concerning obligated persons; (B) audited financial statements for obligated persons if available and if not included in the annual financial information; (C) notices of certain events, if material; and (D) notices of failures to provide annual financial information on or before the date specified in the written undertaking." (MSRB Notice 2008-33)

The SEC further defines "obligated person" as:

> "… any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all or part of the obligations on the municipal securities sold in a primary offering (other than providers of bond insurance, letters of credit, or other liquidity facilities)." (MSRB Notice 2008-33)

The SEC further requires that broker-dealers can only buy securities for which the issuer has agreed to provide written assurance of their continuing disclosure. As noted above, the SEC does not have authority over disclosure requirements in the municipal bond market. Through these rules, however, the SEC has placed restrictions on underwriters, broker-dealers and other business partners, creating effective compliance. (WM Financial Strategies, 2005)

SEC Rule 15c2-12 mandates continuing disclosure unless the bonds qualify for an exemption, which is generally not the case given the size of the Vermont issues. The Director of Financial Reporting is responsible for providing ongoing disclosure information to established national information repositories and for maintaining compliance with disclosure standards promulgated by state and national regulatory bodies. This individual works with Bond Counsel to assure that this is completed annually and in the event of the occurrence of a disclosure event. Notice would be required for the following events:

- Principal and interest payment delinquencies
- Non-payment related defaults
- Unscheduled draws on the debt service reserves reflecting financial difficulties
- Unscheduled draws on the credit enhancements reflecting financial difficulties
- Substitution of the credit or liquidity providers or their failure to perform
- Adverse tax opinions or events affecting the tax-exempt status of the bonds

- Modifications to rights of bondholders
- Optional, contingent or unscheduled calls of bonds
- Defeasances
- Release, substitution or sale of property securing repayment of the bonds
- Rating changes

Annual filings are to be sent to all existing nationally recognized municipal securities information repositories (NRMSIRs). In addition, if the State determines that the occurrence of an above listed event is material under applicable federal securities laws, the State has a duty to promptly file a notice of such occurrence with the NRMSIRs and Municipal Securities Rulemaking Board. A listing of the current repositories is provided in the Procedures Manual and can also be found at http://www.sec.gov/info/municipal/nrmsir.htm.

Risk Management

Risks to Investors:

Certain risks accrue to the purchaser of bonds. While these are not direct risks to the State, and are not included in the more detailed risk assessment, they do have an impact on the marketability of the bonds. As such, they are included in considerations around bond structure and pricing. These include:

Credit Risk

Credit risk is the likelihood that a bond issuer's ability to pay debt service (principal and interest) will be impaired in the future. Bond ratings provide some measure of credit risk. A bond's rating is generally based on an analyst's assessment of the credit quality of an issuer at the time the rating was published. However, unanticipated future events may change the perceived credit quality and rating of the issuer. A bond's value will generally increase with a rating improvement while its value will generally decrease with a rating downgrade. The State’s efforts to maintain high credit ratings through the Capital Debt Affordability process and through open communication with credit rating agencies, mitigates this risk.

Market/Interest Rate Risk

Market risk involves an investor's exposure to changing market conditions. Because a bond entitles its holder to fixed payments of interest in the future, the price of a bond will vary inversely with changes in interest rates. A fundamental principal of fixed income securities is that as the price goes down, the yield on a security goes up. When interest rates rise, a bond's value declines. Alternatively, if interest rates drop, the bond's value increases. Absent a default or call, however, a municipal bond will return its stated par value at maturity. The inverse relationship between interest rates and bond prices holds for all fixed rate bonds, regardless of the complexity of their interest payment structure. Additionally, market fluctuations will alter the interest rate environment for the reinvestment of interest payments. While overall market conditions are outside of the control of the State Treasurer’s Office, timing, term and rate structure of the bond are considerations in issuance.

Call Risk

Call risk exists in bonds that are subject to an optional call. A call provision allows the issuer to repay a bond's principal, often at a premium to par, on or after a date but prior to the maturity date. If interest rates drop significantly during the life of the bond, the issuer may decide to exercise the call option and repay the principal. The issuer then issues new bonds at the lower rates. This is similar to homeowners refinancing mortgages when interest rates drop. Early repayment adversely affects bond investors because they must reinvest their principal in a lower interest rate environment. Because of these market concerns, the investor is generally compensated for this but the calculations on this risk are difficult to determine due to cash flow considerations. It also exposes the investor to market risk.

