

Reuters: How to Navigate the Troubled Municipal Bond Market.

Oct 15 (Reuters) – If you can avert your eyes from the federal government’s budget and debt-ceiling crisis, you may spot more trouble ahead in the state and local municipal bond markets.

Detroit’s bankruptcy, Puerto Rico’s fiscal woes and unfunded pension liabilities in other states and cities are giving the nearly \$4 trillion muni bond market the jitters. Investors have been yanking money out of muni bond funds for more than seven months – triggering redemptions of almost \$50 billion since March, according to Morningstar.

That beats the nearly \$45 billion in outflows from November 2010 to August 2011, when some soothsayers were predicting massive defaults based on weakening state and local finances and pension liabilities. And the exodus is far from over as the muni bond market heads for one of its worst years in the past half decade.

If you’re an income-oriented investor in this market, it’s high time to look for safer ground. You need to be conscious of credit quality, the fiscal condition of the bond issuers in your portfolio and maturity dates.

The tried-and-true route is to go short on maturities and high on credit quality. Bonds that mature in under three years have the least amount of risk and volatility, though they also pay the lowest yields. Exchange-traded funds and mutual funds offer you a basket of different issuers, so you avoid concentrating too much risk in a small number of bonds.

One fund that invests in short-maturity munis is the iShares short-term National AMT-Free Municipal Bond ETF, which invests in an index of short-maturity bonds.

With a yield just under 1 percent, the iShares fund charges 0.25 percent annually for expenses. The fund has gained 0.26 percent, compared with a 2.6 percent loss for the Barclays Municipal Total Return Index through Oct. 14.

A worthy alternative is the SPDR Nuveen Barclays Capital Short Term Muni ETF, which offers a slightly higher yield at 1 percent and slightly lower expense ratio at 0.20 percent. It’s up 0.02 percent for the year through Oct. 14.

As always, credit quality is also critical to avoiding possible defaults. You have to concentrate on issuers who are in good financial shape in areas that support economic growth.

Marilyn Cohen, co-author of “Surviving the Bond Bear Market” and chief executive officer of Envision Capital Management in Los Angeles, suggests sticking with the best-quality bonds rated AAA down to A-.

“You aren’t getting paid enough to go into low credit quality,” she says.

Use more than one broker to seek out munis, she says, because prices and yields can vary from broker to broker by 1 percent to 5 percent.

What kinds of individual bonds offer the lowest default risk? "The safest municipal bond investments are crème de la crème credits," Cohen says. They include "essential-service water, sewer and irrigation munis in good areas with growth."

Other strong issuers include "essential large airports; senior liens and issuers that didn't buy Wall Street's interest-rate swaps," she says.

The Detroit bankruptcy is the most high-profile trouble spot in the muni market, and it's worth watching carefully as a sign of things to come. That's assuming, of course, that the big gorilla issue of Congress potentially breaching its debt-ceiling deadline on Oct. 17 doesn't sabotage global credit markets.

How will the bankruptcy court treat the Motor City's general obligation bonds? If it's decided that creditors will get only pennies on the dollar, that could hurt other city-issued bonds, especially those with large pension debts such as Chicago's.

During the past decade, general obligation bonds, which are regarded as the safest issues, represented 60 percent of the total muni market. What will happen to Chicago bonds if Detroit is allowed to write down its general obligation debt? Puerto Rican bonds are also in trouble; the U.S. territory has \$70 billion in debt and holds an estimated \$33 billion in pension liabilities.

As if that weren't enough to worry about, you also need to keep an eye on the Federal Reserve's interest-rate policy.

If the Fed decides to "taper," or back off its easing policy of buying Treasury bonds, that could lead to another round of interest-rate increases. That, in turn, could trigger another round of muni selloffs and punish those holding higher-yielding bonds and investors in ETFs and mutual funds, especially funds that hold intermediate- to long-maturity bonds.

By John Wasik

[Muni Credit: Harrisburg Parking Bond Sale Avoids Chicago Regret.](#)

Harrisburg is set to be the first U.S. city in three years to lease its parking operations, part of a plan to rid Pennsylvania's insolvent capital of \$363 million of debt from an ill-fated incinerator project.

The deal is slated to move forward next month with the sale of about \$285 million in bonds backed by parking revenue, said Steven Goldfield of Public Resources Advisory Group, which is working for the receiver charged with stabilizing Harrisburg's finances. Bond proceeds will retire parking-authority debt and repay creditors of the incinerator venture, which hasn't generated sufficient revenue to cover debt costs.

Officials in the city of 50,000 say they've learned from Chicago, which in 2008 agreed to a 75-year parking-meter lease for a \$1.15 billion upfront sum amounting to about a 10th of the potential profit. Harrisburg, which would see rates as much as double next year, would earn annual revenue, letting it benefit from gains in collections during its 40-year lease. That could be a model for other localities considering consigning assets to private operators, said Howard Cure at Evercore Wealth

Management LLC.

"Cities are struggling still," said Cure, head of municipal research at the New York-based firm, which manages about \$4.7 billion. "These types of transactions are going to be scrutinized."

Recovery Key

U.S. cities' revenue is projected to rise this year for the first time since 2006, as they repair their finances following the longest recession since the 1930s, according to a survey by the Washington-based National League of Cities. The collections still can't keep up with outlays for pensions and health care.

For Harrisburg, the deal is key to recovery, as the incinerator debt burden is about seven times the general-fund budget, according to William B. Lynch, the state-appointed receiver.

The community guaranteed debt for the overhaul and expansion of the plant in 2003. A fiscal crisis developed after the facility, originally built in 1972, didn't produce enough revenue for the obligations. Harrisburg started skipping payments and in 2011 its city council filed for bankruptcy protection. A federal judge threw the case out after concluding it wasn't authorized. Harrisburg has been under receivership, the state's only one for a municipality, since 2011.

Ripple Effect

Harrisburg's lease would be the first parking deal for a U.S. city since Indianapolis in 2010, according to Xerox (XRX:US) Corp.'s Parking Solutions unit and Walker Parking Consultants, the largest parking consultant by revenue. Cincinnati also intends to lease its system.

The paucity of municipal parking transactions shows the lingering effects of Chicago, whose meters may earn a Morgan Stanley-backed partnership \$9.58 billion in profit, according to a Chicago Parking Meters LLC document.

"There was a lot of backlash over the Chicago deal that scared government officials in cities who didn't want to have the same thing happen to them," said David Cummins, senior vice president of Parking Solutions in Washington for Xerox. The company provides parking services in 30 U.S. cities and about 100 municipalities in the U.K.

The approach in Cincinnati and Harrisburg would accelerate efforts by other cities to relinquish their parking operations, Cummins said.

Xerox Meters

"You won't have the concern that a private entity would try to gain more profits on the backs of the citizens," he said. He said he expects four or five parking deals from cities and universities next year. Xerox manages the Indianapolis system and would assume Cincinnati's meters under the city's proposal.

Cincinnati officials also applied lessons from Chicago by detailing rate increases upfront, said Meg Olberding, a city spokeswoman.

"We had a whole comparative chart of how this is not Chicago," she said. "We're the next generation."

Some municipal investors don't see a trend taking hold.

"A handful of one-off deals is about all you will see, because too many things need to fall in place," said John Donaldson, who helps manage \$750 million in munis at Radnor, Pennsylvania-based Haverford Trust Co. He said potential buyers prefer assets that don't need a turnaround, and those systems make up a short list.

Garage Takeover

Under Lynch's court-approved blueprint, the Pennsylvania Economic Development Financing Authority would take over Harrisburg's 9,100-space parking system, including garages and lots, under a lease from the Harrisburg Parking Authority, the city agency that owns them. Next year, hourly meter rates would double to \$3 from \$1.50, and two hours in most garages would cost \$7, up from \$5.

The state authority would sell about \$285 million in tax-exempt revenue bonds to retire about \$100 million of debt from the Harrisburg parking agency and pay creditors of the incinerator project.

By Romy Varghese October 15, 2013

FT: Puerto Rican Woes Hit US Bond Insurers.

A downgrade of Puerto Rican debt could eat into the capital cushions of the two biggest bond insurers, as they work to rebuild their finances after the credit crisis, a rating agency has warned.

MBIA and Assured Guaranty will need to set aside more than \$100m apiece if the credit rating of the US territory is cut by two categories, Standard & Poor's estimated after "stress testing" the companies' exposure to Puerto Rican municipal bonds.

The pair have written insurance on almost \$11bn of Puerto Rican bonds, whose value has tumbled as investors have begun to doubt that the island will be able to pay its debts.

Bond insurance company shares have also fallen sharply as investors have examined their potential exposure to a downgrade or even a default of Puerto Rico. The island's politicians have been struggling to balance the budget amid 13.9 per cent unemployment and a disappointing recovery from recession.

The S&P analysis provided a fillip to the shares on Monday, since it concluded that MBIA and Assured had already built capital reserves above the required minimum, giving headroom if they needed to reserve more to cover potential losses on Puerto Rican debt.

Insurers must increase reserves if the credit rating of the bonds is lowered. MBIA, through its subsidiary National Public Finance Guarantee Corp, has insured \$5.3bn of Puerto Rican municipal debt; Assured backstops \$5.5bn.

The companies would need to take capital charges of \$65m apiece if Puerto Rico is downgraded from BBB to BB, and \$115m if it drops one category lower.

Assured and MBIA have been trying to improve their own credit ratings so that they can restore their businesses underwriting new municipal bonds, which were put on hiatus during the credit crisis thanks to losses from insuring mortgage-backed securities. As part of that effort, Assured has built a capital adequacy cushion of at least \$400m, and National of \$350m.

Mark Palmer, an analyst at BTIG, said that the S&P report amounted to “a resounding passing grade for the capital levels” of the two companies, and provided confidence that Assured will soon be able to start returning capital to shareholders. There had been “a significant market overreaction recently in their shares in the midst of the Puerto Rico fear frenzy”.

Chris Ryon, a municipal debt portfolio manager at Thornburg Asset Management, cautioned that the insurers may also hold significant exposure to Detroit, which filed for bankruptcy earlier this year.

“It is true that insurance companies don’t have to make a one-time payment in the case of a default. There’s a lot of factors at play, such as exposure in terms of maturity and what’s their earnings potential, which could help offset some of the impact,” Mr Ryon said. “But the real problem here is the order of magnitude of the situation in Puerto Rico: several times bigger than what we’ve seen in Detroit.”

Assured said last week that it had cut its exposure to Puerto Rico by 17 per cent annually since 2010 and that it believes the territory was making strides to improve its finances.

Puerto Rico’s Treasury secretary said on Monday that first-quarter revenue for the fiscal year starting in July beat previous government estimates and rose 5.4 per cent to \$1.7bn. The island had initially estimated its first-quarter revenue would rise 4.4 per cent, missing its budget target.

By Stephen Foley and Vivianne Rodrigues in New York

U.S. States, Local Gov'ts Slow to Post Finance Reports.

Oct 8 (Reuters) – U.S. states and local governments are taking nearly a year to release annual financial statements, according to a report released on Tuesday as federal regulators crack the whip on giving municipal bond investors timely information.

In the first half of 2013, issuers on average posted audited financial statements 339 days after the close of their fiscal years, according to the Municipal Securities Rulemaking Board, the \$3.7 trillion market’s self-regulator.

That is exactly the same as in 2012, a full month longer than it took in 2011 and roughly three times as long as federal securities regulators would prefer. In 2010, the first year the MSRB assembled the data, states and local governments posted audited statements 329 days after the close the fiscal year.

Even unaudited reports are taking longer: 260 days so far in 2013 versus 249 in 2012, 222 in 2011, and 226 in 2010.

Tuesday’s report comes amid a campaign by the Securities and Exchange Commission to push issuers to post current and accurate financial information.

In May the SEC charged Harrisburg, Pennsylvania, with fraud for misleading statements made by city officials about its crumbling financial condition. The regulators said they were forced to use those statements to determine fraud because Harrisburg was remiss in filing annually required financial information.

While there are no federal reporting deadlines, as there are for publicly traded companies, and no

penalties for late filings, the SEC encourages municipal bond issuers to post annual reports within 120 days of the end of their fiscal years.

Still, many issuers do not file audited financial reports until they are preparing a new bond sale, the MSRB report showed. Then they cram in years of information at once.

So far this year, these “catch-up” reports account for about 16.4 percent of the audited financial statements filed, compared with 18.5 percent last year.

Until recently regulators and investors largely relied on a private research firm, Merritt Research Services, to analyze the speed of audits, using its database of more than 8,000 financial reports.

Merritt, which measures the timeliness of reports somewhat differently, recently said that in 2012 the median time for states to turn in audited financial reports was 174 days after the close of their fiscal years, nearly twice the time of their corporate equivalents. For cities, the median was 171 days.

Richard Ciccarone, the firm’s president, expects issuers to speed up annual reports in light of the Harrisburg decision, with the full effects becoming apparent in 2014 and 2015.

Texas Municipal Pension Moves Funds to Loans From Bonds, Equity.

The Texas Municipal Retirement System is investing \$250 million in bank loans as it shifts money from equities and bonds.

Highland Capital Management LP will invest the money for the fund in senior secured bank debt and collateralized loan obligations, said Mark Okada, co-founder and chief investment officer of the Dallas-based investment adviser. Highland, which manages \$17.7 billion of assets, will target large, liquid, high-quality loans, Okada said.

“The floating rate nature of bank loan/CLO debt coupons is particularly attractive in the current low yield environment where the risk is exposure to higher interest rates,” Bill Wallace, director of communications of Texas Municipal, wrote in an Oct. 11 e-mail.

Highland announced it was selected Oct. 8, after the retirement fund’s board of trustees approved a search for managers June 19 to invest as much as \$2 billion in bank loans, CLOs, emerging-market debt and mortgage-backed securities, according to meeting minutes. The \$2 billion, equal to about 10 percent of the Austin, Texas-based pension fund’s \$21.3 billion of assets, was shifted from passive equity and core fixed-income allocations, according to March meeting minutes.

“A lot of conservative pension plans like Texas Municipal have a lot of bond exposure,” Okada said in an Oct. 9 telephone interview. “Now those bonds that have been performing extremely well for them are the problem, especially if rates are going to be rising.”

Two Lawyers Focused on Muni Bankruptcies Hop to Chadbourne.

Two lawyers focused on municipal bankruptcies are jumping firms, as the practice area heats up.

Lawrence Larose and Samuel Kohn are leaving Winston & Strawn LLP to join Chadbourne & Parke LLP as partners.

Larose and Kohn have represented a number of large creditors in municipal bankruptcies, including in the Detroit and Jefferson County, Ala. cases.

“Our municipal bankruptcy expertise will be a new addition to the Chadbourne line up,” Mr. Larose said.

It is possible others from Winston & Strawn may join the two partners at Chadbourne in the future, Mr. Larose said. A Winston & Strawn representative didn’t immediately comment.

The partners give Chadbourne an entrée into an area it’s been seeking to break into for some time, said Howard Seife, global chair of the firm’s bankruptcy and financial restructuring practice. Chadbourne most recently worked on mortgage lender Residential Capital LLC’s bankruptcy in addition to being active in the cross-border bankruptcy space.

“We think it’s an area that will continue to grow,” he said of muni bankruptcies. “There are so many municipalities that are suffering from stress because of diminishing tax revenues, too much debt and the overwhelming obligations of pension funds.”

Larose and Kohn will bring clients with them, including bond insurer National Public Finance Guarantee Corp., a spokesman for the bond insurer said.

In early July, the bond insurer decided to stop using Winston & Strawn for its representation in Stockton, Calif.’s bankruptcy case after Calpers, the public pension fund, complained that the firm recently had hired away attorneys who had access to the pension fund’s legal strategy, court documents show.

Several weeks earlier, a bankruptcy judge disqualified Winston & Strawn from the San Bernardino, Calif., bankruptcy case in light of the same attorney hirings.

Prior to that ruling, Winston & Strawn said in a court document that its “screening procedures are more than sufficient to protect Calpers’ confidences.”

By EMILY GLAZER

California City Prevails Against Investor Lawsuit.

LOS ANGELES — A federal appeals court ruling in a case brought by investors should set a favorable precedent for municipal bond issuers, said an attorney who handled the case for the city of Alameda, Calif.

In September, the U.S. Court of Appeals for the Ninth Circuit found in favor of Alameda in a lawsuit brought by Nuveen Investments alleging the firm was misled into purchasing notes issued for the Northern California city’s cable television venture.

A three-judge panel found that securities that trade in inefficient, illiquid markets are subject to the same stringent loss causation rules as exchange-traded securities that trade in liquid, efficient markets such as the national stock exchanges.

Judge M. Margaret McKeown wrote the opinion, issued Sept. 19, affirming the summary judgment ruling against Nuveen by U.S. District Court Judge Susan Illston.

The lawsuit could have wider implications in cases alleging fraud by municipalities, because defaults on municipal bonds have been rare, and therefore little case law exists, said Richard Elder, a partner in Oakland, Calif. law firm Wulfsberg, Reese & Colvig, which represented the city.

It's significant that the Ninth Circuit issued a written decision, because Nuveen claimed that a special test should apply to securities issued in an inefficient market, Elder said.

"It is hard to prove misrepresentation when the trade was made in an inefficient market," Elder said.

In her May 2011 ruling, Illston found in the case of Nuveen Municipal v. Alameda that, according to California securities law, the city is not liable for negligent or intentional misrepresentation by an employee.

California public entities are immune from civil liability under state securities fraud laws, Elder said.

Other states have similar immunity provisions, said Gregory Aker, another Wulfsberg, Reese & Colvig partner who represented Alameda.

On the federal claims, which don't provide immunity to municipalities, the Ninth Circuit court found in its ruling that Nuveen failed to show a link between "the claimed misrepresentations and the economic loss the purchasers suffered when the city sold the cable and Internet system."

Kristyna Munoz, a Nuveen spokeswoman, said her firm doesn't comment on litigation issues such as this.

Aker summarized Nuveen's argument as trying to draw a distinction between "efficient" and "inefficient" markets.

Securities that trade on a national stock exchange daily are seen as trading in a more "efficient market," because it's easier to determine the value of those securities that are traded more frequently, according to Aker.

Under that theory, municipal bond markets would be considered "inefficient," because the securities trade less frequently, he said.

Taking that a step further, Nuveen argued it is easier to show loss causation for securities that trade more frequently, because it is easier to ascribe a market value. In the case of the Alameda bonds, there were maybe a couple of dozen trades in the course of four years, Aker said.

"The importance is that the Ninth Circuit judges said that no matter how efficiently or inefficiently the securities traded, Nuveen still had to prove the fraud it was claiming caused its loss," Aker said.

The case stemmed from Alameda's failed foray into operating a telecommunications company, funded partly by municipal bonds. The utility laid fiber optic lines for cable TV and high-speed internet service.

The city of 75,000 residents in the San Francisco Bay area threw in the towel on its telecom operation in 2008, selling it to Comcast for a price less than what was owed on the bonds that financed it.

Alameda paid the bondholders of the unrated 2004 bond anticipation notes, which financed completion of the system and refinanced outstanding debt, \$15 million for the outstanding principal of \$33 million.

The city claimed that high construction and labor costs and stiff competition from Comcast caused it to sell.

The city launched the cable system in 1998. The project faced financial problems soon after it was completed in 2005 and the city hired a consultant to find ways to cut costs. The cuts resulted in a small operating surplus in 2007, but weren't enough to provide the revenue needed to refinance the BANs when they came due in 2009.

The sale to Comcast, which closed in November 2008, received consent from 95% of noteholders, including Nuveen, with the stipulation that it retained the right to sue the city to recover their losses. The holders of the other 5% were paid in full.

Nuveen held \$20.5 million in face value of the notes, and had received \$6.5 million in interest payments over the life of the notes, according to facts stated in the appeals court opinion.

Nuveen sued Alameda and underwriter Stone & Youngberg in U.S. District Court in October 2008 for \$11 million alleging the city and the underwriter committed securities fraud by concealing information about the true risks associated with the city's cable business. Nuveen held the bonds in two high-yield tax-exempt funds.

The firm also alleged the city issued 2004 notes, which were tied only to the cable revenue, because it feared the terms of the \$16 million in certificates of participation issued in 2000 for the system would allow the lender, Citibank, to seize assets from the city's electric utility to satisfy the debt. Those COPs were paid with the proceeds of the 2004 BANs.

Nuveen's suit also alleged that Stone & Youngberg was aware of Alameda's alleged fraud and provided substantial assistance to advance the fraud.

The underwriter, which had been slated to go to trial in October 2011, five months after Illston ruled in the city's favor, settled with Nuveen in September 2011 for an undisclosed sum.

Nuveen has until Thursday Oct. 3 to ask for a rehearing, either before the three-judge panel that issued the decision or before an 11-judge panel in Ninth District Court. Nuveen could also petition for review by the U.S. Supreme Court.

"We don't think either of those steps have likelihood of success; but they could try those remedies to further appeal the decision," Aker said.

The appeals court did affirm the lower court's denial of Alameda's request that Nuveen pay its defense costs.

by: KEELEY WEBSTER

[Shutdown Halts Rebates on Build America Bonds, Dents Appeal.](#)

(Reuters) - The inability of the U.S. Treasury to send Build America Bond payments to state and

local governments during the federal government shutdown is the latest blow to hopes these securities might grow into an alternative to tax-exempt municipal bonds.

Taxable Build America Bonds, created in the 2009 economic stimulus plan, pay issuers federal rebates equal to 35 percent of the bonds' interest costs. The rebates were so attractive that state and local governments rushed to sell \$181 billion BABs in the 20 months of the program's existence.

When the BABs program expired with the end of the stimulus plan, issuers pushed to bring it back or create a similar form of taxable debt with rebates, often also called "direct-subsidy."

Since the government shutdown began on October 1 because of a budget impasse in Congress, all tax refunds have been halted, including BABs rebates.

It is the latest complication to make issuers skeptical of proposals for new direct-subsidy bonds because many say the bonds entangle state and local governments in federal budget fights that jeopardize their funds.

The across-the-board spending cuts known as sequestration that started this spring sliced into all BABs rebates. Issuers had believed rebate amounts were guaranteed and were dismayed to find they could shrink. On Monday, the day before the shutdown began, the Internal Revenue Service said that year-two sequestration cuts would trim BABs payments by 7.2 percent.

"We've already gone through this drill with sequestration," said Chris Mier, managing director of analytical services for Loop Capital Markets, about the suspension of rebates.

The Government Finance Officers Association, the largest organization representing issuers, could not say how many issuers were expecting rebates during the shutdown. There is no central calendar of BABs interest payments or rebates. Recent IRS statistics show that in 2010, the last year data is available, issuers received \$1.78 billion total in BAB rebates.

About 90 days before an interest payment is due, an issuer formally requests the rebate and then receives it typically 30 days before the payment date, according to Utah Treasurer Richard Ellis.

Like many issuers, Utah does not use the rebates to cover its interest payments due in January and July. It has set aside enough funds for interest costs and then treats the rebates as additional revenues, said Ellis.

Most at risk from the suspension would be to small issuers such as remote school districts that also apply the rebates to the interest payments and have payments due soon, Loop Capital's Mier said.

President Barack Obama has pushed for an alternative to traditional tax-exempt municipal bonds, arguing they cost the federal government more than they benefit local governments. Obama has suggested creating more direct-subsidy debt programs and also capping the tax exemption on municipal bonds, which would drive down the demand for them.

Richard Ciccarone, a managing director at McDonnell Investment Management, said the current payment suspension shows direct-subsidy bonds make states and cities too dependent on the federal government.

Issuers should see "they have a strong interest in preserving the current tax-exemption structure," he said.

Asked if he would ever push for Utah to issue direct-subsidy bonds should they reappear, Ellis, the

state treasurer, said: "I wouldn't."

Detroit Bankruptcy Could Change Municipal Market, Chicago Fed Says.

Detroit's historic bankruptcy filing could upend long-established market views on the high standing of general obligation bonds, the form of debt sold most frequently in the U.S. municipal bond market, Chicago Federal Reserve Bank researchers said Friday.

The city's move in July to seek protection from creditors so far has had only a modest effect on the overall muni market, apart from driving up borrowing costs for issuers in Michigan.

But how the bankruptcy court rules on the treatment of different debt classes could profoundly alter market perceptions of their risk, particularly for issuers with mushrooming pension obligations like Detroit's, two of the bank's economists wrote in a monthly research note, the "Chicago Fed Letter."

A key issue in the city's pending Chapter 9 bankruptcy is whether Detroit's state-appointed emergency manager, Kevyn Orr, may treat certain general obligation bonds as unsecured debt on a par with its pension obligations, and repay them at just pennies on the dollar.

General obligation, or GO, bonds have long been viewed as the muni market's gold standard, and none of the handful of municipal bankruptcies since 1970 has resulted in a writedown of GO debt. Since 2003, GO bonds accounted for nearly 60 percent of new debt deals in the \$3.7 trillion muni bond market, where cities, states, hospitals, school districts and others raise cash for capital projects and other needs.

Orr's proposed cuts to retirement benefits, which are being challenged in the bankruptcy case by labor unions, retirees and pension funds, conflict with strong protections in the Michigan Constitution against impairing those benefits.

The judge in the Detroit case has not yet determined if Detroit is eligible to formally enter bankruptcy protection, as hearings in that phase begin later this month.

A successful challenge by unions and retirees, on the basis of the U.S. Constitution's Tenth Amendment regarding states' rights, could impact the pricing of bonds issued by cities with large unfunded pension liabilities, according to the Fed report.

"If the court agrees with pension creditors that state protections hold supreme, this could change market expectations with respect to the relative standing of municipal debt issued by cities located in states with such protections," the Fed report said, pointing to Chicago, Los Angeles, and New York City.

Overall, large U.S. cities in a recent Pew study have funded only 57.5 percent of the \$511.2 billion of retirement benefits they promised.

Orr has lumped about \$411 million of unlimited tax GO bonds into the unsecured debt pile even though Detroit voters approved a special property tax levy to pay off the debt.

That pile also includes limited tax GO debt, secured only by Detroit's general fund revenue, and pension debt - neither of which was approved by voters.

"This issue will be ultimately settled by the court, and it might have wide-reaching consequences for the pricing of voter-approved GO debt," the report said.

Detroit defaulted on its "unsecured" GO bonds this week by skipping debt service payments due on Tuesday.

Stockton Proposes Bankruptcy Exit Plan.

Stockton, Calif., released a draft of its plan for exiting Chapter 9 bankruptcy, which it expects to file in federal bankruptcy court in early October.

"The plan is a Spartan one," the draft said. "It returns the city to financial and public service provider solvency, but, in the absence of agreements with city creditors whose obligations are secured by leases of city real estate, the plan includes the potential loss of city control of certain city properties."

The city disclosed a preliminary deal with bond insurer National Public Finance Guarantee about \$88 million of outstanding bonds insured by the guarantor.

The city agreed to resume lease payments on \$45.1 million of NPFG-wrapped obligations for the city's sports arena, and \$43.7 million of debt secured by parking garages, thus guaranteeing continued city control of the properties, according to the draft plan.

"We're pleased to have reached a settlement agreement with the City of Stockton that should expedite its exit from bankruptcy," said Kevin Brown, a spokesperson for National.

However, the draft plan says Stockton is still negotiating with Assured Guaranty over \$124.3 million of insured pension obligation bonds, which are unsecured.

"As this document was being finalized, the city was in negotiations with this creditor and had developed the outlines of a negotiated settlement," the draft said.

A spokesperson for Assured declined to comment.

Stockton said it had not reached an agreement with Franklin Advisers, Inc., Franklin High Yield Tax Free Income Fund, and Franklin California High Yield Municipal Fund, which together own around \$35 million of the city's lease revenue bonds.

Prior to releasing its plan, Stockton had negotiated with 18 sets of creditors, including bondholders. Those include its employee unions as well as other stakeholders Dexia Credit Local, Union Bank and the U.S. Department of Housing and Urban Development.

"If agreements are reached with Assured and/or Franklin, Stockton might avert a fight over whether the plan is 'fair and equitable,'" according to a Municipal Market Advisors report written by managing directors Matt Fabian, Lisa Washburn, and Bob Donahue. "This could mean that the relative priority of [the California Public Employees' Retirement System] in a Chapter 9 bankruptcy may remain murky since it would not be subject to a court decision."

They added that the plan's release could be a nudge to help ink settlements to speed the process to exit bankruptcy.

"The plan contains a placeholder for a confirmation hearing in 2014, which would put the city on track for a relatively quick emergence from Chapter 9," MMA analysts said.

National and Assured previously led efforts to keep the city's bankruptcy case from moving forward, contending that bondholders should not be lower in seniority to pension liabilities.

Stockton's draft plan will not impair the city's obligations to CalPERS for pensions.

"The maintenance of pensions is critical to the city in order to retain employees — particularly police officers — rather than losing them to other local governments, all of which have defined benefit pension plans, and the overwhelming majority of which have pension plans administered by CalPERS," city officials said in the draft plan.

The plan will, however, impair retiree health benefits. Claimants will be paid a portion of their claims equal to the unsecured claim payout percentage of 0.94796%. Current employees of the city also agreed to forgo health benefits in retirement, which reduces their post-employment benefits by 30% to 50%, the city estimated.

The loss of retiree health benefits, wiping out the city's obligations after the settlement payout, is a substantial concession of approximately \$1 billion, the draft said.

"By continuing to fully fund its pension obligations, Stockton has both acted in accordance with applicable constitutional and statutory law and acknowledged the importance of a secure retirement to its current employees and retirees, and the positive impact that pensions have on recruitment and retention of quality public servants," CalPERS said in a statement. "We look forward to working with the city as a valued CalPERS employer as the City moves forward toward a healthier future."

The plan depends on the passage on November 5 of a ballot measure to impose a 3/4 cent sales tax increase, the city said. If the measure fails, the plan's projections will not be achievable.

"Not only will the city be unable to fund the plan, but it will be unable to pay its current operating costs," the draft said. "The result will be further and significant staff and service reductions, reaching across virtually all city departments."

The Central Valley city of 300,000 declared bankruptcy in June 2012, after struggling to recover from the housing downturn and years of fiscal emergencies. As a result of prior poor fiscal management, overspending on construction projects, the economic downturn and resulting decline in home values, and lower tax revenues, the city had virtually no general fund reserves.

In the past three years, the city has cut its general fund workforce by 30%, reduced compensation by \$52 million and cut staffing and service levels by \$38 million.

Stockton released its proposed bankruptcy exit plan on its website on Friday. It will hold a press conference on Tuesday to provide further information on its plan of adjustment and answer questions about the bankruptcy process. The city council will take up the draft in a special meeting on October 3.

The council must authorize City Manager Bob Deis to file the plan in court, where it must then receive approval from U.S. Bankruptcy Judge Christopher Klein.

Incoming NABL President Details Group's Agenda.

The National Association of Bond Lawyers is working on projects aimed at shedding more light on the varying strength of general obligation bond pledges, as well post-issuance tax and disclosure compliance, NABL president-elect Allen Robertson said in a recent interview.

Robertson, an attorney at Robinson Bradshaw & Hinson in Charlotte, N.C., will become NABL's new president Wednesday afternoon at the group's meeting in Chicago. He will replace Scott Lilienthal, a partner at Hogan Lovells US LLP in Washington, D.C.

The projects are part of NABL's ongoing efforts to provide education about tax, securities and bankruptcy issues in the wake of major Securities and Exchange Commission and Internal Revenue Service regulatory and enforcement actions and market events.

The project on GO bonds, he said, is "in large part because of a recent spate of Chapter 9 bankruptcies and some of the ways that GO bonds and/or revenue bonds have been treated or proposed to be treated in those Chapter 9 cases."

Investors in Detroit's GO debt have been grappling with the prospect of getting back only a fraction of their money following the Motor City's bankruptcy filing in July. GO bondholders often assume the debt they hold will be the most senior obligation of a municipality, but not all GO bonds are actually created equal.

"We know, from state to state, that we have GOs that are backed up by the taxing power and some that are not, and even within the ones backed by the taxing power, sometimes it's an unlimited pledge of the taxing power and sometimes it's a limited pledge of taxing power," Robertson said. "We think that finding the right examples from various states - it might be four or six or eight or 10 examples - we can help point out the various characteristics that GOs might have."

"We're not going to undertake a 50-state survey," he added. "But we want to provide enough examples to help our members and others who would read the paper to get a flavor for that. To get a sense of the range of the possibilities" of how they might be treated in bankruptcy filings.

The project is headed up by Dee Wisor, a partner at Sherman & Howard LLC in Denver. Robertson says he hopes the project will be completed before next year's Tax and Securities Law Institute is held in March.

NABL is also working on post-issuance compliance initiatives, because the IRS and SEC have been emphasizing, in audits and enforcement cases, the importance of issuers having policies and procedures for complying with the tax and securities laws, he said.

"We are working with the [Government Finance Officers Associations], at their suggestion, on a joint project to explore bond tax post-issuance compliance procedures," Robertson said. "The goal of that project will be to analyze everything that we've heard and read from the IRS on that topic and try to explore it and make as much sense of it as we can for the benefit of both GFOA members, that is issuers, and NABL members who are bond lawyers."

The idea is for the project to produce, not a checklist, but a paper that can be used to craft a set of procedures tailored to a specific issuer, "recognizing there's going to be differences in the resources and the ability of various issuers to undertake post-issuance compliance," he said.

Kimberly Betterton, with Ballard Spahr LLP in Baltimore, is heading up the project, which is just

getting started, according to Robertson.

Post-Issuance Disclosure

NABL will be making a similar effort on post-issuance disclosure on the securities law side, he said, aiming to provide an educational resource that could prove useful for bond lawyers and their issuer clients.

“When you look at recent SEC enforcement actions, one of the themes that comes out of those is that many problems in the enforcement cases presumably could have been avoided if the issuer had disclosure policies in place that it followed,” Robertson said. “And we know that’s one of the ways the SEC has resolved enforcement cases in recent years is by requiring the development of disclosure policies and engaging consultants to help develop those policies and monitor them.”

That project, which is being led by Dan Deaton, with Nixon Peabody LLP in Los Angeles, has been underway for some months and should be done sooner than the post-issuance tax law compliance project, he said.

Asked about NABL’s other key areas of focus, Robertson said, “On the tax front, our number one task will be to continue to monitor any proposed changes to the muni bond interest exclusion, whether that would be a possible outright appeal or a proposal to cap the exclusion.”

President Obama has proposed capping the value of tax exemption at 28% cap repeatedly, though market participants have warned that would effectively impose a tax on tax-exempt bonds.

Also, he said, “We are already trying to work with legislative and regulatory officials on some guidance about what constitutes a political subdivision” that can issue tax-exempt debt.

The question stems largely from a dispute between the IRS and the Village Center Community Development District, a Florida retirement community empowered by state law to collect fees and issue bonds. In May, the IRS chief counsel issued a [technical advice memorandum] that concluded the CDD does not qualify as a political subdivision, and therefore could not issue tax-exempt bonds, because its board is, and will always be, controlled by the developer rather than publicly-elected officials.

NABL and others, including some lawmakers, have suggested the TAM may depart from existing rulings and guidance and could adversely affect similar types of structures and bond transactions around the country. Both Sen. Bill Nelson, D-Fla., and Rep. Rich Nugent, R-Fla., have urged the Treasury to reconsider its decision.

An IRS official told Nelson that the Treasury was not considering further guidance on whether CDDs are political subdivisions. However, the Treasury and IRS recently added this project to their regulatory priorities for 2013-2014.

Robertson said NABL’s efforts will focus on bringing clarity to the question. “We hope to do something there one way or the other constructive to, from our point of view, come back to what we thought was a fairly well understood view of the law on that topic,” he said.

Issue Price

NABL is also studying proposed changes to the arbitrage rules released by Treasury and the IRS, particularly those regarding issue price, which is used to determine compliance with arbitrage rebate and yield restriction requirements. Under the current rules, the issue price for each maturity

of bonds publicly offered is the first price at which a substantial amount of the bonds is reasonably expected to be sold to the public, with substantial defined as 10%.

The proposed rules eliminate the reasonable expectations standard and require issuers to look at the actual prices at which their bonds sold. They also expand a substantial amount to mean 25% instead of 10%.

"I think we're trying to understand them and how they would work," Robertson said. "Again, our role would be to try to help provide objective and technical analysis. Where we see issues that could be problems, or issues with administrability, we want to point those out."

"You know, we've been able to, based on the reasonable expectations test, determine yield for arbitrage purposes at the time of pricing, which is typically, in a fixed-rate deal, two to three weeks before closing," Robertson said. "With the proposed regulations, it may well be the case that we will not know the final yield on the pricing date. And in fact, we may not know the final yield on the closing date. It's possible we might not know the yield for some time thereafter."

NABL's new president did not set out to be a bond lawyer. After graduating from the University of North Carolina with an economics degree, Robertson graduated magna cum laude from Harvard Law School and began a career in corporate bankruptcy law after joining Robinson Bradshaw in 1989.

"I know I had no idea, no thought of being a bond lawyer at all," he said. "We had real need for additional help in the bankruptcy area when I showed up in the fall of '89, and I had done some projects in that area in the summers here and so sort of got volunteered into that practice. For four years it was really all I could do."

Robertson represented both debtors and creditors, and shifted into leveraged lending work, representing banks providing loans to non-investment grade companies. He said that work was a natural fit for a bankruptcy attorney, but it was not long before another necessity at the firm pulled him into municipal finance.

"One of our partners here in the summer of '94, said 'Gosh, we need a lending person to help us representing banks who provide letters of credit for variable rate demand bonds in the muni market.' So I started to shift over to do that as a lending lawyer and then it quickly morphed into being underwriters' counsel, then bond counsel," he said.

Muni bond work is a "happier set of circumstances" than bankruptcy, Robertson said.

"Obviously in the litigation context and the bankruptcy context, your interactions with your fellow lawyers are much more guarded. You know, you have to be very careful about anything you say, anything you might reveal," he said. "When you work on transactions, you still have to keep your client's confidences and you are negotiating points, but often you're trying to get to a common goal. And there's just much more of a sense of camaraderie there."

Robertson added that he finds bond work rewarding because the impact it makes on a community can be very real.

"Working on public facilities, public projects, with governmental units and with charitable organizations, it has sort of an appeal to it."

CNBC: Issue Municipal Bonds? No Thanks, We'll Crowdfund Instead.

When most towns need trash cans, they use money raised from taxes or municipal bonds. But when a city that emerged from bankruptcy less than a year ago needs trash cans, a touch of creativity is required. That's why Central Falls, R.I., is trying to use a method more commonly associated with Internet start-ups and low-budget movies: Crowdfunding.

In 2011, Central Falls became the only Rhode Island city to ever file for bankruptcy. And while the impoverished 1.2-square-mile city of about 20,000 residents never missed a bond payment, pensions were slashed, and the city budget became very tight. So tight, in fact, that the city couldn't afford to buy trash cans for its public park.

"We have these plastic blue bins that we literally got for free from the state," explained Stephen Larrick, the city's director of planning and economic development. "They're not mounted to the ground at all. So if they're empty, they will just blow over. Or kids will push them over. And the trash gets everywhere."

In addition to being unsightly, the spilled trash increases the city's maintenance costs. And since the cans don't provide a recycling option, Central Falls is also paying more than necessary to landfills, and missing out on a Rhode Island recycling-based rebate.

But due to the city's precarious financial situation, simply buying trash cans proved a daunting task for Central Falls.

"The outlook is bleak to get additional things funded," said Larrick (who is a college acquaintance of the author). "I don't have a line item that would cover that."

That point was emphasized by Len Morganis, the city's administration and finance officer, who is responsible for ensuring that the city abides by its bankruptcy plan. "There's very little discretionary spending," Morganis said. "There is not a lot of room for, 'Hey, this just came up, let's put ten grand towards it.' That doesn't happen."

And the city won't turn to the bond market for additional funding anytime soon. The city hasn't issued debt since the bankruptcy, and according to Morganis, "that's a long way off. We haven't even talked about it."

After all, even though Moody's recently upgraded the city's credit rating from B1 to B2, Morganis said bond issuance "would still be too cost-prohibitive."

So Larrick turned to crowdfunding, and specifically to a new company called Citizinvestor. Its concept is simple: Municipal employees post projects that they are trying to get funding for on to the site. Citizinvestor, which is a for-profit company, increases the total project costs by 8 percent—3 percent for transaction fees, and 5 percent for the company. Individuals then donate online, and their credit cards aren't charged until the project is fully funded.

"We're giving citizens an alternative way to fund projects," explains Citizinvestor co-founder Jordan Raynor. "Government has never had enough resources to provide every good and service that citizens want. This was exacerbated by the recession, but it's always been true."

But while the need was simply for mounted trash cans with a recycling capability, Larrick wanted something more. He wanted the project to "reflect a sense of place or purpose."

He also needed the somewhat-staid municipal project to stoke interest online. So he proposed artistic garbage bins constructed by The Steel Yard, a Providence, R.I.-based nonprofit industrial art firm.

All in all, the project, which would see five creative garbage units installed (each with a bin for trash and a bin for recycling) has a price tag of \$9,300. With Citizvestor's 8 percent added on, the city is trying to raise \$10,044. The project quietly went live on Friday ("Clean up CF: New bins in Jenks Park") and as of Wednesday evening, \$246 has been raised from eight people.

WSJ: Oakland County, Mich., Opts For Private Placement In Wake of Detroit's Bankruptcy.

Oakland County, Mich., a triple-A rated county whose seat is located about 30 miles north of Detroit, privately placed about \$316 million of debt Thursday with Bank of America Corp. instead of selling the bonds to municipal bond investors as originally planned.

The deal, which will refinance debt sold in 2007 that funded retiree medical benefits, will lower the county's interest rate to 3.62% from 6.2%, the county said in a statement.

Bank of America "made us an offer that was acceptable and were able to ensure the transaction was completed by our [fiscal] year end" of Sept. 30, said Robert Daddow, Oakland's deputy county executive. "We had no assurances of completing the transaction otherwise in a timely manner, and in doing so, [it] would have cost us additional underwriting fees."

Detroit's record bankruptcy filing "had no impact on the county's debt offering," Mr. Daddow added.

If Oakland County had proceeded with its original plan to sell the bonds to municipal bond investors, it would have been the biggest debt sale from a Michigan locality since Detroit's bankruptcy filing July 18, according to Thomson Reuters data.

The county had originally planned to sell its bonds to municipal bond investors earlier this month, but delayed the deal because bond offering documents weren't ready.

Oakland's private placement comes as some investors say they are hesitant to buy debt from Michigan local governments because Detroit's emergency manager, Kevyn Orr, has proposed that some bondholders receive steep haircuts. The uncertainty over Detroit debt's value makes it harder to assess the risk of other Michigan debt, these investors say. Michigan localities, such as Genesee County and the city of Battle Creek, have been able to sell debt in recent weeks, but have done so at relatively higher interest rates versus similar debt.

Wall Street Owning Least Since 2002 Speeds Retreat: Muni Credit.

Wall Street securities firms are pulling back from the \$3.7 trillion municipal market at the fastest pace since 1986, helping fuel the worst performance in U.S. local debt in more than a decade.

Brokers and dealers held \$19 billion of city and state debt as of June 30, the least since 2002 and a 39 percent drop from three months earlier, according to Federal Reserve data released Sept. 25. It

was the steepest quarterly decline since 1986 for the tax-exempt market's middlemen, who typically provide a buyer base during times of stress.

The companies have unloaded further since July, even as municipal debt rebounded after the Fed unexpectedly refrained from reducing its monthly bond purchases, data compiled by Bloomberg show. The retrenchment can increase price swings and elevate the yield levels at which certain buyers will emerge, said Peter Hayes, head of munis at New York-based BlackRock Inc. (BLK:US), which manages \$109 billion of local debt.

"When we do see market dislocation, it's probably going to be exacerbated because of the lack of liquidity," Hayes said. "It's going to take a bigger price adjustment or yield movement to attract the value buyer, and for the municipal market, that means the cross-over buyer."

Even with a rally this month, the municipal market has lost 3.3 percent this year through Sept. 25, the biggest tumble since the same period in 1999, Bank of America Merrill Lynch data show. Individuals have joined Wall Street firms in the exodus from local debt, withdrawing a record \$43.7 billion from muni mutual funds in 17 straight weeks through Sept. 18, according to Lipper US Fund Flows data.

"We are looking at a somewhat less liquid market, and I'm not sure that changes just because the market stabilizes," said George Friedlander, chief muni strategist at New York-based Citigroup Inc.