Risk Accruing to Both Issuer and Purchaser

Tax-Exempt Status:

Municipal bonds are generally attractive because of their tax-exempt status. Interest on many municipal securities is exempt from federal income taxation pursuant to Section 103 of the Internal Revenue Code, and may or may not be exempt from state income.

To qualify for tax-exemption, municipal securities must be and remain in compliance with Federal tax laws and regulations. Failure to maintain the tax-exempt status of the bond through a violation of covenants or IRS code would have significant adverse financial impacts on the bondholder and would severely limit the state’s ability to issue future bonds. All credibility in the market would be lost. One of the requirements is that the bonds issued must be for a public, not private use, generally bridges, schools, infrastructure used by the general public. Some uses get a bit foggier; loans programs for environmental cleanup, generally, private use and private debt service of the bond cannot exceed 10% of the issue (5% for some elements such as certain loans). In structuring a bond issue the State needs to be careful to avoid private use as much as possible. Bond counsel reviews each proposed use of the capital project appropriations with the department of Finance & management to determine if the use should be classified as public or private.

Due Diligence, Disclosure and Adverse Conditions

As the issuer of the bonds, Vermont has an obligation to assure that investors receive an accurate picture of the State and the nature of the bonds to be sold and receive any information on material events that might affect the status or marketability of the bonds. This issue was reviewed in the previous section. Lack of compliance can have serious repercussions including, but not limited to:

- Detrimental impact on the marketability of future bonds
- Tax consequences to the State and bondholders
- Penalties and fines
- Legal action by bond holders against the State
- Inability to reenter the bond market

As noted previously, the Director of Financial Reporting, assisted by Bond Counsel, is responsible for providing ongoing disclosure information to established national information repositories and for maintaining compliance with disclosure standards promulgated by state and national regulatory bodies. This individual works with bond counsel to assure that this is completed annually and in the event of the occurrence of a disclosure event. The National Association of Bond Lawyers (NABL) and the Government Finance Officers Association (GFOA) developed and issued a Post Issuance Compliance Checklist to assist bond counsel and issuer staff in identifying and monitoring disclosure. A copy of this document is included in the Procedures Manual.

Contractual and Operational Risks

Qualified Firms (Bond Counsel, Financial Advisor, Underwriter)

In order to maintain a successful debt management program, the quality of the financial and legal advice is critical. The Government Finance Officers Association (GFOA) Recommended Practices (see listing below) provide guidance on the selection of qualified bond counsel, financial advisors, and underwriters. In all cases, the recommendations include selection on the basis of merit, the use of a competitive process, and periodic review those relationships. The State uses a well documented Request for Proposal (RFP) process that assures periodic review to compare qualifications of firms and select a firm or firms that best meets the needs at the best overall value. Fees and compensation are important factors in the evaluation of responses; however, the Office of the State Treasurer selects the bid that demonstrates the "best value" overall, including proposed alternatives, that meet the objectives of the procurement.

Independence of Financial Advisor/Underwriter:

The Financial Independence of a financial adviser (see business partners above) is essential to the bond issuance process. Some firms providing these services also have an underwriting unit and, in some cases, firms hired as financial advisors subsequently provide underwriting services. While the Treasurer's Office recognizes that there are reasons that industry professionals believe justify consideration of a dual role, such as the existence of complex issues associated with a deal, the size of the deal and economies of scale or unusual market events, the Office takes the position that the roles should be independent to avoid conflict and protect the interest of the state, whenever possible. As noted below:

> "The role and interests of a securities professional acting as financial advisor to a governmental unit are significantly different from the role and interests of a securities professional acting as an underwriter or as a purchaser in a private placement. For example, as agent for the issuer, a financial advisor

would normally seek to achieve the lowest possible interest cost for the issuer, while an underwriter, acting as principal for its own account, would normally want to establish yields which make the securities attractive for resale to others." (source: WM Financial Strategies, "Rule G-23 of the Municipal Securities Rulemaking Board," www.munibondadvisor.com)

The Municipal Securities Rulemaking Board (MSRB) rule governing this, G-23, establishes ethical standards and disclosure requirements for brokers, dealers, and municipal securities dealers who act as financial advisors to issuers of municipal securities. Among other provisions, it recognizes an inherent conflict between advisor and underwriter but provides that a financial advisor may resign and then either bid on the bonds in a competitive sale or serve as the underwriter in a negotiated sale (http://www.msrb.org/msrb1/rules/ruleg23.htm). The GFOA, in its best practices statement (source: GFOA Recommended Practice Selecting and Managing the Method of Sale of State and Local Government Bonds (1994 and 2007), recommends a practice beyond this rule:

- "Due to inherent conflicts of interest, the firm acting as a financial advisor for an issuer should not to be allowed to resign and serve as underwriter for the transaction being considered."