With heightened volatility, brokers and dealers are inclined to thin inventories to lessen vulnerability to munis, said Matt Fabian, managing director of Municipal Market Advisors in Concord, Massachusetts. That inflates the cost of borrowing for states and cities, he said.

"It's the legacy of the financial crisis," Fabian said, referring to the 18-month recession that ended in June 2009. "Munis are more expensive from a risk-management perspective. The main concern would be that if the market does weaken, their cost of borrowing will rise faster."

By one measure, 10-year muni yields have been the most volatile in four years. Ninety-day volatility has approached 40 percent since June, almost double the level at the start of the year, and the highest since mid-2009, data compiled by Bloomberg show.

Localities sold about \$224 billion of long-term debt this year through Sept. 20, the least in two years. Sales this year are about 13 percent less than the same period of 2012, Bloomberg data show.

"Issuance is likely to remain weak or lower through the rest of the year," said Michael Decker, co-head of the Securities Industry and Financial Markets Association's municipal securities division. "So there will be less trading activity and as a result, there will be smaller dealer positions."

The sales calendar remains slower than average. Issuers from California to Connecticut plan to offer \$8.9 billion of long-term debt in the next 30 days, compared with a five-year average of almost \$10 billion.

As borrowings slowed, the municipal market shrank about 0.2 percent to \$3.72 trillion in the three months through June, the Fed data showed. Households owned about \$1.65 trillion of the securities, the least since 2007.

While securities firms and households have been cutting holdings, U.S. banks and depository institutions are buying the most ever.

Banks have added local debt every quarter for the past four years, to about \$390 billion as of June

30, almost double what they held at the end of 2007.

That trend may persist, especially if muni yields stay above interest rates on Treasuries, Decker said.

"Banks are flush with cash," Decker said.

Municipalities plan to issue about \$4.1 billion of long-term debt next week, the slowest non-holiday period since August, even as yields are the lowest since June. At 2.69 percent, benchmark 10-year yields compare with 2.65 percent on Treasuries with a similar maturity.

The ratio of the yields, a gauge of relative value, is about 102 percent, compared with a 10-year average of about 95 percent. The higher the figure, the cheaper munis are compared to federal securities.

By Michelle Kaske September 27, 2013

Debt Ceiling Impasse Would Hurt Muni Issuers - Moody's.

Funding to hospitals, states and other issuers in the \$3.7 trillion U.S. municipal bond market would be jeopardized if Congress does not raise the federal debt limit by the Oct. 17 deadline, Moody's Investors Service said on Monday.

Without a deal on the debt ceiling, the U.S. Treasury will have only \$30 billion every day to pay bills that can sometimes total twice that much for daily expenditures, Moody's said.

That would place even non-discretionary spending on the chopping block, including funding to public finance issuers.

"Issuers would also likely face higher borrowing costs, and market access would be challenging, particularly for issuers with thin liquidity and a need to refinance debt or access the short-term note market for cash-flow purposes," Moody's said in the report.

Most issuers have already prepared, setting aside funds or scheduling payments to protect against possible delays or reductions in federal fund transfer, the credit rating agency said.

Hospitals, especially those that treat many poor patients, would take a big hit because they rely so heavily on federal Medicaid and Medicare revenue.

Children's Hospital Central California, rated A1 with a stable outlook, gets 70.7 percent of its revenue from Medicaid reimbursements - the highest percentage of any hospital. All 10 hospitals that rely the most on Medicaid are children's hospitals, Moody's report said.

Separately, a potential federal government shutdown — which would happen on Monday at midnight if Democrats and Republicans fail to agree on a spending bill - could also hit some muni bonds, though the impact would likely be limited.

Among the bonds most at risk in that scenario are highway and mass transit debt, federal lease financings and military housing bonds, the report said.

Volume Predictions Plunge.

Municipal bond pros are slashing their forecasts for long-term issuance this year, saying the industry is likely to shrink after climbing interest rates curtailed demand for refundings.

Most industry watchers now expect total issuance for 2013 to weigh in closer to \$300 billion, down from totals nearer to \$400 billion that had been predicted as the year began.

BlackRock, which anticipated in January that \$388 billion would reach the market in 2013, has lowered its estimate to \$345 billion. Municipal Market Advisors says 2013 issuance could tumble below \$325 billion, which would represent the second lowest level in a decade. Citi's number falls even lower, at \$320 billion, and that assumes the pace of refundings will pick up.

"We're in a higher interest-rate environment; rate volatility has remained elevated," said Sean Carney, BlackRock's muni bond strategist. "So, issuance will be down. And the two have certainly curtailed the current refundings, either delayed them or shelved them altogether in 2013."

As a result, issuers will not only be less encouraged to start needed infrastructure projects, but the market is likely to contract, Carney said.

"It's still going to be a net-negative year," he said. "We predict the muni market will shrink by \$20 billion in size, which in a \$3.7 trillion market is not huge. But it's the trend that there's more coming out of the market, via calls, redemptions and maturities than bonds coming to the market."

Investors in a market primed for a drop in issuance could weather more outflows from muni bond funds without an appreciable selloff, Citi Municipal Analyst George Friedlander wrote in a research report. "With issuance that much more infrequent," he wrote, "the market may well be in a position to hold in or even rally modestly despite continuing muni fund outflows."

Volume through August has fallen by 12% from the same period in 2012, to \$225.9 billion from \$257.6 billion, Thomson Reuters numbers showed.

Refundings are down 29% over the span, to \$80.5 billion from \$113.3 billion in 2012. New money deals are up 5% through August 2013, to \$100.4 billion from \$96.1 billion a year earlier.

The fall in refunding numbers makes sense, in light of this year's climb from historic lows in muni yields, analysts say. The 10-year triple-A yield has rocketed 117 basis points since the start of May, to 2.83% by Friday's close, according to Municipal Market Data.

The 30-year has surged 160 basis points over the period to 4.39%. The two-year yield has increased to 0.43%, a 14-basis-point rise.

The calendar through August stands at roughly 96% of the year-to-date average for the last four years, Matt Fabian, managing director at Municipal Market Advisors, wrote in a research report. Issuance in 2013 won't reach \$325 billion, should it continue at its current sluggish pace, he added.

"We are thus on track to notch the second lowest year for issuance in the last decade," he wrote, "2011 was the lowest at \$287 billion."

Fewer refundings account for the difference, agreed Fabian, Carney and Friedlander. As issuance fell 38% last month from August 2012, refundings fell 77%. By comparison, new money deals

decreased 7%.

Refis represented a sizable chunk of the calendar in August 2012, at 45%, against 16% of the total last month.

"With yields on the long end at 5% or higher in a number of sectors, and above 4.5% in many more, refundings simply do not make financial sense for a large proportion of potential refunding candidates," Friedlander wrote.

Citi recently fixed its issuance estimate at \$320 billion. But as issuance through August fell more than \$31 billion short of the total for the first eight months of 2012, Friedlander wrote, the current pace of refundings and new-money issuance would bring volume in 2013 to \$308 billion.

Sales in tax-exempts have fallen 15% for the year through August, MMA's Fabian noted. And the whole of that decrease involves credits extending out no further than 15-year maturities.

"Note that, we also show a dramatic drop in advanced refunding economics over the summer, implying no ready uptick in longer sales or pre-re generation," Fabian wrote. "And, of course, new money issuance remains mired at 1997 levels."

Until state and local hiring appears to improve, he expects no real increase in public infrastructure financings.

Munis Extend Biggest Rally Since April on Puerto Rico Purchases.

The \$3.7 trillion municipal-bond market extended its biggest rally since April, with investors buying Puerto Rico, Illinois and California debt ahead of the Federal Reserve's two-day meeting beginning tomorrow.

Yields on top-rated munis maturing in 10 years declined 0.04 percentage point to 2.99 percent at 1 p.m. in New York, the lowest since Aug. 16, according to data compiled by Bloomberg. The tax-exempt interest rate touched a 29-month high of 3.15 percent on Sept. 6 before declining the most in five months.

Dealers today sold bonds from weaker issuers to muni investors at a faster pace than they've bought the securities, according to Municipal Securities Rulemaking Board data compiled by Bloomberg. That includes debt from Puerto Rico, which is on the brink of junk, as well as Illinois and California, the two lowest-rated U.S. states. The MSRB counts all trades over \$5 million as \$5 million transactions.

Even though Treasuries surrendered some of their earlier gains today, "the muni market rallied nicely," said David Manges, muni trading manager at BNY Mellon Capital Markets LLC in Pittsburgh. "This is likely to be a volatile week."

The muni market's rally preceded two days of deliberations by Fed policy makers on whether the economy is strong enough to begin tapering \$85 billion in monthly bond purchases. The \$3.1 billion iShares S&P National AMT-Free Municipal Bond Fund, known as MUB (MUB), rose \$0.58 to \$102.52 at 1:33 p.m. in New York, the biggest jump since July. The price was the highest in a month.

The yield on 10-year U.S. Treasuries fell as much as 0.11 percentage point to 2.78 percent today,

Bloomberg data show. The interest rate has since jumped to 2.86 percent as of 1:25 p.m.

States and localities are set to sell \$4.1 billion in long-term debt this week, the least for a non-holiday week since Aug. 16, Bloomberg data show.

SIFMA: Ending Mandatory Arbitration Will Hurt Individual Investors.

The Investor Choice Act of 2013 is the latest in a series of attacks on securities arbitration at the state and federal level. Introduced last month, the bill would ban broker-dealers and investment advisers from specifying in their agreements with clients how future disputes between them should be resolved, whether by arbitration or in court.

Unlike prior bills, however, this one would destroy the existing fair, well-functioning dispute resolution process by turning it into a lawyers' free-for-all, driven by strategic gamesmanship rather than common sense. The bill would give investors the unilateral right after a dispute arises to force firms into either court or arbitration, or perhaps even both at the same time, depending on where the client's lawyer thought he or she could extract the biggest payday.

Individual investors with modest-size claims in search of prompt, low-cost dispute resolutions could well be sacrificed on the altar of greed if false promises of mind-boggling jury awards led them astray.

Investor choice, much like investment risk, has both upside and downside potential.

One downside is that one person's choice may adversely affect others in a manner that imposes greater burdens and costs on everyone. Another downside is that people may choose incorrectly, leaving them worse off than they would have been if they had followed the time-honored path.

Choice for its own sake isn't always a benefit. The bill is ill-conceived because it assumes that it is.

Perhaps the bill's saving grace is that it is so brazen in its overreach that it actually highlights certain bigger-picture issues and clarifies what "choices" really are at stake.

First, the securities arbitration system works.

There is no longer any serious debate that securities arbitration is faster and less expensive than court and that investors fare well in it, recovering through settlements or awards in the vast majority of cases. The statistics on the Financial Industry Regulatory Authority Inc.'s website bear this out.

The bill's proponents don't seriously contest these points. Arbitrator selection and rulings are consistently fair and transparent.

Multiple regulators oversee the system and maintain its focus on investor protection and fairness. Problems are promptly addressed, and rule changes are approved by a committee of practitioners from all constituencies.

Second, the system is premised on "mandatory" arbitration.

Finra rules grant clients the right to require broker-dealers to arbitrate disputes with them if the clients elect to do so. Firms secure the same right for themselves by including arbitration clauses in client contracts.

Thus most broker-dealer client contracts include arbitration clauses so that all parties know in advance that any dispute that does arise will be dealt with on a level playing field.

If mandatory arbitration is banned, then the Finra rule that compels broker-dealers to arbitrate will have to be re-examined and probably repealed. The Catch-22 is that without the Finra rule and without an arbitration clause in the client contract, both the firm and the client would need to agree — post-dispute — to arbitrate.

That is highly unlikely to happen, because after a dispute arises, tactical considerations for one party or the other will lead to refusals to arbitrate, leaving court-based litigation as the default.

If the bill were to pass, and the Finra rule remained, the Catch-22 for investment adviser clients would become even worse. They would have virtually no access to arbitration, as there is no comparable Finra rule that compels investment advisers to arbitrate at the client's election.

This would create an even more uneven playing field for clients, brokers and financial advisers at a time when harmonization is the stated goal.

Third, the issue is legal parity and fairness, not “investor protection.” The bill seeks to strip firms of the contractual freedom to name a commercially reasonable dispute resolution forum at the outset of the client relationship.

Firms rely on dispute resolution clauses to provide certainty to all parties and to control dispute costs. Without such clauses, dispute resolution would be much more costly and time-consuming for all parties.

Financial services clients don't have a “right” to their choice of dispute resolution forum. When a dispute arises, both parties have legal rights that are entitled to equal protection.

Clients are entitled to adjudicate their claims in a fair forum that provides due process. Both securities arbitration and court afford these same protections.

Finally, unilateral post-dispute client choice generally would be a disservice to investors. If the bill passed, securities arbitration as a fair and effective dispute resolution process would die a gradual but sure death.

Post-dispute choice of forum would be governed by tactical advantage. Court would be the default and the norm, to the particular detriment of investors with small claims or a need for expeditious resolution.

Moreover, parties would be left with a confusing, bifurcated regime where some cases, and perhaps even some claims, went to court and others went to arbitration. The resulting smaller caseload in arbitration would downsize the forum, perhaps drastically, resulting in higher costs and delays for investors.

Investors by their own choice, or on the advice of their lawyers, would inevitably and perhaps frequently choose unwisely by opting to litigate cases and claims that were better suited to arbitration. How many court systems can demonstrate, as Finra can, a track record of concluding cases within an average of 15 months, with most claimants receiving payments in resolution of their claims?

For customers who choose court, their ability to collect a judgment promptly could be compromised. Finra arbitration rules, on the other hand, require brokers to pay awards within 30 days or face

sanctions.

The prospective benefit offered by the bill — granting investors a license to try to game the dispute resolution system to exact their highest return — is grossly outweighed by the costs and inefficiencies that all parties would bear, but none more so than individual investors.

If the arbitration process needs to be changed, as it has been routinely over the years, then reasonable people familiar with the process should sit down and work together to improve it. Such people meet on a regular basis every few months to do just that.

Recklessly destroying the process in the name of “choice” isn’t the answer for investors or anyone else.

Kevin Carroll is managing director and associate general counsel at the Securities Industry and Financial Markets Association.

[NYT: Struggling, San Jose Tests a Way to Cut Benefits.](#)

SAN JOSE, Calif. — This metropolis of nearly a million residents is the third-largest city in California, home to tens of thousands of technology industry workers, as well as many thousands more struggling to get by. Yet even here, in the city that bills itself as the capital of Silicon Valley, the economic tidal wave that has swamped Detroit and other cities is lapping at the sea walls.

San Jose now spends one-fifth of its \$1.1 billion general fund on pensions and retiree health care, and the amount keeps rising. To free up the money, services have been cut, libraries and community centers closed, the number of city workers trimmed, salaries reduced, and new facilities left unused for lack of staff. From potholes to home burglaries, the city’s problems are growing.

“We’re Silicon Valley, we’re not Detroit,” said Xavier Campos, a Democratic city councilman representing San Jose’s poor East Side. “It shouldn’t be happening here. We’re not the Rust Belt.”

The situation in San Jose is not anywhere near as dire as it is in Detroit or two other California cities, Stockton and San Bernardino, already in bankruptcy. But government officials and municipal bankruptcy experts across the country are watching San Jose closely because of a plan to reduce benefits — drafted by Mayor Chuck Reed, a Democrat, and passed by 70 percent of voters in a referendum last year.

The plan is being opposed in court by unions that represent city workers and say it is illegal under state law. It would introduce a second tier for new city employees involving much lower pension and health benefits. It would also alter pension benefits for existing workers, allowing them to choose either a similar, second-tier benefits plan or to pay significantly more out of their own pockets for the benefits they had come to expect.

The outcome of the case is expected to have a major impact on municipal budgets around the state and, perhaps, the country. If a state court rules later this year or early next year that the referendum allows San Jose to alter pension plans for existing workers, and it survives appeals, similar measures are expected to pop up elsewhere.

By pushing the cuts, Mr. Reed joins a small but growing group of Democratic officials, including Mayor Rahm Emanuel of Chicago and the Rhode Island treasurer, Gina Raimondo, who are talking

about altering municipal pension plans in ways that unions do not like, and that Democratic officials have avoided because of their traditional alliance with labor. "I think it needs to be led by Democrats," Mr. Reed said. "It can't become something Republicans are doing to unions."

City unions, led by the San Jose Police Officers' Association, say that by California law, the pension deal in effect when government workers are hired cannot be lowered for the rest of their career. Mr. Reed and his supporters believe that state law, backed by the referendum, allows the city to cut future pensions as long as it does not touch the benefits that workers have already accrued. The mayor has gone forward with the lesser benefits for new employees.

Mr. Reed said he was also contemplating a campaign with other California mayors to mount a statewide ballot initiative for November 2014 that would grant city officials even greater power over pension and health care benefits.

A decision on whether to go ahead with the initiative must be made by early next month, Mr. Reed said.

Even some supporters of Mr. Reed's plan do not blame the workers or the unions.

"These employees did nothing wrong, and their unions did nothing wrong for pushing for these benefits," said David Crane, a lecturer at Stanford University and special adviser to former Gov. Arnold Schwarzenegger on pensions and other issues. "Nobody forced government officials to make these promises and not fund them. And now you have some really brutal things happening to people who had counted on a certain level of retirement."

Staff cuts, lower salaries, uncertainty about their pensions and the threat of having to pay higher contributions for lower benefits are causing hundreds of San Jose officers to try to move to less troubled police departments, union officials say.

"They're kind of encouraging us to leave," said Officer Pete Urrutia.

Officer Steve Gibson said he intends to join the exodus of experienced San Jose officers. "I'm leaving as soon as I get my 25 years in," he said. That will happen in a few months.

Officer Gibson and three others had pulled their patrol cars into the center of St. James Park, on the edge of downtown, following complaints of a fight among homeless people living there.

"What they're doing is destroying what had been a great police department," said Officer Deborah Manion as she oversaw the scene of the dispute.

The impact has been hard on families hit by both lower salaries and possible benefit cuts.

"I have to sell my house," Officer Steve Brownlee said as he directed city workers toward a pile of debris. The only alternative, he said, was to work endless overtime to make up the difference. "I'd rather lose my house than do that," he said.

Cities in California are under particular pressure because it is so difficult to raise property taxes in the state, and because in 1999, at the height of the tech bubble, the Legislature voted for a huge benefit increase allowing, for instance, police officers to retire at age 50 with 90 percent of their salaries.

"We have this all over the state of California," said Karol K. Denniston, a bankruptcy lawyer with the firm of Schiff Hardin in San Francisco, who is advising a number of local taxpayer groups. "There is

growing recognition that there is not enough money to keep doing what they're doing, and something's got to change."

Picturesque, prosperous Sonoma County has cut road maintenance to just \$4.2 million a year to make way for the growing cost of its workers' pensions.

The seaside city of Pacific Grove is considering whether to form a combined fire service with other municipalities nearby.

San Diego, which has been in pension-related turmoil for a decade, has fallen hundreds of millions of dollars behind on its program of fixing roads, sidewalks and storm sewers. Last year, voters there approved their own ballot measure requiring all new city employees, except police officers, to be given 401(k)-style retirement plans instead of defined benefit pensions.

As in San Jose, public employees' unions sued. In March, a state administrative labor-law judge found that the city had failed to bargain as required with its workers. The city went ahead with the ballot-measure change, but the administrative finding portends further litigation.

Mr. Crane blames the political leadership in Sacramento, San Jose and all similarly struggling cities for failing to deal with the pension problem while it was still manageable. Mr. Reed agreed. "I have to accept my share of the responsibility," he said. "There's plenty of blame to go around."

Now, he said, city workers must understand that the 10 percent pay cut they accepted a few years ago, in a previous attempt to right the city's imbalance, was not sufficient to solve the problem and that deep, painful pension and retiree health care changes were needed.

Already, the city payroll has dropped by thousands of workers in recent years — a decline that in the case of the police has been exacerbated by the departure of veteran officers.

"It was pension layoffs," said Sharon W. Erickson, the city auditor. "We had to lay off employees because pensions were going up. The park department alone was cut 47 percent."

Joe Nieto, president of the Plata Arroyo Neighborhood Association in the heart of the city's East Side, said he has definitely noticed the service cutbacks. Vandalism in the neighborhood's park has gotten so bad that he said he has stopped trying to keep ahead of the graffiti that festoons its sprawling skateboard ramps.

"What's the point in cleaning it up?" he said. "It'll look just the same in two weeks' time. The bottom line is that we don't feel as safe as we used to feel here."

No one wants to cut workers' wages and benefits, Ms. Erickson said, least of all Democrats. Providing city services was the reason most Democrats went into government, she said.

"But for every one of us, there was a tipping point," she said. "For me, it was when they announced that swimming pools wouldn't open in the summer. Then you drive around the city, and roads are in abysmal shape."

Police response times for Priority 1 calls, meaning a violent crime that is still under way, have stayed steady, at about seven minutes, Ms. Erickson said. But response times for Priority 2 calls, involving violent but not active crimes, have crept up, and lower priority calls are taking hours and sometimes more than a day to generate a response.

"We have a huge opportunity here to get it right," Ms. Erickson said. "And if we can't get it right

here in San Jose, where can we get it right?"

WSJ: Bond Lawyers Rattled by Proposed Clampdown on Local Borrowing.

Pennsylvania lawmakers are considering a crackdown on local public borrowing that's making bond lawyers nervous.

A proposed package of bills would subject bond deals to greater scrutiny and ban certain types of risky transactions. Lawmakers say the extra oversight of local debt is necessary to prevent another fiasco like the Harrisburg incinerator project that saddled the city with \$300 million in debt. The city filed for bankruptcy in 2011.

Another bill would prohibit counties, cities, school districts and municipal authorities from entering into interest-rate-swap agreements with banks. Municipalities across the country have turned to swaps to cushion themselves from market volatility of floating-rate debt. But critics of such transactions say they are opaque and risky and have often backfired on distressed local governments, including Detroit.

The statute also spells out criminal sanctions against local officials, financial advisers and bond lawyers for making misleading statements in regulatory filings or for executing unauthorized deals.

The broad language has rattled bond lawyers. A representative of the Pennsylvania Association of Bond Lawyers said at a legislative hearing this week that the criminal provisions were "unprecedented" and "have no place in the regulation of local government unit debt."

Federal and state laws already make it a crime for an issuer to lie to investors and regulators, but lawmakers say the bill would encourage local prosecutors to open investigations.

Sen. John H. Eichelberger Jr., the main sponsor of the bills, told Law Blog that the sanctions "would make it clear that those laws apply to financial dealings."

"We think the attorney general has the proper tools to police that now," said Lisa Chiesa, president of the bond lawyers association and a municipal finance attorney.

The association contends that by putting attorneys in the cross hairs, the legislation conflicts with a provision of the commonwealth's constitution gives the Pennsylvania Supreme Court exclusive jurisdiction over regulating the practice of law.

Moody's: U.S. Local Governments Have Little Control Over Pensions.

Many U.S. local governments have large pension liabilities, but few control the management, reforms and investments of their retirement plans, according to a report by Moody's Investors Service released on Monday.

Altogether, an estimated 75 percent of U.S. local government pensions are run through centrally administered plans, such as state "cost-sharing" systems, the ratings agency found in a sweeping survey of the public pension landscape that analyzed 8,000 local governments.

School districts in particular have little pension independence, it added, as all but a handful of school district pensions are run by cost-sharing plans. In addition, more than a dozen states pay part or all of school districts' annual pension contributions.

"The unfunded liabilities of U.S. municipal defined benefit pensions are significant, whether expressed in terms of balance sheet or annual budget," Moody's said in its report.

The aggregate net pension liabilities for the thousands of governments it studied are equivalent to 150 percent of their outstanding direct debt, Moody's found.

In budgetary terms, the approximate median pension liability for the governments is equivalent to 100 percent of annual operations.

State governments have generally received more scrutiny during the heated battles over public employees' retirement benefits.

But the Pew Center on the States at the beginning of the year found the most populous 61 U.S. cities are short by a collective \$99 billion for pensions. The shortfall grew to \$217 billion when other retiree promises, such as healthcare, were added.

Moody's noted "taxpayers can be responsible for the pension obligations of multiple levels of government," which in turn can cloud large aggregate pension exposure. For example, a resident of the city of Chicago could support 16 different pension plans.

Local pensions face other risks, as well, it said, such as exposure to changes in financial markets. Centrally administered plans have been moving out of fixed-income investments and into equities in the search for higher returns.

"In half of the states, many local governments of all types are directly linked to the asset performance of one or two large pension plans," Moody's said. "Management of this market risk is beyond the control of most local governments in cost-sharing plans, where they typically have little if any influence over investment policy or decisions."

As for the subsidies, states frequently pay at least part of pension contributions on behalf of school districts - New Jersey districts do not have to bear any pension costs or liabilities for their schools. The states may cut these payments as they grapple with their own budget and pension problems, Moody's said.

"How likely is the risk that on-behalf payments would be terminated? For many states, it may not be a matter of if but when," Moody's said, noting Maryland recently approved shifting pension costs to local schools.

Without a subsidy, Illinois school districts' unfunded pension liability would rise to more than 30 percent of their budgets compared to 2 percent currently, Moody's found.

However, Pennsylvania school districts' pension burden would double.

Moody's also said there are advantages to centralized plans, mainly in the form of lower administration costs.

Altogether, it found pension contributions may have more bearing on credit quality than local government control.

"A strong history of funding based on conservative financial assumptions confers low risk even if plan types are not conducive to local control of benefits or funding, or if state law constrains the ability to alter benefits," the report said.

Rout Opens Opportunity for Investors Seeking Yield.

The worst rout in the \$3.7 trillion municipal-bond market in more than two years is proving a gift for wealthy investors buying through brokers and professional asset managers who see a chance to make long-term money.

With state and local debt at its cheapest since April 2011, such buyers are grabbing munis with yields at record highs, according to data compiled by Bloomberg. For example, Ace Ltd. (ACE), a Zurich-based property and casualty insurer, increased its muni holdings by 15 percent in the first six months of this year.

Meanwhile, individuals who invest in munis mainly through mutual funds, a strategy that requires less money, have withdrawn the most since February 2011 on concern that the Federal Reserve will scale back bond purchases, sending interest rates higher and eroding the value of the funds.

"It's a fantastic opportunity" as withdrawals force sales by funds, said Peter Kuhn, a 52-year-old business owner from San Jose, California. After investing more than \$1 million in munis through online broker-dealers, Kuhn said he has been buying more in the past two weeks.

One investment — \$250,000 of general-obligation debt issued by San Ysidro School District in San Diego County — will yield almost 7 percent, Kuhn said by telephone. The zero-coupon bonds will pay debt and interest in future years, "and then you get all the tax-free benefits," he said.

Getting Out

Mutual funds holding U.S. municipal bonds hemorrhaged \$24.5 billion over 15 weeks through Sept. 4, the most since February 2011, Lipper US Fund Flows data show. As investors shunned tax-free fixed-income investments, yields on benchmark 30-year munis rose to 4.76 percent yesterday, near the highest rate since April 2011, data compiled by Bloomberg show.

Amid the withdrawals, smaller trades have increased. In July and August, transactions of \$100,000 or less, typically involving individual investors, accounted for 85 percent of municipal-debt trading, according to Municipal Securities Rulemaking Board data. That's the highest proportion of such trades for those two months since at least 2006, the data show.

Other investors adding munis to their holdings include property and casualty insurers such as Ace. The company had \$4.45 billion of the securities, based on fair-market value, as of June 30, compared with \$3.87 billion at the end of last year, regulatory filings show. State and local debt accounted for 7.9 percent of its fixed-income investments, up from 6.8 percent on Dec. 31.

CNA Buying

Stephen Wasdick, a spokesman for Ace, declined to comment on why the insurer has boosted its muni investments.

CNA Financial Corp. (CNA), a Chicago-based insurance holding company majority-owned by Loews

Corp., invested \$500 million in the securities from April through June and may invest \$500 million more before the end of this month, said James Anderson, senior vice president for financial planning. The company tends to buy local debt maturing in at least 20 years, he said.

"The combination of being able to lock in the higher yields for such a long period of time, which matches our liabilities, makes it very attractive," Anderson said.

CNA's second-quarter investments in munis brought its holdings in the securities to \$10.1 billion as of June 30, regulatory filings show.

Muni Magnetism

Buyers of U.S. Treasuries and taxable corporate debt are also investing in munis for their higher relative yields, Justin Hoogendoorn, a managing director at BMO Capital Markets in Chicago, said in a Sept. 4 report. "Our trading desk has seen increased purchase activity from crossover buyers, likely due to these valuations," he said.

The 4.76 percent yield on benchmark 30-year munis compares with an almost 3.9 percent rate for Treasuries with similar maturity, data compiled by Bloomberg show. The ratio of the yields reached 122 percent yesterday, up from about 89 percent on Jan. 3 as muni prices have fallen relative to U.S. government debt. In the past week, that proportion has hovered near a level last reached in December 2011, according to the data.

Negative headlines in recent months have fueled withdrawals from muni-focused mutual funds, Hoogendoorn said. Detroit's record bankruptcy filing July 18 led to delays in bond offerings by Michigan issuers amid concerns that defaults may increase in cities burdened with unfunded liabilities and rising costs.

Fund Drops

The exchange-traded iShares National AMT-Free Municipal Bond Fund fell 9.7 percent from April 30 through yesterday, when it closed at \$101.03 a share, its lowest closing price since April 2011. By comparison, it dropped 12 percent from Sept. 9, 2008, less than a week before Lehman Brothers Holdings Inc.'s bankruptcy filing, to Oct. 10 of that year, when the U.S. announced plans to prop up Wall Street banks by buying shares.

As individual investors see the value of their muni mutual funds decline, they sell to avoid deeper losses, said Ed Reinoso, chief executive officer of New York-based Castleton Partners LLC, which manages \$250 million of fixed-income securities for people with a minimum of \$2 million to invest.

"It's become such a stampede that it's created a real opportunity," Reinoso said. "We've been more active in the past two months than we had been in the last 18 months."

On Aug. 20, Reinoso bought Detroit School District notes maturing in a year with a yield of almost 4.4 percent, about 14-fold more than top-rated munis of similar duration, data compiled by Bloomberg show. The notes, rated SP-1, Standard & Poor's second-highest grade, were issued through the Michigan Finance Authority, to be repaid with state-aid revenue.

It was the first debt sale by a Detroit issuer since the city sought court protection.

Looking Deeper

Looking past the negative headlines and "digging out situations that are extraordinary" gives

investors higher yields on securities with a reliable repayment stream, Reinoso said. Such was the case with the school notes, he said.

"The principal and interest is already funded by the state," Reinoso said. "So you're not buying a Detroit school district, you're buying the state of Michigan."

Reinoso and Kuhn, the California investor, said they are focused on fixed principal and interest payments that they can collect tax-free rather than possible price changes of the debt.

A zero-coupon San Ysidro School District bond rated BBB-, one grade above junk, and maturing August 2034 last traded Aug. 29 with an average yield of about 6.6 percent, data compiled by Bloomberg show. The bonds are backed by Assured Guaranty Ltd. (AGO)

For investors in the highest federal income-tax bracket of 39.6 percent, that's a taxable-equivalent yield of almost 11 percent.

Making Rent

"I view each muni bond that I own as an apartment," said Kuhn, a co-founder of IBP Insurance Services, an employee-benefits consulting firm. "It just pays me every day, every month, every year. If I invest my money prudently and if I can get 6 percent or 7 percent year in and year out, I'm good and I don't have to worry."

In the broader market, states and municipalities plan to offer \$5.5 billion of long-term debt next week, led by a \$758 million New York State Urban Development Corp. personal income-tax revenue deal, according to data compiled by Bloomberg.

At 3.14 percent, yields on benchmark 10-year munis are at the highest level since April 2011. The interest rate compares with about 3 percent for similar-maturity Treasuries.

The ratio of the yields, a measure of relative value, was about 105 percent yesterday, compared with a five-year average of 101 percent. The higher the figure, the cheaper munis are compared with U.S. government debt.

By Michelle Kaske

[Detroit Defends Right to Enter Chapter 9.](#)

Detroit defended its right to enter into bankruptcy Friday in a 135-page court paper that tackles creditors' objections one by one and offers a few glimpses into arguments it may use down the road to justify proposals to cut pensions protected by the Michigan Constitution.

The filing comes ahead of the first hearing in a two-stage trial beginning later this month to determine if the city is eligible to enter into Chapter 9 bankruptcy protection. If approved by the federal courts, the case would become the largest municipal bankruptcy in U.S. history.

Also this week, U.S. Bankruptcy Judge Steven Rhodes, who is overseeing the case, is expected to hear arguments Tuesday about whether Gov. Rick Snyder, the state treasurer and other top officials can be compelled to testify in the case. The unions filed subpoenas requesting their testimony last week. Another hearing is set for Wednesday.

Creditors objecting to Detroit's filing had until Aug. 19 to file objections to the city's eligibility. No bondholders or bond insurers objected.

The city's court documents address the roughly 109 challenges filed by unions, pensions funds, and dozens of individual creditors that range from challenging the constitutionality of municipal bankruptcy to the notion that Detroit is truly insolvent.

"This Chapter 9 case is the city's sole remaining option to address its financial condition and enhance its ability to provide its citizens with core municipal services," the city argues at the conclusion of the filing.

The state also weighed in Friday with a court brief that argues the city is eligible.

Michigan's filing, which came from Attorney General Bill Schuette's office, argues as Detroit does that objections on the grounds that creditors' claims — mostly pensions — will be impaired are invalid, because the city has not yet formally proposed impairing pensions or other debts. Authorizing Chapter 9 itself does not impair pensions, the city argued.

"These are simply steps that begin the bankruptcy process, where pensions may be impaired by order of a federal bankruptcy court at some later date," Bennett wrote.

The challenge is not an obstacle to eligibility, the city and state argued, and should only be considered by the court later in the case, when the city unveils a formal restructuring plan.

Rhodes already appears to agree with that argument, ruling in August that he will not consider any pension-related constitutional challenges as part of the eligibility trial.

To enter into bankruptcy, Detroit has to prove that it is insolvent, that it negotiated in good faith with its creditors or that such negotiations were too difficult, and that it has the authority to file for Chapter 9 under state law.

The city's attorneys, led by Bruce Bennett of Jones Day, argued that it is empowered by the state's law for distressed local governments to file for Chapter 9, and each requirement under the law was met prior to the filing.

The Michigan Constitution does not bar a city from seeking bankruptcy and does not impose any conditions on the city as part of the move, the city contended.

"None of the objections contest any of the foregoing points," Bennett wrote. "Instead, the objectors invent additional requirements, not found in the Michigan Constitution, and then allege that these additional requirements have not been met," the filing says.

On the question of whether Detroit negotiated in good faith or such negotiations were too difficult, which many legal experts expect to be one of the more difficult criteria for the city to prove, attorneys argue that local officials met repeatedly with creditors, that none produced counterproposals to the city's plans, and that negotiating with "more than 100,000 holders" was impracticable.

The unions cannot represent all of Detroit's 20,000 retirees in negotiations — some even refused to do so during negotiations — and the fact that none of the thousands of bondholders objected to the eligibility support the impracticability of negotiations, the city argued.

The court documents devote nearly 14 pages to refuting one of the most surprising and wide-

reaching challenges. The city's largest union, the Michigan chapter of the American Federation of State, County, and Municipal Employees, argued that Chapter 9 violates the U.S. Constitution in part by violating states' rights, and that the bankruptcy court does not have the jurisdiction to decide whether Chapter 9 is unconstitutional.

In response, city attorneys said the question has been settled for more than 70 years and objectors offer no compelling reasons for a fresh look. Further, states preserve their sovereignty rather than relinquish it by seeking the help of federal courts to impair their contracts, attorneys argued.

The documents offer a glimpse of what the city may argue down the road if it unveils a plan that calls for cutting pensions. The so-called Pensions Clause in the Michigan Constitution protects the pensions from impairment by the state, and not necessarily from the federal court, the city argues.

"Instead of adhering to the plain terms of the Pensions Clause that require the state to refrain from impairing pensions, the objectors contend that the Pensions Clause should be read to require state officials to take affirmative steps to prevent even the possibility of the federal bankruptcy court from impairing pensions in Chapter 9. This is not an interpretation of the Pensions Clause but a complete rewriting of it," Bennett argues. "While the state may act as a gatekeeper in determining whether to authorize a Chapter 9 filing, state law cannot alter or override the federal scheme for determining the tools of debt adjustment that a municipal debtor may use once it is in bankruptcy."

Rhodes has scheduled two phases for the eligibility trial.

On Sept. 18 and 19 he will hear arguments over constitutional objections to the bankruptcy, such as whether Chapter 9 is unconstitutional and whether Michigan's law for distressed local governments is valid, among others.

On Oct. 23 and 24 the judge will hear factual objections to eligibility, including whether the city is insolvent or negotiated in good faith ahead of the July 18 filing.

by: CAITLIN DEVITT

Report: Congress Should Be Careful if Changing Tax-Exempt Bonds.

Any reforms made to the tax-exemption of municipal bonds should be "careful and deliberative, particularly in how they treat previously-issued debt," a report from the Committee for a Responsible Federal Budget warned.

But the group also noted that tax reform could allow the federal government to make subsidies to public investments more efficient and to make gradual changes to subsidies that are undesirable. Tax reform also could generate revenue that could be used to reduce tax rates and the deficit, it said.

"The exclusion for interest on state and local bonds is an expensive tax preference that steers investors toward a category of investments that may not otherwise be preferable to unsubsidized investments," said CRFB, a bipartisan nonprofit that educates the public about fiscal issues. "On the other hand, states and investors have come to rely on tax-free municipal bonds as the main way to finance infrastructure. Importantly, whatever the merits of having the exclusion in the first place, there is a \$3.7 trillion market built around the exclusion."

The CRFB's report, part of a series that analyzes and reviews the tax breaks under discussion as part of tax reform, includes a chart with estimates about how much revenue would be generated over 10 years if various reforms were made to the municipal bond tax-exemption.

The data is based in part on estimates from the Joint Committee on Taxation and from private and public groups. It is also based on the CRFB estimates that assume that grandfathering existing bonds will result in 40% as much revenue as applying a reform to all bonds, said CRFB senior policy director Marc Goldwein.

The report said that eliminating the exemption for all new municipal bonds would raise \$200 billion in revenue from fiscal 2014 to 2023, while eliminating the exclusion for all munis would raise \$500 billion during that period.

It also said that capping the value of the exemption at 28%, as President Obama proposed in his fiscal 2014 budget, would result in \$20 billion in revenue in the next 10 fiscal years if applied to new bonds and \$50 billion if applied to all bonds.

Replacing the tax-exemption with a 25% tax credit, like the 2011 proposal by Sens. Ron Wyden, D-Ore. and Dan Coats, R-Ind., would raise \$25 billion in the next 10 fiscal years if required for new bonds and \$60 billion in the same time period if required for all bonds.

The tax-exemption on interest income will cost the federal government \$58 billion in fiscal 2013 and about \$540 billion over the next 10 years, according to JCT numbers cited in the CRFB report.

Tax exemption is the third largest portion of federal aid to states behind federal grants and the state and local tax deduction, the report said.

Supporters of tax-exemption argue that it helps state and local governments make public investments, including those in infrastructure, education and health care. They also warn that making changes to the exemption could result in large disruptions in the muni market and the broader economy and could hurt state and local governments' abilities to borrow money, the report said.

But those who oppose excluding municipal bond interest from income tax believe that the tax code shouldn't be used to support local governments and local projects – particularly those like sports stadiums that have a private purpose and benefit a small number of people, CRFB said.

Opponents of tax exemption also argue that the policy is an expensive and poorly-targeted way to encourage investment in important projects, the report said. They note that the exclusion gives people who want to reduce or eliminate their tax burdens a large benefit, with the tax-exemption being the reason why many wealthy people do not pay any taxes.

Mike Nicholas, president and chief executive officer of the Bond Dealers of America, said the revenue numbers for capping or eliminating the tax exemption mentioned in the report are "greatly exaggerated." He said that investors are dynamic and won't automatically default to investing in taxable bonds if the tax exemption for munis is eliminated.

"They don't make investment decisions in a static environment," Nicholas said.

Additionally, Nicholas said that issuance would be affected by changes to the tax-exemption. When munis are less attractive in the secondary market, borrowing costs will increase and taxes will increase to pay for the rising borrowing costs. Rising borrowing costs will also hurt investment in infrastructure.

“On a net basis, the negative consequences are much higher or worse than the positives of taxing municipal debt,” he said.

Nicholas also noted that municipal bonds are not just held by the wealthy, and that the majority of investors in tax-exempt debt have household incomes below \$250,000.

by: NAOMI JAGODA

WSJ: In Muni-Bond Market, Some Investors Fly First Class.

Municipalities Are Allowed to Treat Large Investors Differently.

On a Friday in late March, representatives of about two dozen investment firms gathered at the New York offices of Barclays PLC to hear Puerto Rico government officials explain why the island’s bonds—recently downgraded to near “junk”—were still a good investment.

The officials told the firms, major holders of Puerto Rico debt, that a controversial pension-overhaul proposal favored by investors would pass the island’s legislature. Some investors also got private meetings with island officials that day, and at least one firm at the event sold Puerto Rico bonds. Slides from the meeting were posted online by the following Monday.

Puerto Rico didn’t break any laws or regulations in holding the meeting, attorneys say. The event highlighted differences in the rules governing how companies and municipal-securities issuers interact with investors.

Securities laws generally require firms to disclose what they say to investors if the information is both material and nonpublic. These regulations don’t apply to municipalities, in part because of concerns about the federal government interfering in state and local affairs.

This exception can give large money managers with access to public officials an edge in the \$3.7 trillion municipal-bond market, according to industry executives and investors.

Puerto Rico’s bonds are down 16.42% this year as the island’s economic outlook has deteriorated. The bonds are on track for their worst year since 2008 when they fell 12.5%, according to the S&P Municipal Bond Puerto Rico Index.

Investors and others have informed regulators including the Securities and Exchange Commission and the Municipal Securities Rulemaking Board about the Puerto Rico meeting, but regulators haven’t said what they have done in response.

Lynnette Kelly, executive director of the MSRB, said the board is concerned about debt issuers disclosing material information to investors selectively.

“The municipal market should...ensure that all investors have equal access to information and that the market operates fairly,” she said.

Unpublicized meetings involving powerful institutions create a “two-tiered market,” said Malcolm Northam, a consultant in the financial-services business who is a former official at the Financial Industry Regulatory Authority, the Wall Street-funded self-regulator.

“That’s not how markets are supposed to work,” Mr. Northam said.

Since the financial crisis, the SEC has ramped up its enforcement of fraud in the municipal-bond market amid concerns about issuers' disclosure practices. The SEC launched a new unit in 2010 to focus on the market and public pensions.

Since then, the agency has filed fraud charges against Harrisburg, Pa., accusing the state capital of making misleading statements about its finances, and against Miami and its former budget director, alleging the city misled investors about its financial health. Harrisburg agreed to settle the charges and didn't pay a financial penalty. Miami has said it would fight the allegations.

The SEC also last year pushed for Congress to give it more authority to oversee municipal bonds. The MSRB, which oversees securities firms, banks and municipal advisers, encourages issuers to post information on its disclosure website.

Investors who attended the Puerto Rico meeting said officials didn't disclose any new information.

Even so, the gathering offered attendees some advantages, including a chance to talk with people in charge of the island's finances and an opportunity to ask follow-up questions. In May, Puerto Rico held another private gathering for some investors on the sidelines of a more-public conference in San Juan.

Other municipalities have hosted investor gatherings in more transparent fashion. Massachusetts says it allows individual investors to attend its annual investor conference.

Puerto Rico's exclusive meeting drew ire from professional fund managers who didn't make the list.

"Why should any one investor have more access to an issuer than another?" said Adam Mackey, managing director of municipal fixed income at PNC Capital Advisors. He wasn't invited.

The meeting came at a crucial time for Puerto Rico, which had struggled through a prolonged recession. Many investors hadn't met officials from the administration of Gov. Alejandro Garcia Padilla, who was elected the previous November. Puerto Rico bonds are widely held, in part because the interest—unlike on most other municipal bonds—is exempt from federal, state and local income taxes, regardless of where the investor lives.

Officials from the Government Development Bank, Puerto Rico's financial adviser, declined to comment about the exclusive nature of the March meeting.

Ron Pearson, a financial planner in Virginia Beach, Va., who has a client with \$1.2 million of Puerto Rico bonds, said he didn't know about the meeting but noticed that his client's Puerto Rico bonds lost 6% of their value in March.