- "Due to potential conflicts of interest, the issuer should also enact a policy regarding whether and under what circumstances it will permit the use of a single firm to serve as an underwriter on one transaction and a financial advisor on another transaction."

The Treasurer's Office Financial Advisor does not have an underwriting capacity or function, thus eliminating this risk.

Other Operational Risks

The issuance of debt requires that principal and interest be paid to the bondholders on schedule and in the correct amount. A violation of the terms of repayment would constitute bond default. Such bond default could arise from a missed scheduled payment or through inadequate cash to pay funds. Since there are critical impacts in terms of the bondholders and reputation risk associated with such a default that would severely damage Vermont's ability to re-enter the bond market, multiple scheduling prompts are used to verify that payments are executed in a timely manner. In addition, bond costs must be appropriate to the issue. A separate bond issuance account is appropriated to identify and include all costs in the appropriation for debt issuance, provide an accurate allocation of debt service costs, and to verify that all bond issuance costs submitted for payment to the State of Vermont are valid and accurate.

Web Resources: Bond issuance and Management

National Association of Bond Lawyers http://www.nabl.org/

The Bond Buyer	http://www.bondbuyer.com/
Municipal Securities Rule Making Board (MSRB)	http://www.msrb.org
National Federation of Municipal Analysts (NFMA)	http://www.nfma.org/
GFOA Public Policy Statements - Debt Management	http://www.gfoa.org/services/policy/
Securities Industry and Financial Markets Assoc.*	http://www.sifma.org/
CUSIP Service Bureau	http://www.cusip.com
The Council of Development Finance Agencies	http://www.cdfa.net/
National Association of State Treasurers	http://www.nast.net/
Securities and Exchange Commission	http://www.sec.gov/
NRMSIRs listing	http://www.sec.gov/info/municipal/nrmsir.htm
MRSB/EMMA**	http://emma.msrb.org/default.aspx
E-Muni (Electronic Municipal Statistics)	http://www.emuni.com/
Muni IRIS, DPC Data	http://www.muniiris.com/iris/s_iris.cfm

*The Bond Market Association merged with the Securities Industry Association to form the Securities Industry and Financial Markets Association.
** Electronic Municipal Access (Official Statements and trade Data)

Best Practices

The Government Finance Officers Association has issued a series of recommended practices related to debt management. These include:

- Analyzing an Advance Refunding (1995)
- Payment of the Expense Component of Underwriters' Discount (1996)
- Preparing RFPs to Select Financial Advisors and Underwriters (1997)
- Sale and Securitization of Property Tax Liens (1997)
- Using Variable Rate Debt Instruments (1997)
- Issuer's Role in Selection of Underwriter's Counsel (1998)
- Issuing Taxable Debt by U.S. State and Local Governments (1998)
- Pricing Bonds in a Negotiated Sale (1996 and 2000)
- Underwriter Disclaimers in Official Statements (2000)
- Using a Web Site for Disclosure (2002)
- Debt Management Policy (1995, 2003)
    - Post Issuance Compliance Checklist
- Maintaining an Investor Relations Program (1996, 2003)
- Evaluating the Use of Pension Obligation Bonds (1997, 2005)
- Secondary Market Securitization of Tax-Exempt Obligations (1993, 1996, 2005)
- Use of Debt-Related Derivatives Products and the Development of a Derivatives Policy (1995, 2003, 2005)
    - Derivatives Checklist

- Auditor Association with Financial Statements Included in Offering Statements or Posted on Web Sites (2005, updated 2006)
- Tax Increment Financing as a Fiscal Tool (2006)
- Debt Service Payment Settlement Procedures (2003, 2007)
- Investment of Bond Proceeds (1996 and 2007)
- Need for Considerable Caution in Regard to OPEB Bonds (2007)
- Selecting and Managing the Method of Sale of State and Local Government Bonds (1994 and 2007)
- Selecting Bond Counsel (1998 and 2008)
- Public-Private Partnerships for Economic Development (2008)

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