His client continues to hold the Puerto Rico bonds.

"My client is not happy to see his portfolio drop," said Mr. Pearson, a former Navy pilot.

One firm that sold Puerto Rico bonds the day of the March meeting was Nuveen Asset Management. John Miller, co-head of fixed income, said his firm didn't sell the bonds because of what Nuveen heard in the meeting.

He said Nuveen already was looking to trim its exposure to longer-term Puerto Rico debt in a handful of its funds, adding that those funds sold a similar amount of Puerto Rico bonds in the prior week. He also said Nuveen bought shorter-dated Puerto Rico bonds during the same time frame.

“What happened for a long time is that the SEC didn’t pay attention to the municipal market because there were so few bankruptcies and so few problems, and there were so many on the corporate side,” said Andrea Bacon, a public-finance lawyer at Chapman and Cutler LLP.

Many observers said they believe the agency should be looking at the issue of private meetings.

“It certainly would be an issue I would be concerned about if I were still at the SEC,” said Martha Haines, former chief of the SEC’s office of municipal securities.

WSJ: Your City Might Be the Next Detroit...But That’s Not All Bad.

Coming between the bankruptcy in California of Stockton and the looming insolvency of San Bernardino, Detroit’s bankruptcy saga has sent shivers through cities all around America. And on first glance, with good reason. Many municipal governments, like their state and federal counterparts, seem caught in cycles of overspending and undertaxing that have strained their finances and left public pensions in peril and bondholders at risk. At a moment when cities are in many ways like the best bet for the future of political pragmatism and democratic problem-solving globally and locally – the thesis of my new book “If Mayors Ruled the World” — too many are feeling strangled by fiscal constraints and robbed of their democratic autonomy by legal challenges.

With 40% of Detroit’s street lights out, 2/3rds of the parks closed, and 911 call response time nearly an hour, city officials elsewhere are understandably anxious. Stressed federalism has put burdens on cities without giving them the power or resources to lift those burdens: cities have become gargantuan unfunded mandates where much of the nation’s productivity, innovation and prosperity are generated without adequate support from the outside. Why? Because our skewed national political infrastructure – when it functions at all — continues to favor rural regions over cities, even though cities represent over three quarters of the American population and the absolute electoral majority (if every citizen actually voted!)

Nevertheless, the good news is that even if many American cities face the destiny that is Detroit’s today, that is by no means all bad. For even in Detroit, the natural creativity, entrepreneurship and civic resilience that are hallmarks of cities everywhere are much in evidence; whereas the problems are caused by difficult but remediable challenges that are not endemic to the city but a function of larger challenges facing every level of government around the world.

Here are just a few of the key problems, and a suggestion of how cities can deal with them in the promising ways that Detroit itself has already embraced.

DECLINING MANUFACTURING BASE: The outsourcing of jobs to other countries and the decline of American manufacturing is a national not an urban story, and while rustbelt cities such as Pittsburgh, Cincinnati and Detroit must bear the consequences, the problem is not of their making. Moreover, cities have proven more resilient than nations, finding ways to transition from the old to the new economy and allowing the endemic attractions of city life that attract culture, tourism and young people to afford innovation in new areas. Detroit is a new destination for young cultural hipsters and entrepreneurial innovators with bankruptcy being seen as a transition phase on the road to renewal.

STRESSED FEDERALISM AND A TOO NARROW DEFINITION OF CITY LIMITS: Cities like Detroit and other major metropolitan centers often find themselves defined narrowly by maps conceived in the 19th century that do not begin to correspond to the urban regions in which the populations they

serve and the jobs they support are located. In just a few decades, Detroit proper has lost more nearly two thirds of its population (down from 2 million to 700,000) and most of its old economy jobs (though Jefferson North in Detroit sports one of Chrysler's most successful Grand Cherokee Jeep plants.) Yet during the same period the ten counties around the city that comprise the greater Detroit metropolitan region have grown to 5.3 million (with up to 2 million jobs!) and now comprises the fourth most prosperous "new economy" region in the nation after Silicon Valley, San Francisco and New York (see the city's "New Economy Initiative.") If the fit between the real city today defined by all who are served by its resources and public goods, and the much narrower economic base, can be adjusted, the "real" Detroit defined by regional demography, transportation and economics will afford the old Detroit a genuine rebirth.

THE BURDEN OF PENSIONS: Some conservatives claim that the problems of cities like Detroit are created by public employee pensions too rich for the city revenue stream. Yet Detroit's public pensions, (at a mean of \$19,000 per annum), average about one half the cost of those offered in Chicago or L.A. And these pensions are earned by workers in professions crucial to urban life - transportation, education, health, fire and safety. Moreover, in these domains many commuters and suburban citizens receive services they do not pay for because of the federalism issues noted above. Yet the tendency is to put public pension obligations behind obligations to bondholders or even commitments to build sports stadiums. (Detroit has a quarter of a billion dollar hockey stadium pending even as it considers selling off the holdings at the Detroit Institute of Arts). As Bruce Katz (The Metropolitan Revolution) has argued, there is a deep disconnect between the urban public and the urban private, between city government and the city economy. Repair that disconnect, balance government and market needs, and cities thrive.

After all, cities are where civilization began and where democracy was born. As Edward Glaeser has said, we are an "urban species" defined by the kinds of sociability, creativity and interdependence that define our cities. Cities are where we are born and where we die, where we learn and work, pray and play. Mayors are pragmatists and problem-solvers, and urban citizens are innovators and survivors. London, Rome, Alexandria and Boston are much older than England, Italy, Egypt and the United States. And in today's world it is not the US and China that are containing carbon emissions (80% of which are generated in cities) but Los Angeles and Shanghai (by greening their ports), New York (by insulating its old housing stock) and Bogota (by upgrading its public transportation). Organizations like the C-40 Cities and ICLEI are allowing cities to work together to curb emissions, even where states do nothing.

Detroit's fate may in time be Miami's, Atlanta and San Diego's. But that's just fine. John Kennedy once moved the world by saying "Ich bin ein Berliner!" Proud urban Americans can move the nation today by proclaiming "we are all Detroiters!" By embracing Detroit's greatest urban activist, the 95-year-old Grace Lee Boggs, and declaring "I am Detroit!"

[WSJ: Detroit's Woes Add to Angst Over Municipal Debt.](#)

Municipal-bond prices have fallen further than other debt amid rising U.S. interest rates this summer, highlighting investor jitters spurred by Detroit's record-setting bankruptcy filing.

Bonds from some financially troubled issuers, like Puerto Rico and Chicago, have been particularly hard hit. Debt from the Windy City, which was downgraded by Moody's Investors Service last month amid questions about its pension liabilities, now yield about 1.50 percentage points more than a municipal market benchmark, up from about one percentage point in early July, according to Dan

Toboja, senior vice president in fixed-income trading at investment bank and broker-dealer B.C. Ziegler & Co. in Chicago. Higher yields indicate lower prices.

"Credit concerns are front and center in this market," Mr. Toboja said.

The Motor City's case has been particularly worrisome for municipal-bond investors because the city's emergency manager has indicated that bondholders could see significant losses, undermining investors' assumption that states and cities would raise taxes as much is necessary to repay them.

Yields on investment-grade municipal bonds have risen to almost the same as similarly rated corporate bonds. That is a rare occurrence, considering municipal bonds have lower default rates and the interest is generally tax free. As of Tuesday, yields on corporate bonds were 3.37% and yields on municipal bonds were 3.33%, according to investment-grade indexes from Barclays. Typically, municipal bonds yield about 25% less than corporate bonds.

Debt prices in general have weakened since May. The Federal Reserve has discussed slowing its easy-money policies as the economy improves, prompting long-term bond yields to increase. The Fed has been buying \$85 billion a month in Treasury notes and mortgage bonds to stimulate the economy by keeping rates low but could start reducing those asset purchases soon, which could push interest rates higher.

The municipal-market selloff has been steeper, though, thanks in part to Detroit's bankruptcy filing on July 18, which listed more than \$18 billion in obligations and is the largest municipal bankruptcy filing ever. When rates rise, prices on existing bonds fall.

A few Michigan municipalities have decided to postpone bond sales, because investors spooked by Detroit's filing have demanded interest rates that were too high.

Detroit's bankruptcy filing came at a bad time for the municipal market. Investors already had begun pulling money out of municipal-bond mutual funds due to general interest-rate fears, and large outflows have continued after the filing. Over the past 13 weeks, municipal-bond mutual funds that report weekly have seen a net outflow of \$20.7 billion, while investment-grade corporate funds have seen a net inflow of nearly \$7 billion, according to data provider Lipper.

Municipal-fund outflows "tend to pick up momentum when you have negative headlines like Detroit," said Tom Weyl, director of municipal strategy at Barclays. "Certainly, Detroit has added to what was happening already."

The last time municipal bonds yielded almost as much as corporate debt was in mid-2011, after analyst Meredith Whitney predicted hundreds of billions of dollars of municipal-bond defaults. The prediction didn't come true.

Some investors said they are taking advantage of the opportunity to buy municipal debt on the cheap, in part because they believe it remains safe. Specifically, some investors are focusing on municipal bonds issued by public entities but backed by corporations, because those bonds are yielding more than pure corporate bonds issued by the same companies.

For instance, an International Paper Co.-backed, tax-free municipal bond that matures in 2019 traded at a yield of 4.48% on July 24. That compares with a taxable yield of 3.23% on a similarly rated International Paper corporate bond on July 29. The proceeds from the International Paper municipal bond refinanced existing debt that paid for various environmental projects, like improvements to a landfill and pollution control at a paper mill.

Detroit has been worrisome for municipal-bond investors because the city's emergency manager has indicated that bondholders could see significant losses, undermining investors' assumption that states and cities would raise taxes as much is necessary to repay them. A vacant house sits in a once-thriving neighborhood in eyeshot of Detroit's central business district. The General Motors headquarters is in the background.

"The fact that tax-free is higher than taxable and the issuer and credit guarantor are the same is absurd and signifies an inefficient market," said David Kotok, chairman and chief investment officer of Cumberland Advisors. He said tax-free debt backed by Marathon Oil Corp. also was trading with a higher yield than the equivalent corporate bond.

Others, though, are keeping their powder dry. Bill Larkin, fixed-income portfolio manager at Cabot Money Management, said he still is worried that interest rates will rise and said he is sitting on the most cash in his 19-year career.

Although bonds are yielding more now than they were a few months ago, and municipal debt is relatively cheap, rates are still at fairly low levels historically.

"When the tide goes out, there are better places at the beach, but when it comes in, you'll be underwater," said Mr. Larkin, who helps oversee \$500 million.

Write to Mike Cherney at mike.cherney@dowjones.com and Kelly Nolan at kelly.nolan@wsj.com

[Urban Institute: Implementation Evaluation of the Community-Based Job Training Grant \(CBJTG\) Program.](#)

Community and technical colleges are important training providers for the nation, uniquely positioned to develop a skilled regional workforce, but often lack the capacity to respond to the needs of industry. The Community-Based Job Training Grant program, administered by the U.S. Department of Labor's Employment and Training Administration, was intended to address a critical capacity shortage at community and technical colleges to train workers for high-growth occupations to help strengthen an industry's regional competitiveness. The Urban Institute's implementation evaluation provides a comprehensive picture of the grants and discusses innovations, successes and challenges, and trends and patterns across the grants.

<http://www.urban.org/uploadedpdf/412890-Implementation-Evaluation-of-the-Community-Based-Job-Training-Grant-Program.pdf>

[Bonds: Beware This Major Flaw in Moody's Rating System.](#)

The fallout from Detroit's bankruptcy filing has investors - and even ratings agencies - questioning the validity of the bond rating system.

Now investors need to know if it can be fixed in a way that actually helps those investing in general obligation (GO) bonds.

In June, Detroit Emergency Manager Kevyn Orr sent the financial equivalent of a nuclear blast

through the muni bond markets when he stated that holders of Detroit's GO bonds – whose holdings total roughly \$600 million – will be lumped together with other unsecured creditors who collectively account for \$11 billion in city obligations.

Historically, GO bonds were seen as the safest form of municipal debt. That's because historically municipalities would raise taxes, cut services – do anything – rather than force losses on bondholders.

"The bottom line is, Orr said that these bonds are unsecured, which potentially forces a loss on these investments," explains Money Morning Chief Investment Strategist Keith Fitz-Gerald. "If that's the case, then here we go: those formerly secured debts are in fact no safer than junk bonds. Which means, all of a sudden, in the blink of an eye, all the ratings on municipalities everywhere are suspect."

Already under pressure from having misjudged the entire financial crisis, ratings agency Moody's Corp. has proposed changes on how they will rate local governments' GO bonds thanks to Orr's not-so-subtle push.

Moody's suggests doubling the weight of pension debt in the rating criteria from 10% to 20%. It reduced the "economic factors" weighting from 40% to 30%. It also introduced a scorecard for U.S. local governments to boost the transparency of the rating process.

Moody's stated that increasing the emphasis on pension debt will recognize that both pensioners and debt holders have "enforceable claims on the resources of local governments."

But Moody's also stated the modifications likely won't affect a vast majority of the 8,200 local governments that it rates, which begs the question...

How much can investors rely on Moody's rating system?

Bond ratings are supposed to reflect whether or not the issuer will be able to meet payment obligations, but Detroit's bondholders could be left with mere pennies on the dollar – a risk they didn't realize they were taking.

Here's what Moody's is missing – and how you can avoid ratings pitfalls but enjoy bonds' high yield...

Investing in Bonds: What to Do About Ratings

"If there's one thing we've learned from the Detroit failure, it's that the ratings system is absolute crap," says Fitz-Gerald. "Moody's has perpetually underestimated the impact of the most out-of-control aspect of most municipal spending: employee wage levels and pension obligations."

In the past, the wage levels (debt and pension) were at around 10% consideration; upping it to 20% doesn't have Fitz-Gerald convinced the rating system's accuracy will improve.

"I think the percentage should be higher because the municipalities are paying arguably huge pensions," he says. "As long as that's part of the ratings criteria, it seems to me pensions should have a higher weighting when it comes to ratings."

At the same time, Fitz-Gerald still sees the ratings as something investors must consider.

No matter how the agencies ultimately account for municipal liabilities, there is no way around the

system's flaws. According to Fitz-Gerald, Detroit's muni ratings are going to be like "the proverbial canary in a coal mine."

So where does that leave those investing in muni bonds?

Right now, investors can nab many munis at bargain prices. Detroit's bankruptcy thoroughly spooked investors and the muni bond prices plunged.

"I am against conventional wisdom on munis at the moment," says Fitz-Gerald. "They have been beaten down so far that the income is extremely appealing... assuming investors manage the risks appropriately."

That means check the ratings system, but be aware of its limitations. Take a look at the track record, stability, and management tenure before even beginning to consider individual bonds.

"If you're going to pick individual bonds, you want to stick with areas that are generally prosperous and growing, versus areas that are failing," Fitz-Gerald explains. "For example, I wouldn't buy any muni bonds in California right now; on the other hand, as an extreme example, some tiny town in the middle of North Dakota situated in the fracking boom might be a pretty good bet."

Finally, investors absolutely cannot approach blindly when investing in muni bonds, as they might have in the past. Therefore, make sure you're aware of what it is you want to achieve, and the losses you're willing to sustain. This is part of having a carefully planned and structured portfolio.

"The return of your money is much more important than the return on your money in today's market," Fitz-Gerald points out.

Reuters: U.S. Municipal Bond Funds Report 14th Week of Outflows.

Aug 29 (Reuters) - U.S. municipal bond funds reported net outflows \$1.74 billion in the week ended Aug. 28, lower than the \$2.14 billion of outflows in the previous week, according to data released by Lipper on Thursday.

It was the 14th week in a row of outflows, which kept the four-week moving average negative at \$1.52 billion, said Lipper, a unit of Thomson Reuters.

Fears of interest rate hikes and nervousness about credit risk have led to a mass exodus from municipal bond funds, with outflows reaching a record high of \$4.53 billion at the end of June. Detroit, which filed for the largest U.S. municipal bankruptcy in July, added to investors' concerns.

Investors pulled \$335.79 million out of high-yield funds, compared with \$460.03 million the week before. Exchange-traded funds had net outflows of \$24.79 million, after outflows of \$114.85 million the previous week.

During the same week in August last year, municipal bond funds reported \$602.32 million of net inflows, according to Lipper.

In 2013 so far there have only been 11 weeks of inflows, and the string of consecutive outflows, when combined with credit issues, "have resulted in yields that are significantly cheaper than their corporate bond counterparts," according to S&P Dow Jones Indices. The S&P National AMT-Free

Municipal Bond Index, made up of investment-grade municipal bonds, is down 1.68 percent for August and down 5.55 percent for the year to date.

Long-term debt has felt the most strain.

The Vanguard Group's short-term tax-exempt bond fund has posted a year-to-date return of 0.01 percent. In comparison, its long-term tax-exempt fund's return for the year to Aug. 28 is a negative 5.79 percent.

Similarly, PIMCO's fund of investment-grade municipal bonds has had a year-to-date return of a minus 6.99 percent, while its fund focused exclusively on short-term municipal debt has fared better, with a year-to-date return of negative 0.13 percent.

On Thursday, top-rated 10-year bonds on Municipal Market Data's benchmark scale yielded 2.94 percent, and highly rated 30-years yielded 4.45 percent. A year ago, yields were much lower, and prices, which move inversely to yields, higher. Yields on 10-year bonds were 1.75 percent and on 30-year bonds 2.90 percent, according to MMD, a Thomson Reuters company.

Nonetheless, retail interest in buying individual bonds has remained strong. According to BondDesk Group LLC, investors bought five bonds for every two they sold in the week ended Aug. 28, the same as the week before.

Pension Costs Burden Local Government Budgets.

The unsustainable nature of defined benefit contribution plans is the primary budget challenge for local governments even though local revenue growth is improving, Wells Fargo Securities said in a report released Monday.

In its annual local budget outlook, Wells Fargo said the main challenge remaining for local governments is tied to the high costs of their pension liabilities. After peaking in 1997, cash flows for state and local pensions began to slow "nearly in lockstep with the deceleration in the key age ranges for state and local government employees," the report said.

While the Great Recession exacerbated the long-term trend of public pension challenges, the dominant factors relating to problems today for some municipalities relate to the demographic shift in worker composition at the state and local levels, the report said.

"While the more prominent cities of Stockton, Detroit and Chicago are among the severe cases of pension problems, several municipalities have attempted to make progress on pension reform," the report said. "However, in many cases these reforms have been met with court challenges, further complicating the reform process."

Wells Fargo noted that in the past three years there are at least 54 court cases challenging public pension reform efforts that have been brought at the state and local level including in Colorado, Florida, Massachusetts, New Hampshire, Rhode Island and Minnesota.

Given the difficulty of pension reform efforts, Wells Fargo anticipates pension liabilities to be an ongoing budget burden in the next few years.

Local governments in some states also continue to face reductions in state aid. Nearly 30% of total

local government revenues is state aid. While the number of states reducing aid to local governments has declined, the degree of dependence of local governments on state aid is still high and the outlook is closely tied to the stability of state budget situations, the report noted.

“The potential negative effects of the federal budget cuts known as sequestration represent another potential looming cloud over local governments in the year ahead,” the report said.

The main concern for the outlook for state government budgets are metro areas with high concentrations of federal workers. For example, areas with high concentrations of defense-related contractors and the military have the potential to affect sales tax and property tax collections as furloughs weigh on local area income growth.

On a positive note, sales tax collections were up 5.7% over last year’s levels -a sign that some of the job gains in addition to wage and salary growth are tying into local revenue collections.

Wells Fargo expects local sales tax collections to improve at a modest pace over the coming year with retail spending hovering around 4.5% through the end of the year before accelerating to 5.5% by the end of 2014. Retail sales should rise to 5.1% in calendar year 2014 up from 4.3% so far observed this year.

The stronger pace of job growth over the past few months has helped stabilize local sales tax collections.

Texas holds four of the top 10 major cities for fastest job growth with Austin, Houston, San Antonio and Dallas according to a list compiled by Wells Fargo.

by: JENNIFER DEPAUL

[NACo: Public Prayer, Fair Housing Claims Among Local Issues on SCOTUS Docket.](#)

The next U.S. Supreme Court term is already shaping up to be an important one for local governments, and the court is likely to accept some 30 more petitions before February.

The cases set for argument so far may lack the glamour and media hype of this summer’s rulings on same-sex marriage, voting rights and affirmative action, but they deal with some of the essential mechanisms of local governance across the country.

The highest court in the land has agreed to hear cases affecting local government on everything from legislative prayer and demonstrations near abortion clinics to the proper route for age discrimination lawsuits and federal court abstention. Here are a few cases to watch for next term, which begins Oct. 7, that may have a big impact on local government.

Town of Greece v. Galloway

This could redefine the court’s approach to legislative prayer practices. Under the 1983 case *Marsh v. Chambers*, the court held that a state Legislature could hire a chaplain to deliver a prayer at the beginning of its sessions as long as the practice was not “exploited to proselytize or advance any one, or to disparage any other, faith or belief.”

The Town of Greece, N.Y.'s official policy allows any person of any or no denomination to deliver an invocation at the beginning of Town Board meetings, and the town does not approve or even examine the prayer in advance.

In practice, all but four invocations (two Jewish, one Baha'i and one Wiccan) have been led by Christians.

The court will review a "totality of the circumstances" test employed by the 2nd Circuit to declare the town's practice a violation of the Establishment Clause of the U.S. Constitution and revisit its holding in *Marsh* for the first time in three decades. The case could impact many local governing bodies that begin their sessions with a prayer.

Mount Holly Gardens Citizens in Action v. Township of Mount Holly

The question presented by this case is whether a policy or action (here, a plan to redevelop a low-income minority neighborhood in New Jersey) that disproportionately affects a protected class of citizens without intentionally discriminating on the basis of race or other factors can also give rise to a Fair Housing Act (FHA) claim. Because redevelopment plans frequently, though unintentionally, can have disparate impacts on minorities, Mount Holly could expose cities and other local governments to increased liability.

The court will decide whether the FHA allows plaintiffs to bring disparate-impact claims in addition to disparate-treatment claims. The act makes it unlawful to "refuse to sell or rent . . . or otherwise make unavailable or deny, a dwelling to any person because of race, color, religion, sex, familial status, or national origin." If a person is treated differently on account of a protected status, he or she may sue under the FHA.

McCullen v. Coakley

The court will examine the constitutionality of a Massachusetts law that creates a 35-foot "buffer zone" around reproductive health care facilities which demonstrators are not allowed to enter.

A 2008 case, *Hill v. Colorado*, upheld a similar law against a First Amendment challenge because it: 1) addressed a legitimate state concern for the safety and privacy of individuals using the facilities; 2) was "content-neutral" in that it applied to all demonstrators equally regardless of viewpoint; and 3) regulated the "time, place, and manner" of speech without foreclosing or unduly burdening the right of demonstrators to communicate their message.

A broad ruling by the justices could have sweeping consequences beyond this particular context, since local governments are continually challenged to strike a balance between free speech rights and the duty to protect their citizens from harassment at clinics, funerals, political events and other locations. The State and Local Legal Center (SLLC) will file an amicus brief in this case.

Madigan v. Levin

Harvey Levin claims he was fired from his job as an assistant attorney general in Illinois for being too old. In *Madigan v. Levin*, the Supreme Court will decide whether he and others like him must follow the procedures of the federal Age Discrimination in Employment Act (ADEA) before initiating a lawsuit, or whether terminated employees may go to court directly under the Fourteenth Amendment and Section 1983 of Title 42 of the U.S. Code (42 U.S.C. Section 1983). The ADEA contains a comprehensive scheme that requires potential plaintiffs to file a complaint with the Equal Employment Opportunity Commission, which will attempt to resolve the issue informally before the former employee can sue. A Section 1983 claim would circumvent this process and end up costing

employers, including local governments, substantially more time and money.

Sprint Communications Company v. Jacobs

This case arose out of a telecommunications dispute in Iowa. Sprint refused to pay another company's intrastate access charge for a service and asked the Iowa Utility Board (IUB) for confirmation that it was under no obligation to do so. The IUB ordered Sprint to pay, and Sprint challenged the IUB's decision in U.S. district and state courts simultaneously.

The 8th Circuit ruled that the district court should not hear the case until the state court review of the IUB decision was complete — if at all — citing the so-called "Younger abstention doctrine," which requires that a federal court abstain to avoid interfering with a pending state court case.

The Supreme Court took the case to decide whether it mattered for the purposes of abstention that Sprint initially asked the IUB for approval — a remedial proceeding — or if Younger abstention only applies where the state brings a party before the court or administrative board in a coercive proceeding. Most remedial proceedings happen on the local level and involve zoning variances, the denial of gun permits, and the like. The question is whether a federal court should be able to review this type of decision immediately or whether it should abstain until the state proceedings have ended. The SLLC will file an amicus brief in this case.

By Victor Kessler

LEGAL INTERN, STATE AND LOCAL LEGAL CENTER

WSJ: California Sells \$764 Million in Debt.

California sold \$764 million in debt Tuesday at lower-than-expected interest rates, a vote of investor confidence in the state's improved finances.

Tuesday's sale shows municipal bond-market participants no longer view the state as "a distressed credit," said Dan Genter, president and chief investment officer of RNC Genter Capital Management in Los Angeles, which oversees about \$2 billion in municipal investments. RNC Genter didn't plan to buy any of California's new debt Tuesday, Mr. Genter said, because it could buy the state's outstanding debt at more attractive yields.

California sold its bonds through a competitive process, in which banks bid for blocks of bonds through an auction, then usually reoffer the debt to investors. Citigroup Inc. bought \$249 million of the debt, with bonds maturing in one to 10 years. A 10-year bond had at a yield of 3.41%, lower than the 3.49% at which the state's outstanding 10-year debt traded Monday, according to Thomson Reuters Municipal Market Data.

J.P. Morgan Chase & Co. purchased the remaining \$515 million, reoffering maturities ranging from 11 to 20 years to investors. A 20-year bond had a yield of 4.80%, lower than the 4.86% at which the state's outstanding 20-year debt traded Monday, according to MMD.

"We're extremely pleased with the outcome," said Tom Dresslar, spokesman for California Treasurer Bill Lockyer. "We consider the rates excellent for taxpayers."

The additional yield, or premium, that California offers on its debt compared with triple-A rated

municipal bonds has shrunk over the past year, in light of the state's better finances as well as the passage of an income-tax increase in November 2012, which made the state's tax-exempt municipal debt more appealing. This time last year, the yield premium on 10-year California debt was 0.71 percentage point, according to MMD. As of Monday's close, the premium for the state's 10-year debt was 0.53 percentage point, and in Tuesday's sale, the premium for a California 10-year bond was 0.45 percentage point.

Proceeds of Tuesday's sale will be used for financing new capital projects, as well as to refund older debt with higher interest rates, according to the state treasurer's office. The bond sale comes on the heels of a successful \$5.5 billion short-term debt sale earlier this month, in which California sold notes maturing next year at record-low interest rates for the state. California has ratings of A1 from Moody's Investors Service and single-A from Standard & Poor's Ratings Services as well as Fitch Ratings. One of the municipal bond market's most frequent debt issuers, California last sold long-term debt in April, with a \$2.6 billion deal, according to Ipreo LLC.

The California bond sale comes against a challenging municipal-bond market environment, in which bond prices have generally been falling, thanks in part to Detroit's record municipal bankruptcy filing last month. Concerns about the Federal Reserve reducing its support of the bond markets amid the slowly improving economy have hurt prices across debt markets since May. Investors have also taken a net \$20.7 billion out of weekly reporting municipal bond mutual funds over the last 13 weeks, according to Lipper FMI.

Once a municipal bond market problem child, with delayed budgets and deficits in the tens of billions of dollars, California lately has seen its fiscal picture brighten. The state is no longer the lowest-rated U.S. state, and its credit rating has been raised twice this year, once by S&P in January and by Fitch this month. California expects to end its current fiscal year with a surplus, and for the third year in a row, the state has passed its budget on time.

Furthermore, California's unemployment rate, which was 8.7% in July, dropped over the past year, while its housing market—which took a big hit in the wake of the financial crisis—is on the mend.

[WSJ: Ruling Clears a Path for California City's Bankruptcy.](#)

A federal judge ruled Wednesday that the city of San Bernardino, Calif., is eligible for Chapter 9 bankruptcy protection.

The decision comes more than a year after officials in the southern California city of 213,000 residents about 60 miles east of Los Angeles declared a state of fiscal emergency and filed paperwork for bankruptcy protection.

That filing was the third in a string of municipal bankruptcy filings in California last summer, preceded by the Northern California city of Stockton and the resort town of Mammoth Lakes.

San Bernardino's case is being closely watched by officials in financially troubled cities across the U.S. that are grappling with ways to scale back pension costs.

Last year, San Bernardino officials said the city faced pension costs of more than \$26 million, and that employee costs—including pensions—accounted for roughly 80% of its annual budget.

In an unprecedented move, the city ceased making full payments to the California Public Employees'

Retirement System, the \$254 billion statewide public pension fund known as Calpers, for several months after filing its petition.

City officials couldn't be reached Wednesday afternoon for comment.

Calpers was the sole party objecting to the city's bankruptcy filing. Federal Judge Meredith Jury heard arguments from both sides before issuing a final ruling on the matter.

After hours of argument and discussion, including strong dissent from Calpers attorney Michael Gearin, the judge finalized her ruling in favor of the city's eligibility.

Calpers issued a statement Wednesday afternoon saying it was considering appealing the ruling. In the statement, Calpers promised to work with San Bernardino to "resolve its financial problems," adding that it would also "aggressively pursue all past due contributions," including penalties, from the city.

Once the eligibility ruling is finalized, the city is expected to negotiate with its creditors and produce a bankruptcy plan for the judge to approve.

The economic conditions that have forced California cities toward bankruptcy have eased greatly of late. Housing markets that contributed to the financial troubles of many of the cities are mostly on the rebound.

NYT: When Lenders Are Not Paid Back.

Much of the lending done in the United States relies on having both collateral and contractual obligations (loan covenants) that together provide the lender with assurance that the funds lent out will be repaid. Drivers falling behind on an auto loan, for example, will eventually find themselves without wheels — the car is the collateral. The house is likewise the collateral for a mortgage; lenders can foreclose on borrowers in default, though with rules that differ across states.

In financial markets, borrowers might pledge instruments like mortgage-backed securities as collateral for cash loans, whether for a term of years or just overnight. Rather than putting up physical assets as collateral, governments often instead promise to repay bondholders out of a dedicated stream of income like the tolls on a bridge or out of unspecified revenue from future taxes. The attraction of such collateralized borrowing is obvious for both sides, since the borrower generally can obtain funds at a lower interest rate than with an unsecured loan, in which lenders would typically find themselves back in the line for recovery in a bankruptcy proceeding if the borrower defaulted.

It is not surprising that a financial crisis involving trillions of dollars of bad loans led to legal conflicts and policy debates about the role of collateral and the sanctity of contracts. In several prominent cases, there have been disputes over the ability of lenders to enforce the terms set when the loan was made, including the ability to seize collateral. These include the 2009 automaker bankruptcies, Detroit's municipal troubles and, most recently, efforts to use the process regarding eminent domain to force mortgage write-downs.

These issues involve sometimes difficult trade-offs between the treatment of borrowers facing distress and the potential harm to future borrowers who will find their access to credit constrained if lenders cannot rely on the security of collateral or the sanctity of contracts. The varied resolutions of

these debates over collateral and contracts thus have important economic implications for borrowers of all kinds, including businesses, governments and families, and for the overall economy.

It seems likely that people owed money by the city of Detroit will get less than promised. One of the many interesting elements in the city's bankruptcy proceedings is the treatment of the holders of general obligation bonds, which are \$530 million out of the city's \$18 billion in total debt. In the past, this type of municipal bond was considered relatively safe in that the borrowing authority was seen as having an implicit commitment to raise taxes as necessary to pay off the obligation. The proposal from Kevyn Orr, Detroit's emergency manager, however, would have these bonds paid back at only 20 cents on the dollar.

With Detroit city services already threadbare, and with Mr. Orr's bankruptcy proposal foisting losses on retired city workers and current employees through reductions in pensions and other benefits, it seems only fair for bondholders to share in the pain. This might seem especially the case when much of the loss would fall not even on bondholders, but instead on specialized companies that have collected premiums to provide insurance against just the possibility of such a municipal default.

Bond insurers are likely to file suit, but success by Mr. Orr in upending the heretofore accepted view of general obligation bonds could inflict considerable pain on other municipal borrowers, who might well expect to pay higher interest rates to investors nervous that one day other cities might follow Detroit's example. Indeed, several other cities in Michigan are reported to have delayed their bond sales out of concern over interest rates demanded by investors after Detroit's July 18 bankruptcy filing.

Even before the city's ordeal, the bankruptcy cases of Chrysler and General Motors likewise challenged notions of the sanctity of contracts and the security of collateral, with unintended negative consequences for other borrowers. Along the lines of the proposal by Mitt Romney on Nov. 19, 2008, the Obama administration put the two car companies through a managed bankruptcy with "post-bankruptcy financing" and assurance to "car buyers that their warranties are not at risk." (The quotes are from Mr. Romney's commentary on the Op-Ed page of The New York Times but apply precisely to the Obama bankruptcy plan.)

In carrying out the bankruptcies, the administration gained court approval for proposals that reversed the order of priority of the creditors' claims by giving better financial outcomes to junior creditors like funds controlled by some unions than to more senior creditors like banks that had lent to G.M. and Chrysler and investors who owned the two companies' bonds. Academic research has found that unionized companies faced higher borrowing costs relative to non-unionized companies for a year after the Chrysler bankruptcy filing, presumably reflecting the compensation demanded by lenders to put money at risk of being rearranged to favor the administration's political allies.

This research focused particularly on the financial market impact of government pronouncements and court decisions that were especially relevant to creditors' rights, like the announcement on April 26, 2009, that the government had agreed to give the United Automobile Workers a key stake in Chrysler even before striking a bargain with the more senior lenders, and the May 5, 2009, court decision that challengers to the bankruptcy proposal could not remain anonymous.

Other research has looked instead at the impact of announcements that revealed that the two companies would be bailed out and finds no evidence of an impact on borrowing costs. This differing result makes sense: lenders to G.M. and Chrysler might well have been heartened by the possibility that TARP funds would be used to prop up the two companies, since this could make it more rather than less likely that their loans would be repaid. Only the specific events that threatened the collateral or contracts would be expected to indicate concerns on the part of creditors.

The negative effects from the bankruptcy travails of the two auto companies and the home of their headquarters are relevant for the city of Richmond, Calif., which has sent letters to lenders offering to buy the loans on 624 homes at discount, with a looming threat to use eminent domain powers if the financial companies controlling the mortgages do not go along. Working with the firm Mortgage Resolution Partners, Richmond seeks to reduce the principal balance of the mortgages it acquires and allow homeowners to refinance into loans with lower payments with the aim of helping some families avoid foreclosure.

The idea behind the eminent domain proposal is that the mortgages involved are at considerable risk of default and are properly valued at a discount reflecting the costs involved with the foreclosure process; the threat of eminent domain is thus meant to prod a lender into accepting reality by writing down the loan to its fair value. The difficulty, of course, is determining this fair value. Many borrowers whose loans are involved in the Richmond proposal are actually still current on their mortgages. A lender might hesitate to take a write-down on a loan that so far is paying off.

Richmond faces a number of lawsuits seeking to stop its use of eminent domain, while the Federal Housing Finance Administration put out a statement indicating that it could order Fannie Mae and Freddie Mac to cease doing business in areas “employing eminent domain to restructure mortgage loan contracts.” The Obama administration has stated that it is not clear that mortgages seized through eminent domain would qualify for refinancing through the Federal Housing Administration. With Fannie, Freddie and the F.H.A. together covering around 90 percent of new mortgages, a lack of access to these sources would greatly reduce the availability of mortgages for homeowners in Richmond.

Without government-supported financing, people seeking a mortgage in Richmond would need to find a bank willing to make them a loan and hold it on the bank’s balance sheet. It could be quite difficult to get a mortgage in a locale that uses the eminent domain power, since lenders will naturally hesitate to hold housing credit risk when there is uncertainty about the ability to collect on the collateral by foreclosing on a delinquent borrower rather than writing down the mortgage.

An important reason that mortgage rates are lower than interest rates on auto loans and credit cards is that a home provides reasonably good collateral for the lender (even when it can take years in some states to foreclose on residents who stop making mortgage payments). Use of eminent domain to seize mortgages could change this, just as other developments that weakened the value of collateral in the auto industry or the understanding of loan provisions in municipal finance have had unintended negative consequences for other potential borrowers.

If the effort in Richmond succeeds, the 624 homeowners involved and more in other cities that use the eminent domain approach will benefit from lower payments (and the investors in Mortgage Resolution Partners will see a payoff), but potential home buyers nationwide will be examined with a more jaundiced eye from their lenders than is now the case. Indeed, the reaction of financial markets to the Chrysler bankruptcy suggests that favorable court rulings or other such tidings could lead to higher mortgage interest rates nationwide even before the final outcome is known on the legality of this use of eminent domain.

Just as other municipalities in Michigan are finding it more difficult to borrow in the wake of Detroit’s proposal to change the historical understanding of its bond obligations, so too might American families face a steeper challenge as they look to become homeowners if lenders cannot count on homes’ standing as collateral behind mortgage loans.

By PHILLIP SWAGEL

Phillip Swagel is a professor at the School of Public Policy at the University of Maryland and was assistant secretary for economic policy at the Treasury Department from 2006 to 2009.

NYT: Squirrel Power!

Some say the world will end in fire. Some say ice. Some say coordinated kamikaze attacks on the power grid by squirrels. At least, some have been saying that to me, when they find out I've spent the summer keeping track of power outages caused by squirrels.

Power outages caused by squirrels are a new hobby of mine, a persnickety and constantly updating data set that hums along behind the rest of my life the way baseball statistics or celebrity-birthing news might for other people. It started in April, after I read about a squirrel that electrocuted itself on a power line in Tampa, Fla., cutting electricity to 700 customers and delaying statewide achievement tests at three nearby schools. I was curious, just enough to set up a Google news alert: squirrel power. But as the summer progressed, and the local news reports of power outages caused by squirrels piled up in my in-box, my interest in power outages caused by squirrels became more obsessive and profound.

I know: it's hard to accept that a single squirrel can disrupt and frustrate thousands of people at a time, switching off our electrified lives for hours. But since Memorial Day, I've cataloged reports of 50 power outages caused by squirrels in 24 states. (And these, of course, are only those power outages severe enough to make the news.) Fifteen hundred customers lost power in Mason City, Iowa; 1,500 customers in Roanoke, Va.; 5,000 customers in Clackamas County, Ore.; and 10,000 customers in Wichita, Kan. — and that was just during two particularly busy days in June. A month later, there were two separate P.O.C.B.S., as I've come to call power outages caused by squirrels, around the small town of Evergreen, Mont., on a single day.

Squirrels cut power to a regional airport in Virginia, a Veterans Affairs medical center in Tennessee, a university in Montana and a Trader Joe's in South Carolina. Five days after the Trader Joe's went down, another squirrel cut power to 7,200 customers in Rock Hill, S.C., on the opposite end of the state. Rock Hill city officials assured the public that power outages caused by squirrels were "very rare" and that the grid was "still a reliable system." Nine days later, 3,800 more South Carolinians lost power after a squirrel blew up a circuit breaker in the town of Summerville.

In Portland, Ore., squirrels got 9,200 customers on July 1; 3,140 customers on July 23; and 7,400 customers on July 26. ("I sound like a broken record," a spokesman for the utility said, briefing the press for the third time.) In Kentucky, more than 10,000 people lost power in two separate P.O.C.B.S. a few days apart. The town of Lynchburg, Va., suffered large-scale P.O.C.B.S. on two consecutive Thursdays in June. Downtown went dark. At Lynchburg's Academy of Fine Arts, patrons were left to wave their lighted iPhone screens at the art on the walls, like torch-carrying Victorian explorers groping through a tomb.

One June 9, a squirrel blacked out 2,000 customers in Kalamazoo, Mich., then 921 customers outside Kalamazoo a week later. A local politician visited the blown transformer with her children to take a look at the culprit; another witness told a reporter, "There was no fur left on it. It looked like something from 'C.S.I.'" She posted a photo of the incinerated animal to her Facebook page.

When I tell people about power outages caused by squirrels — and trust me when I say that I tell people about power outages caused by squirrels quite often — I wind up hearing a lot of the same

snarky jokes. People say the squirrels are staging an uprising. People say the squirrels are calculating, nut-cheeked saboteurs trying to overthrow humanity. Like the apes in “Planet of the Apes,” or the Skynet computer network in “The Terminator,” the squirrels represent a kind of neglected intelligence that’s suddenly, sinisterly switching on.

Don’t panic, I say. Squirrels have been causing power outages since long before I started cataloging power outages caused by squirrels. (In 1987, a squirrel shut down the Nasdaq for 82 minutes and another squirrel shut down the Nasdaq again in 1994 — a seminal bit of P.O.C.B.S. history that was sometimes noted in coverage of the power outage at the Nasdaq in August, which was a power outage not caused by squirrels. “This is a terrible pain in the neck,” the president of one brokerage firm told The Wall Street Journal in 1994 — which, I’ve found, is still a typical reaction to power outages caused by squirrels.)

Matthew Olearczyk, a program manager with the Electric Power Research Institute, explains that typically a squirrel will cause a blackout by scampering across electrical equipment and touching simultaneously both an energized component, like one of the cylindrical transformers at the top of a utility pole, and a grounded piece of equipment. The squirrel completes the circuit, generating an arc. There is an instantaneous flash of blue light. At its center is the squirrel, combusting. (In one news story, the squirrel was said to make a “popping sound” when it ignited.)

And yet the grid is actually designed to handle this violent interruption. As soon as the dead animal drops to the ground, eliminating the interference, the flow of electricity should resume. But if the squirrel doesn’t fall off the equipment — if its charred carcass is lodged there — the squirrel can trigger a so-called continuous fault, interrupting the restarted flow of electricity all over again. It’s a zombie attack: a lingering, second wave of obstruction. The lights go out when our electrical grid can find no way around this stuck hunk of dead weight that used to be a squirrel.

The aftermath can be gnarly. Often, there are burned-out circuit breakers or other costly, obliterated equipment to clean up or replace. And occasionally, a P.O.C.B.S. will generate an idiosyncratic storm of ancillary mayhem, too. I’ve read about a squirrel that, last February, chewed into high-voltage lines near a water-treatment facility, setting off “a chain of improbable events” that forced the city of Tampa to boil its water for the next 37 hours, and I’ve read about a flaming squirrel that allegedly fell from a utility pole in April and started a two-acre grass fire outside Tulsa, Okla.

Mr. Olearczyk insists that there is no credible way to estimate the number of power outages caused by squirrels nationwide. (He explained that attempting a tally would mean consulting a particular piece of paperwork from every local utility in the country, and that some of those forms might not even have the information I was looking for. Though he told me encouragingly, “You’re after something important, so let us know if you find out!”)

What exists, instead, are only flecks of information, the partial outline of a very annoying apparition. In Austin, Tex., squirrels have been blamed for 300 power outages a year. Other utility companies have claimed that between 7 and 20 percent of all outages are caused by some sort of wild animal, and a 2005 study by the State of California estimated, hazily, that these incidents cost California’s economy between \$32 million and \$317 million a year. Feral cats, raccoons and birds are also nuisances. Last month, reports surfaced in Oklahoma of great horned owls dropping snakes onto utility poles, thereby causing frequent power outages. Still, no one seems to dispute the disruptive primacy of squirrels.

However, Mr. Olearczyk believes strongly that power outages caused by squirrels are on the decline. For at least a decade, utility companies have been tricking out their equipment with an array of wildlife deterrents to combat the problem, like “arrester caps” and “bushing covers,” the Southwire

SquirrelShield, the E/Getaway Guard and free-spinning baffles to make squirrels lose their balance.

The industry has also researched discouraging squirrels by spraying utility poles with fox urine and painting equipment red, though both of these tactics have failed; it's not even clear whether squirrels can see the color red. Some utilities have installed the kind of plastic owl used to keep pigeons off building facades. However, an industry study notes, "one utility reported that the fake owl was attacked by a hawk which in turn caused a substation outage."

AT some point this summer — I think it was around July 31, when just under 13,000 customers got hit by a P.O.C.B.S. in Hendersonville, Tenn. — I found myself trying to imagine power outages caused by squirrels from the squirrels' point of view. So I called John L. Koprowski, a squirrel biologist at the University of Arizona, Tucson.

There have been very few squirrel specialists throughout history. The most accomplished was Vagn Flyger, a University of Maryland biologist who trapped squirrels with a mixture of peanut butter and Valium and then affixed them with radio transmitters; his major contribution to squirrel science was mapping the so-called Great Squirrel Migration of 1968 across the Eastern Seaboard. (Mr. Flyger also liked to eat squirrels.) Mr. Koprowski started studying squirrels as a biology student in Ohio because he needed to study some sort of wild animal and he didn't own a car.

Essentially, Mr. Koprowski explained, power outages caused by squirrels are the product of a cascade of coincidences — of various forces, including basic squirrel behavior, colliding.

Squirrels chew through electrical wiring because the animals are constantly teething. An adult squirrel's incisors never stop growing — they can grow as much as 10 inches per year — and the animals must chew constantly to keep them worn down. Squirrels gnaw or burrow their way into transformers for the same reason they enter rotting cavities of aging trees: hollow spaces offer them den sites and safety from predators. Squirrels break into equipment at substations because the seeds and insects they eat get sucked into that machinery by cooling fans, or are pooled inside by the wind. Mr. Koprowski described the flat tops of transformers as perfect spots for squirrel "basking behavior," when squirrels sprawl out in the sun to warm up, or in the shade to cool down, and also ideal "runways" from which squirrels can start their flying leaps into the canopy.

"Squirrels value many of the same things that humans value," Mr. Koprowski explained. It's why they're among America's most successful synanthropes, what biologists call species that thrive alongside humans, in the landscapes we dominate. The beautiful, shade-producing, property-value-raising trees that we've filled our neighborhoods with, like oaks, walnuts, maples and elms, also produce the seeds, nuts and acorns at the core of the squirrel diet. Thirty-five percent of America's urban areas are now covered with trees, while sprawl and exurban development have pushed homes further into formerly natural areas. Squirrel habitat and our habitat are increasingly converging. And we are only now reaching what may be peak P.O.C.B.S. season. In late August and September, squirrels are both abundant and most active: skittering around, stockpiling food, hustling to get stuff done before winter — more prone to crossing paths with the path of our electricity.

"People are living in areas with higher squirrel densities now," Mr. Koprowski said. It's as simple as that. We're getting in their way, too. It's easy to forget that the party most inconvenienced by a power outage caused by a squirrel is the squirrel that caused it.

What has my interest in power outages caused by squirrels taught me, ultimately? Why do I find power outages caused by squirrels so meaningful?

Naturally, I've been giving these questions some serious thought.

I've come to see each P.O.C.B.S. as a reminder of our relative size on the landscape, recalibrating our identity as one set of creatures in a larger ecology. We are a marvelously successful set of creatures, though. A power outage caused by a squirrel feels so surprising only because we've come to see our electrical grid — all these wires with which, little by little, we've battened down the continent — as a constant. Electricity everywhere, at the flick of a switch, seems like the natural order, while the actual natural order — the squirrel programmed by evolution to gnaw and eat acorns and bask and leap and scamper — winds up feeling like a preposterous, alien glitch in that system. It's a pretty stunning reversal, if you can clear the right kind of space to reflect on it, and fortunately power outages caused by squirrels do that for you by shutting off your TV and Internet.

After the city of Fort Meade, Fla., suffered more than two dozen P.O.C.B.S. in a year, a resident told a reporter: "I just didn't think a squirrel could make the lights go out. They're just tiny little things." A century ago, a shrewd squirrel might have been equally skeptical about our ability to make so many lights go on, watching a few little humans raise the first wooden pole.

By JON MOOALLEM

NYT: In Paper War, Flood of Liens Is the Weapon

MINNEAPOLIS — One of the first inklings Sheriff Richard Stanek had that something was wrong came with a call from the mortgage company handling his refinancing.

"It must be a mistake," he said, when the loan officer told him that someone had placed liens totaling more than \$25 million on his house and on other properties he owned.

But as Sheriff Stanek soon learned, the liens, legal claims on property to secure the payment of a debt, were just the earliest salvos in a war of paper, waged by a couple who had lost their home to foreclosure in 2009 — a tactic that, with the spread of an anti-government ideology known as the "sovereign citizen" movement, is being employed more frequently as a way to retaliate against perceived injustices.

Over the next three years, the couple, Thomas and Lisa Eilertson, filed more than \$250 billion in liens, demands for compensatory damages and other claims against more than a dozen people, including the sheriff, county attorneys, the Hennepin County registrar of titles and other court officials.

"It affects your credit rating, it affected my wife, it affected my children," Sheriff Stanek said of the liens. "We spent countless hours trying to undo it."

Cases involving sovereign citizens are surfacing increasingly here in Minnesota and in other states, posing a challenge to law enforcement officers and court officials, who often become aware of the movement — a loose network of groups and individuals who do not recognize the authority of federal, state or municipal government — only when they become targets. Although the filing of liens for outrageous sums or other seemingly frivolous claims might appear laughable, dealing with them can be nightmarish, so much so that the F.B.I. has labeled the strategy "paper terrorism." A lien can be filed by anyone under the Uniform Commercial Code.

Occasionally, people who identify with the movement have erupted into violence. In Las Vegas this week, the police said that an undercover sting operation stopped a plot to torture and kill police officers in order to bring attention to the movement. Two people were arrested. In 2010, two police

officers in Arkansas were killed while conducting a traffic stop with a father and son involved in the movement.

Mostly, though, sovereign citizens choose paper as their weapon. In Gadsden, Ala., three people were arrested in July for filing liens against victims including the local district attorney and Treasury Secretary Jacob J. Lew. And in Illinois this month, a woman who, like most sovereign citizens, chose to represent herself in court, confounded a federal judge by asking him to rule on a flurry of unintelligible motions.

"I hesitate to rank your statements in order of just how bizarre they are," the judge told the woman, who was facing charges of filing billions of dollars in false liens.

"The convergence of the evidence strongly suggests a movement that is flourishing," said Mark Pitcavage, the director of investigative research for the Anti-Defamation League. "It is present in every single state in the country."

The sovereign citizen movement traces its roots to white extremist groups like the Posse Comitatus of the 1970s, and the militia movement. Terry L. Nichols, the Oklahoma City bombing conspirator, counted himself a sovereign citizen. But in recent years it has drawn from a much wider demographic, including blacks, members of Moorish sects and young Occupy protesters, said Detective Moe Greenberg of the Baltimore County Police Department, who has written about the movement.

The ideology seems to attract con artists, the financially desperate and people who are fed up with bureaucracy, Mr. Pitcavage said, adding, "But we've seen airline pilots, we've seen federal law enforcement officers, we've seen city councilmen and millionaires get involved with this movement."

Sovereign citizens believe that in the 1800s, the federal government was gradually subverted and replaced by an illegitimate government. They create their own driver's licenses and include their thumbprints on documents to distinguish their flesh and blood person from a "straw man" persona that they say has been created by the false government. When writing their names, they often add punctuation marks like colons or hyphens.

Adherents to the movement have been involved in a host of debt evasion schemes and mortgage and tax frauds. Two were convicted in Cleveland recently for collecting \$8 million in fraudulent tax refunds from the I.R.S. And in March, Tim Turner, the leader of one large group, the Republic for the United States of America, was sentenced in Alabama to 18 years in federal prison. (His group does not capitalize the first letter in United.)

Sovereign citizens who file creditor claims are helped by the fact that in most states, the secretary of state must accept any lien that is filed without judging its validity.

The National Association of Secretaries of State released a report in April on sovereign citizens, urging state officials to find ways to expedite the removal of liens and increase penalties for fraudulent filings. More than a dozen states have enacted laws giving state filing offices more discretion in accepting liens, and an increasing number of states have passed or are considering legislation to toughen the penalties for bogus filings.

The Eilertsons, who were charged with 47 counts of fraudulent filing and sentenced in June to 23 months in prison, were prosecuted under a Minnesota law that makes it a felony to file fraudulent documents to retaliate against officials. John Ristad, an assistant Ramsey County attorney who handled the case, said he believed the Eilertsons were the first offenders to be prosecuted under the

law. "It got me angry," he said, "because at the end of the day, these two are bullies who think they can get their way by filing paper."

The liens were filed against houses, vehicles and even mineral rights. In an affidavit, the Hennepin County examiner of titles said that in a conversation with the Eilertsons about their foreclosure, one of them told her, "We're gonna have to lien ya." The examiner later found that a lien for more than \$5.1 million had been placed on her property.

If the purpose was to instill trepidation, it worked. Several county and state officials said in interviews that they worried that they might once again find themselves in the crosshairs. One state employee said it was scarier to engage with offenders who used sovereign citizen tactics than with murderers, given the prospect of facing lawsuits or fouled credit ratings.

Like many who identify with the ideology, the Eilertsons learned the techniques of document filing online from one of many sovereign citizen "gurus" who offer instruction or seminars around the country.

In hours of recorded conversation found by the authorities on their computer, the Eilertsons consulted with a man identified on the recordings as Paul Kappel, learning what he called "death by a thousand paper cuts."

Mr. Eilertson, interviewed at the state prison in Bayport, Minn., denied being anti-government or belonging to any movement. But he was familiar with the names of some figures associated with sovereign citizen teachings, including an activist named David Wynn Miller, who Mr. Eilertson said was "ahead of his time." (Mr. Miller writes his name as David-Wynn: Miller.)

Mr. Eilertson, who had no previous criminal record, said his actions were an effort to fight back against corrupt banks that had handed off the couple's mortgage time after time and whose top executives never faced consequences for their actions.

"It seemed like we were being attacked every day," he said. "We needed some way to stop the foreclosure.

"We tried to do our part with as much information as we had available," he said, though he conceded that "it kind of got out of control eventually."

WSJ: Towns Try to Take Back Water Systems.

Water fights are simmering in small towns across the country this summer, as rate increases irk residents and spur local governments to try to take over privately owned water systems.

Municipalities in Massachusetts, California and Texas have recently filed lawsuits or set ballot measures in a bid to gain control of their water systems. Private firms have defended their rate increases, saying they have had to spend money to improve the infrastructure and are entitled to make a profit.

Residents of Ojai, a small town in Southern California, will vote later this month on whether to fund the purchase of the water system serving them. In Blue Mound, Texas, the mayor has vowed to appeal a July court ruling that prevented his town from operating its water system. Also last month, a trial concluded in Superior Court in Worcester, Mass., in a lawsuit filed by Oxford, Mass., over the

sale of its water infrastructure. A judge's ruling is pending.

In the 1980s and 1990s, private water companies pushed to buy or manage municipal systems at the same time the costs of maintaining these systems were rising because of age, which made sales attractive to cities, said Tony Arnold, a University of Louisville law professor who has studied water privatization. "In order to make a profit [and] invest in upgrades to the system, the companies [had] to raise water rates substantially and quickly," he said.

Joseph Zeneski, the town manager of Oxford, said he objects to residents having to pay a consolidated water rate that he said Aquarian Water Co. of Bridgeport, Conn., set for several towns. He thinks towns should pay varying rates because their water comes from different sources and that Oxford is unfairly subsidizing a water-treatment plant in another town. "They don't want to give up the Oxford water system," he said of Aquarion.

John Walsh, Aquarion's vice president of operations for Massachusetts and Connecticut, said Oxford's rates have risen only about 3.4% annually since the system was purchased in 2002.

According to a 2012 report by Food and Water Watch, a group that supports public control of water systems, the privatization trend is waning. Using Environmental Protection Agency data, the group estimated that between October 2007 and October 2011 the number of Americans served by privately owned systems fell 16%, while the number served by public ones rose 8%.

"Communities large and small are increasingly seeking to maintain or revert back to public control of their water systems," said Seth Gladstone, spokesman for the group. Privatization raises costs because of the profits companies must make, he said, adding that customers have more oversight of local systems.

Michael Deane, executive director of the National Association of Water Companies, said although some of the towns attempting to take over their water systems have received a lot of attention, other cash-strapped ones are still turning to private companies. Private community water systems served about 42 million Americans in 2012, and public systems served some 300 million, he said.

Municipalities sometimes keep water prices impractically low, Mr. Deane said. "Oftentimes the city council may not be as responsible as [state] public service commissions in making sure the utility has the funds it needs to make improvements," he said.

Public-service commissions generally regulate private companies but not publicly owned systems.

In Blue Mound, a suburb of Fort Worth, Texas, Mayor Alan Hooks said he would appeal a court ruling that prevented his town from gaining control of its system. Mr. Hooks, who wants to use eminent domain to take over the system, said his own water bill has risen fourfold since 1998.

"You could stand on one side of the street and throw a rock to the other side, to where Fort Worth is, and they'll pay four times less," he said. A chart compiled by Blue Mound indicates rates about 3.5 times higher in Blue Mound in 2012 than in Fort Worth.

Chuck Profilet, vice president of SouthWest Water Co., which provides Blue Mound's water, said Blue Mound's rates rose 63% between 2005 and 2013. But, he said, "It is difficult to compare the rates of a municipality with that of an investor-owned utility because private utilities do not receive tax payments, grants, franchise fees or loans at low municipal bond interest rates."

In Ojai, residents are pursuing a public acquisition of their system from Golden State Water Co. of San Dimas, Calif. On Aug. 27, ratepayers will vote on letting the Casitas Municipal Water District

issue bonds for the purchase. The utility has indicated it could use eminent domain if purchase negotiations fail.

A takeover won't be easy, though. "We have said repeatedly that the system is not for sale. We are interested in growing our company," said Golden State Chief Executive Robert Sprowls. "Worst case, if we aren't able to keep the system, we are expecting to get fair market value for the assets."

No Challenge to Detroit's Eligibility from Bond Insurers, Investors.

CHICAGO — Bondholders' and insurers' decisions not to challenge Detroit's eligibility to file for Chapter 9 bankruptcy reflect lessons learned in Stockton, Calif., municipal bond attorneys said.

More than 140 creditors objected to Detroit's eligibility to file for Chapter 9 bankruptcy protection by the Monday deadline set by federal Judge Steven Rhodes, who is overseeing the historic case.

The objections came from dozens of individual retirees, the city's unions, and its two pension boards.

There were no objections from bondholders or bond insurers, who face steep losses under emergency manager Kevyn Orr's plan to treat \$2 billion of bond debt as unsecured.

Assured Guaranty Corp. and National Public Finance Guarantee Corp., insurers that together wrap \$4.6 billion of secured and unsecured Detroit bonds, declined to comment. Both insurers contested Stockton's eligibility to enter bankruptcy earlier this year, a move that proved unsuccessful and expensive.

"It's an object lesson that comes from Stockton, that objecting to eligibility is no longer your first opening move," said Karol Denniston, a partner with Schiff Hardin LLP, which represents bondholders and other creditors in the Detroit case. "The smart money says this is not our issue, and we don't want to waste time."

To qualify for bankruptcy, Detroit has to meet five criteria, including proof that it's insolvent, that it negotiated in good faith with its creditors or that such negotiations were too difficult, and that it has state authorization to file.

"If you are a bond insurer or holder, do you want to spend a lot of money proving Detroit doesn't meet any of these five tests?" said Frank Shafroth, director, Center for State and Local Leadership at George Mason University and a public finance attorney.

"Lawyers, and in particular bond attorneys, cost a lot of money," he said. "Do you really want to spend a lot of money on something that hard to argue?"

Bond insurers and investors who challenged Stockton's eligibility found themselves "eating a lot of humble pie," Shafroth said.

Since Orr unveiled his plan to issue \$2 billion of notes to distribute among holders of the city's \$11.4 billion of unsecured debt, many muni experts have said bondholders are better off taking their chances in a bankruptcy than agreeing to a such a steep haircut.

"The general perception is that we're better off having the conversation with the bankruptcy judge in the middle than on our own," Denniston said. "If they're ineligible, and the case is dismissed, you

just made chaos squared.”

The eligibility trial is set for Oct. 23.

The objections that were filed by retirees, unions and pension systems primarily argued that Orr did not engage in sincere negotiation in the weeks before Detroit’s July 18 bankruptcy filing and that the filing violates state law because it will violate the Michigan constitution by impairing pensions.

The filing by the city’s largest union, the Michigan chapter of the American Federation of State, County and Municipal Employees, went so far as to challenge the entire concept of municipal bankruptcy, arguing that Chapter 9 is unconstitutional because it allows federal law to trump state law.

The city’s two pension systems, the General Retirement system and Detroit Police and Fire Retirement System, which are the city’s two largest unsecured creditors with more than \$9 billion of debt, argued in a joint objection that state law prohibits the filing and that Detroit did not negotiate in good faith with its creditors.

“[B]y authorizing a contingency free bankruptcy that makes no exception for the accrued pension benefits of the city’s past and present employees, the Governor stepped outside the bounds of his authority,” the objection said.

Attorney General Bill Schuette filed a brief saying he believed the city was eligible and that Snyder has the legal authority to approve the filing. But Schuette warned that any attempt to cut pensions would be illegal.

Schuette had previously said he would join the case as the “people’s lawyer” to argue for constitutional protections of pensions, which is “absolute,” he said.

“The city can no more authorize a plan that reduces accrued obligations to public pensions than a plan that discriminates on the basis of religion,” Schuette said in his brief. “The city of Detroit is constitutionally obligated to keep the People’s promise as it proposes a plan that will allow the city to flourish while honoring the lifelong commitment of Detroit’s retired public servants.”

Schuette added that neither the city’s retiree health care costs nor its unaccrued pension liabilities are protected, only the vested pensions.

In separate news, officials from the city’s pension systems — which represent about 70% of the city’s 21,000 retirees — met with members of Orr’s team Monday for several hours to discuss a dispute over the size of Detroit’s total unfunded pension liability.

Orr’s restructuring plan is based on the projection that the unfunded liability totals \$3.5 billion, while the pension systems put the figure around \$650 million.

A pair of actuarial reports made public Monday by the Detroit Free Press backed up Orr’s claims, saying the unfunded liability could be as high as \$3.7 billion in 2016.

The reports, commissioned by Orr from the Chicago-based actuarial firm Milliman, said the police and fire fund is around 80% funded while the general employee retirement fund is between 50% to 60% funded.

Orr would be allowed to take over the funds if he can prove they are less than 80% funded under state law. A complete report will be released next week, according to the Free Press.

A status conference hearing on the bankruptcy is set for Wednesday at 10 a.m.

by: CAITLIN DEVITT

Detroit Swap Settlement Could Be Key to Bankruptcy Case.

U.S. Bankruptcy Judge Steven Rhodes Wednesday heard arguments from a bond insurer trying to halt Detroit's one and only pre-bankruptcy filing settlement, which would terminate a series of interest-rate swaps hedging \$800 million of the city's pension certificates.

Detroit says the settlement is key to its fiscal stability as it moves through the historic bankruptcy case because it would give the city access to about \$170 million in annual casino revenue, considered one of its most stable revenue streams.

The settlement is also important because Detroit could use the casino revenue as collateral to secure debtor-in-possession financing. DIP financing typically gives the lender a priority lien, and that could affect the liens of all Detroit's creditors.

"It's going to be one of the more important parts of the case," said a source close to the bankruptcy who asked to remain anonymous.

It would be the first time in a Chapter 9 case that a municipality secured debtor-in-possession financing, the source said.

"If you have DIP financing, you will see another set of discussions about whether it's appropriate in Chapter 9 and the timing of the liens with existing creditors. If you give them enough liquidity, then value is preserved, and if that happens in Detroit it will raise some interesting questions."

Rhodes heard arguments during the Wednesday afternoon hearing from the chief challenger to the settlement, Syncora Guarantee Inc., which insures both the swaps and the pension certificates.

Syncora wants Rhodes to allow it to "trap" the casino revenues, which are used as collateral on the swaps, until the judge rules on the settlement. Rhodes is expected to issue a written opinion on the stay within the week, according to local reports. He may rule on the settlement itself on Sept. 9. The judge ordered Thursday that the dispute be sent to mediation.

The settlement, reached days before emergency manager Kevyn Orr filed for Chapter 9, calls for Detroit to pay UBS AG and Merrill Lynch 75 cents on the dollar to terminate the swaps at a penalty currently estimated at just under \$300 million. The agreement would give the city access to roughly \$11 million a month in casino revenue currently used as collateral on the swaps. The banks would promise not to pursue insurance payments from Syncora.

Before announcing the settlement, the city sued Syncora, which had instructed the swap custodian to hold back all casino revenue in light of the city's June default on a \$40 million debt service payment on the certificates.

Detroit won a temporary restraining order against the freezing of the revenue, and Syncora countersued.

Several bond insurers and holders of some of the pension certificates are also opposed to the

settlement. Along with Syncora, Ambac Assurance Corp., Assured Guaranty Municipal Corp., Financial Guaranty Insurance Company, and National Public Finance Guarantee Corp., filed court briefs challenging the agreement last week, arguing in part that the 75% deal overpays one set of creditors at the expense of others.

The city's attorneys told Rhodes Wednesday that access to the casino money is crucial to Detroit's fiscal health as it attempts to restructure.

"This is probably the highest-quality tax stream the city has," attorney Corinne Ball said. "Being able to use the revenue stream is pivotal."

Syncora argued that the swap termination would negatively affect the firm's financial position, that Orr repeatedly misrepresented the nature of the swaps, which have provisions designed to protect the insurer, and that the casino revenues are exempt from the automatic stay.

"The swaps are an important protection against rising interest rates on the COPs obligations that Syncora insurers," the firm said in a court filing ahead of the Wednesday hearing.

"Put simply, Syncora's exposure will grow dramatically if the city and the swap counterparties are allowed to avoid the operation of the collateral agreement and Syncora's consent rights under the swaps - and that exposure will easily outstrip the ostensible 'release' Syncora will obtain if the swaps are allowed to terminate," Syncora said in the court challenge.

Syncora attorney Stephen Hackney of Kirkland & Ellis LLP said the swaps feature a provision that give Syncora the right to refuse a termination in the event of a default on the certificates, and that in the event of a default, the casino revenues are supposed to automatically accumulate in the trustee's account.

Syncora also argued that the city is not in desperate need of the revenue, citing Orr's restructuring plan as evidence. The plan projects a net operating surplus of \$227 million for 2014 without the casino revenue, Syncora said. "The city's desire for cash is not a basis to disregard the plain language of the collateral agreement, which was designed to operate automatically."

Ambac, in its Aug. 16 court filing, called the validity of the swaps lien on casino revenue "highly dubious" and said it is in violation of state law, which does not allow casino revenue to be used as collateral on a financial obligation.

Ambac also argued that the casino revenue does not qualify as special revenues that are exempt from the bankruptcy case.

"An objective evaluation of the necessary factors simply cannot support a compromise so heavily weighted in the swap counterparties' favor," Ambac said. The city is "overpaying one set of creditors at the expense of other similarly situated creditors," the insurer argued.

Assured called the proposed settlement "unreasonably favorable to the swap counterparties."

[BDA Bankruptcy Paper: Detroit May Be "Game Changer."](#)

Detroit's filing under Chapter 9 of the federal bankruptcy code may be "a game changer" that resolves controversial issues that have not been dealt with in prior cases, according to a nine-page

paper on muni defaults and bankruptcy released on Thursday by Bond Dealers of America.

The Detroit proceeding may answer the question of whether a municipality can use Chapter 9 to cut accrued pension rights that are protected by a state constitution, said the paper, which was prepared for BDA by Nixon Peabody, LLP. Michigan's Constitution states such rights "shall not be diminished or impaired."

The case also is expected to address how the bankruptcy laws treat a general obligation bond in contrast to other debts, whether secured or unsecured, and what a pledge of full faith and credit actually means when the issuer goes bankrupt. Detroit's emergency manager Kevyn Orr has recommended the city's GOs be treated as unsecured debt.

Jefferson County, Ala.'s Chapter 9 case helped clarify the rights of holders of special revenue debt, but there is no significant body of case law on GO bonds backed by the full faith and credit of a municipality, according to the paper.

These issues are at the heart of Detroit's bankruptcy filing because the city does not appear to have enough revenues to fully pay its accrued pension and GO bond debts.

The BDA paper provides a primer on Chapter 9, how it differs from Chapter 11 for business bankruptcy cases, and what issues recent Chapter 9 cases have shed light on, with the goal of "provid[ing] context for the upcoming battle" in Detroit between its unions, retirees, GO bondholders and the ongoing needs of taxpayers for essential services.

In a trial on whether Detroit is eligible to Chapter 9 bankruptcy protection, that is scheduled to begin on Oct. 23, the city will have to address two concerns. First it will have to meet a good faith standard and prove that it negotiated in good faith with its creditors prior to its petition, or explain why it was impracticable to do so. Second it will have to beat back challenges to its attempt to adjust pension and other retiree benefits since the state constitution prohibits the diminishment or impairment of these benefits.

The paper recommends that investors, before buying a municipal security, examine the bond documents, state law, and bankruptcy law to determine what will happen to its investment if the issuer does not pay its obligations when they become due.

It even suggests issuers and other transaction participants consider disclosing to bondholders some the risks associated with Chapter 9 filings such as: whether the issuer authorized by its state to file under Chapter 9; whether the bonds will be treated as secured or unsecured if a bankruptcy case is filed; what the collateral is for bonds considered to be secured; and whether bonds are special revenue bonds as defined by Chapter 9.

However, the paper also warns that Chapter 9, "suffers from limited judicial guidance resulting from a paucity of cases, thereby making hazardous any predictions as to how a bankruptcy court will rule on an issue arising in a Chapter 9 case." It also notes that state laws change over time.

A municipality can only file for bankruptcy under Chapter 9 if its state authorizes it to do so, according to the paper. Several Chapter 9 cases have been dismissed for lack of specific state authorization including those filed by Harrisburg, Pa. and Suffolk Regional Off-Track Betting Corp.

States have taken four different approaches to the authorization requirement, the paper said.

Georgia law prohibits its municipalities from filing a Chapter 9 petition. At least 21 states, such as Wisconsin, Tennessee and Virginia, as well as the District of Columbia, have no laws specifically

authorizing Chapter 9 filings. Many states, such as Colorado and Kentucky, have laws authorizing Chapter 9 petitions, but may restrict which municipal entities can file them. Other states impose conditions on municipalities that want to file a Chapter 9 petition.

Michigan falls into this latter category, imposing a rigorous process of increasing state supervision of the city with the ultimate step of a state receiver filing a petition on its own initiative or with the approval of a specified state executive. California, which also falls into this category, requires a municipality to either engage in a 60-day mediation process or certify that an emergency exists that does not allow time for mediation, before a filing can be authorized.

Chapter 9 provides municipalities with restructuring tools that are not available to them under state law, the paper said. It provides an automatic stay on all litigation against the city. Pending lawsuits are frozen in place and cannot proceed without permission from the bankruptcy court. Efforts to obtain property from the city also are stayed. This gives the city time to gather its resources and devise a plan to address its debts.

A Chapter 9 filing requires creditors or those in possession of city property turn it back to the city. It also permits a city to bypass state law and reject onerous contracts or leases. The city, for example, may avoid moving into a new building it cannot afford it or may get out of employment contracts considered too rich to continue.

Chapter 9 also allows a city to propose a plan of adjustment that includes a restructuring of debt and force all bondholders to adhere to that plan, once it has consent from only a majority of them, even though bond documents may require the consent of all bondholders for a restructuring of the debt.

Because state law requirements must be met before a city files a Chapter 9 petition, the eligibility process may involve months of arguments and hearings, the paper said.

In addition, in virtually every Chapter 9 filing thus far, “issues are presented to bankruptcy courts on which there is limited or no precedent to look for guidance,” the BDA paper said.

Detroit’s Chapter 9 petition will likely plow new ground for both municipalities and bondholders, it said.

Moody's Proposes More Focus on Public Pension Obligations in Bond Ratings.

Moody’s Investors Service is seeking public comment on proposed methodology changes that would increase the weight of debt and pension obligations to 20% from 10% in its ratings of local government general obligation bonds while decreasing other economic factors.

The proposed change “would recognize the potential for large pension liabilities to constrict local governments’ financial flexibility. Because pension liabilities and debt each represent enforceable claims ... the current methodology should be weighted more heavily to capture the combined effect of both debt and pensions,” Moody’s said in a news release Wednesday.

In April, Moody’s revised its approach to state and local government pension data to address what officials there considered underreporting of pension liabilities on government balance sheets, and to increase comparability among plans by investors and credit analysts. It also placed the general obligation bond ratings of Chicago, Cincinnati, Minneapolis, Portland and 25 other governmental units on review for possible downgrade because of relatively large net pension liabilities.

Government pension and finance officials worry that further changes by Moody's will create additional confusion. "The data Moody's uses does not align with the financial data that local governments report on their financial statements," said Elizabeth Kellar, president and CEO of the Center for State and Local Government Excellence. "Giving greater weight to data that may be flawed is a concern."

If the proposed methodology is adopted, Moody's officials predict some bond ratings would change, but "the vast majority would not," according to the news release. Comments are due by Oct. 14.

Lebenthal, MuniAxis to Unveil New Trading System for Odd-Lots.

Lebenthal & Co., LLC, wants to improve liquidity for trading odd-lot municipal bonds in the secondary market.

To that end, the broker-dealer next month will introduce MuniAxis, a trading platform that employs an open-auction bidding process to buy and sell municipal securities in denominations of less than \$1 million.

The goal is to let asset managers sell to a variety of dealers and other investors in a more transparent, yet anonymous, way without taking on additional counterparty risk. The set-up, its creators predict, will improve the percentage of executions per listing of odd-lot bid-wanted, according to Alexandra Lebenthal, founder of Lebenthal & Co.

"Liquidity is very much an issue," she said. "There are a lot of dealers that are reluctant to make bids on a lot of lists. [MuniAxis] is going to expand the liquidity market."

Introducing liquidity into the marketplace represents the best measure of whether MuniAxis is serving the market well, said Charles P. Moore, chief executive officer at MuniAxis. And the percentage of listings that trade will be the most important metric to determining that.

There are roughly 40,000 trades each day, which is a fairly static number, Moore said. "If we can put a dent in that number, we'll be doing really nicely." The market operates much more efficiently for round-lot trades, or those above \$1 million, he added.

The concept of trading efficiently sits at the heart of MuniAxis. Amid today's volatility, the need for liquidity, or the ability to buy and sell bonds when investors want, is more important in the municipal bond market than ever, said Jim Lebenthal, director of public affairs for Lebenthal & Co.

"It just seems to me that what's represented by this effort of ours with MuniAxis is to give those [separately managed accounts] more professional treatment of their bonds, which means improving liquidity," he said, "and for those managers, improving transparency and giving them direct access to bidders, or at least to exposing their bonds to prospective buyers."

Bids to MuniAxis from both dealers and buy side asset managers are anonymous. For buyers, pre-trade price transparency lets them see the high bid, know where they stand among bids, and even to bid again.

MuniAxis Lebenthal, LLC, a wholly owned subsidiary broker-dealer of Lebenthal & Co., LLC, will step in and act as counter-party for both buyer and seller, once the system generates a commitment from both sides, Moore said. The firm, functioning in a similar capacity to a dealer, takes on minimal

risk, he said.

“We wouldn’t have bought it if it wasn’t already sold,” Lebenthal added. “We’re not bidding on it; the bidder is on the other side. We’re essentially the conduit by which the trade happens.”

MuniAxis Lebenthal must approve everybody with access to the platform, Moore said. Once approved, he added, users can see every item that’s out for the bid, what the current high bid is on that item, and use that information to make an informed bid while choosing.

Sellers submit their bonds, which become available and biddable by all the other approved subscribers. The system facilitates a live auction for sellers and buyers to let the market determine fair value.

“Oftentimes, SMA managers have clients who need to raise cash,” Moore said. “They’re listing those bonds for sale because they want to raise cash for that client, and they’ve got compliance rules that say: you can’t put a price on it; you’ve got to put it out for the bid and let the market determine what fair value is for those bonds today, which could be different from yesterday. It’s all based on current market conditions.”

There is no fee to join MuniAxis. Commissions are only paid upon completed trades. All approved subscribers of MuniAxis become trading partners of MuniAxis Lebenthal, LLC.

Introducing an auction platform will add transparency to the bidding process, said Anthony Greco, a trader at Breckinridge Capital Advisors, a MuniAxis subscriber. “Hopefully, that transparency will encourage more participation,” he said. “If [participants] knew that the bid was cheap and the bonds were going to trade, then maybe they’d be encouraged to participate.”

MuniAxis worked with Investortools to set up functionality through its portfolio management software, Perform. Through the partnership, Investortools built links into Perform, making it easier to list bonds on MuniAxis.

MuniAxis also uses the Thomson Reuters Municipal Market Data curve to show all bids with a yield delta to MMD. And MuniAxis hosts and displays locally analytics supplied by Interactive Data and bond ratings from Moody’s Investors Service and Standard & Poor’s.

Lebenthal & Co., and MuniAxis are currently approving and enrolling subscribers so the trading platform has enough buyers and sellers for the launch day. Several firms that helped design the system, as well as define some of its features and functionality, stand as likely users, Moore said.

Currently, asset managers selling odd-lots can use the Bloomberg MBWD bid-wanted system. In addition, BondDesk Group LLC and S&P Capital IQ announced recently that they will launch a pricing service for odd-lot fixed income markets, called Odd-Lot Valuations, sometime in the fourth quarter.

[Bankruptcy Judges Share Insight on Chapter 9 Eligibility.](#)

This October, Judge Steven Rhodes of the U.S. Bankruptcy Court in Detroit will preside over a trial on whether the city of Detroit was eligible to file for Chapter 9 bankruptcy protection last month.

In setting an early trial on eligibility and also keeping a mediator on call as disputes arise, Judge

Rhodes is following in the footsteps of the judges who oversaw prior municipal bankruptcy cases. Speaking Saturday in San Francisco at the American Bar Association's annual conference, two of those judges said Judge Rhodes appears to be taking a page from both of their books.

To file for Chapter 9, the debtor must meet several criteria: It must be a municipality, it must be insolvent and it must have authorization to file, among other issues. The long list of factors and the debates in each case over whether those factors are met make Chapter 9 very different from other chapters of the Bankruptcy Code.

"Eligibility is a huge thing in [Chapter] 9, and in other chapters, it just sort of happens," said Duane Morris LLP restructuring partner Ron Oliner, who is representing San Bernardino's police officers in the California city's ongoing Chapter 9 case.

Not only does determining eligibility pose a challenge to the distressed municipality and the creditors arguing otherwise, but it also challenges the judge overseeing the case. Is that an issue that is tackled right out of the gate, or, because so much evidence is required, do you give both sides plenty of time to make their case?

Take Stockton, Calif. The city filed for Chapter 9 protection last summer, and Judge Christopher Klein didn't set a trial to determine the city's eligibility for municipal bankruptcy until the following spring.

"My rationale, and I don't apologize for it at all, is that if you think about Chapter 11 as a negotiating model...successful Chapter 11 plans are fundamentally consensual," he said. "Given the restrictions that are in Chapter 9, it's the Chapter 11 negotiating model on steroids."

He appointed a mediator, fellow bankruptcy judge Elizabeth L. Perris, whom he said "worked very long and hard" to establish the facts surrounding the city's bankruptcy filing, including its insolvency. That "vastly simplified" the trial, said Judge Klein, who ultimately found that the city was eligible for municipal bankruptcy protection.

"All those months of time were spent in very extensive and intensive exchanges of information so that people could get on the same page," Judge Klein said. "That exchange of information is going to have to occur in any case."

Judge Klein was the first person that Judge Frank Bailey said he called when he was appointed to oversee Central Falls, R.I.'s Chapter 9 case. Instead of waiting to determine the city's eligibility for bankruptcy protection, Judge Bailey resolved the question within months of its Chapter 9 filing. The city was in and out of bankruptcy in little over a year.

Judge Rhodes in Detroit, according to Judge Bailey, is taking a page from both Stockton and Central Falls rulebooks by scheduling a fast-approaching trial on eligibility and also lining up a mediator, U.S. District Judge Gerald Rosen, should one be needed.

"Compared with other cases, will be remarkably fast," Judge Klein predicted.

[WSJ: Finding Attractive Muni Yields Post-Detroit.](#)

The shock waves of Detroit's bankruptcy are helping to raise municipal-bond yields nationally to levels not seen since early 2011.

The average top-rated 10-year municipal bond was yielding nearly 2.8% entering Wednesday, according to market researcher Municipal Market Data. That amounts to a tax-equivalent payout of slightly less than 5% for the highest income earners, notes Michael Comes, a portfolio manager at Cumberland Advisors in Sarasota, Fla., with \$2.2 billion in assets.

A similar-termed taxable Treasury with a triple-A rating has been yielding about 2.7%, he points out. At the same time, Mr. Comes says he can find 10-year investment-grade corporates from highly rated issuers such as Apple Inc. with yields in the 3.5% range. High-grade debt issued by companies, which unlike municipal issues are taxed at the federal level, normally can be expected to offer higher yields since they come with heightened credit risks.

The muni marketplace has been hemorrhaging since early March as concern about higher interest rates and rising expectations that the Federal Reserve will curtail its economic stimulus programs sent fund investors heading for the exits.

Although the financial problems of Detroit were well-documented before last month's bankruptcy filing, net investment flows out of muni-focused mutual funds and exchange-traded funds peaked around \$4.5 billion a week immediately following the event, according to Lipper FMI, a Thomson Reuters research group.

Perhaps just as significantly, muni-bond funds produced eight-straight weeks of declining returns through the end of July, says Lipper analyst Jeff Tjornehoj.

"Since about a week after Detroit's bankruptcy, the muni market has stabilized and the bleeding in fund flows has slowed," he says.

By Mr. Tjornehoj's estimates, the typical muni-bond fund has lost around 0.6% in the past six weeks. By contrast, those same funds were down by slightly more than 5% in the two months leading up to the latest crisis.

As the dust settles from Detroit's bankruptcy, investors hungry for better income opportunities are finding the best market conditions in nearly two-and-a-half years, says Alan Schankel, a muni strategist at broker Janney Montgomery Scott.

The last time munis looked so attractive was during a selloff from late 2010 into early 2011 that started after analyst Meredith Whitney predicted that muni markets faced billions of dollars in defaults, Mr. Schankel observes.

"This is a rather unique time. We're finding better after-tax yields in municipals than many types of low-rated investment-grade corporates," Mr. Schankel says.

Munis are also attractive relative to some grades of so-called "junk bonds," says Anthony Valeri, head of fixed-income research at LPL Financial Holdings Inc., with \$350 billion in assets.

The firm's managers say they are considering putting more money into munis after taking profits in bonds that offer higher yields but come with lower credit ratings.

"The fears about Detroit have created more market uncertainty, something that we think investors can turn to their advantage," Mr. Valeri says.

Cumberland's Mr. Comes says he is favoring essential-services bonds that are rated double-A or better from states with relatively low debt levels and attractive demographics such as Utah, Texas, Virginia and Maryland.

In particular, he likes the prospects for a 30-year New Jersey turnpike project paying 4.73% tax-free to investors in the state. Another issue they are monitoring is a water-services bond in San Diego, yielding about 4.2% and due to mature in about 18 years. Also under review is a 25-year general obligation bond from Washington state that is currently paying around 4.5%.

"The havoc created by Detroit's bankruptcy filing is providing investors with their best entry point into muni bonds since that Meredith Whitney moment more than two years ago," Mr. Comes says.

WSJ: Sizing Up Discounted Muni Closed-End Bond Funds.

Some municipal closed-end bond funds, including Michigan-specific funds, are trading at appealing discounts following interest-rate increases and Detroit's bankruptcy filing.

"Municipal closed-end bond funds are on sale," says Cecilia Gondor, executive vice president at Thomas J. Herzfeld Advisors Inc., a Miami investment-advisory firm, which oversees about \$167 million.

Closed-end funds can deviate significantly from the value of their underlying assets. The five Michigan-specific municipal closed-end bond funds currently trade at discounts of 12.45% to 13.5%, while the average discount on all municipal closed-end bond funds is 7.31%, according to Ms. Gondor's firm.

While discounts on the Michigan funds are much wider than those of muni closed-end funds generally, "they all seem to be out of favor," she says.

Investors in closed-end municipal funds have had a very positive experience over the past several years as interest rates fell, the values of the funds' underlying bond holdings rose and the funds, which use leverage, paid out attractive distributions.

But many investors sold in May when interest rates began rising. And Detroit's July 18 filing kept the bad news coming.

"It was a double-edged sword; it started with the interest-rate shock and then continued with the credit shock. People were saying, 'Maybe this isn't risk-free return,'" says Maury Fertig, chief investment officer of Relative Value Partners LLC in Northbrook, Ill.

Though many experts believe the selling has been overdone, the discounts linger. "Investors are still afraid of them," says Ms. Gondor, "and their distributions are even more attractive on the lower share price."

Mariana Bush, closed-end fund analyst at Wells Fargo Advisors, says those closed-end fund investors that understand leverage have become concerned about rising rates over the past few months. "They recognize that just as the (net-asset value) can go up more because of leverage, it can go down more because of leverage."

A few months ago, Wells Fargo Advisors didn't include any muni closed-end bond funds on its "select" list for financial advisers, she says. But it has since added Eaton Vance Municipal Bond Fund (EIM), Nuveen Dividend Advantage Municipal Fund 2 (NXZ) and MFS Municipal Income Trust (MFM), among others, on its list of most favorable closed-end funds.

Over the past few weeks, Dennis Houlihan, a financial planner with Houlihan Asset Management Inc., purchased BlackRock MuniYield Michigan Quality Fund (MIY) and Nuveen Michigan Quality Income Municipal Fund (NUM) for clients who live in Michigan.

"They were oversold at such deep discounts to net-asset value that they were at almost historic lows," says Mr. Houlihan, whose Fort Wayne, Ind., firm manages about \$50 million.

The BlackRock and Nuveen funds currently trade at discounts of 12.45% and 13.5%, respectively, but have three-year average discounts of 3.78% and 6.24%, according to Morningstar Inc. Each have distribution rates of more than 7%.

"I'm not necessarily expecting them to bounce back immediately," says Mr. Houlihan, "but I think you're going to see a stabilization, and as they revert to fair market value, you're getting paid a nice monthly income."

The funds offer a bargain for those willing to take on some risk "unless you believe this is a seminal moment of a triple-A general obligation bond no longer having the full faith and taxing power of whatever the underlying municipality," he says. "If that's no longer any good, well, the whole muni market is going to fall apart."

A. Raymond Benton, a financial planner with Lincoln Financial Advisors in Denver, has been buying muni closed-end bond funds over the past few weeks. "A number of the funds that had been selling at premiums are at fairly significant discounts," he says.

Mr. Benton is assuming that the muni-bond market's reaction to concerns about Detroit's treatment of general obligation bondholders has been overblown, and that interest rates are unlikely to rise as fast as many believe.

Among the funds he has purchased is Nuveen Select Tax-Free Income Portfolio (NXP) and Invesco Municipal Income Opportunities Trust (OIA), which trade at nearly 8% and 10.1% discounts, respectively, and offer distribution rates of about 5% and 6.8%, according to Morningstar.

But Mr. Benton says one has to be "something of a contrarian" for the funds to be appealing. Closed-end funds will be more volatile because they are leveraged, and if market sentiment changes, the discounts can widen immediately, he says.

Mr. Fertig of Relative Value Partners, whose firm oversees \$750 million for wealthy families and small institutions, says he hasn't been buying muni closed-end bond funds. Their generally long durations make them very interest-rate sensitive, he notes, adding that some muni closed-end bond funds also have been cutting their dividends.

Instead, he has been purchasing discounted taxable closed-end funds, he says.

Still, Mr. Fertig doesn't rule out buying some muni closed-end bond funds later in the year when, he says, they may present a good opportunity: "We don't want to move too early on them."

[Los Angeles County Bars Brokers That Donate to Bond Campaigns.](#)

Los Angeles County will no longer do business with underwriters that make financial contributions to school bond campaigns.

Under Treasurer and Tax Collector Mark Saladino's new policy, underwriters cannot donate to school bond measure campaigns if they want to qualify for the treasurer's pool of dealers eligible to sell county bonds.

California Audit Finds Major Lapses In Oversight for School Bond Funds

"We will not allow anyone in our pool if they engage in giving contributions to school campaigns," said Glenn Byers, assistant treasurer and tax collector for the county. "It amounts to pay-to-play and we are opposed to that.

In July, 12 dealer firms asked the Municipal Securities Rulemaking Board to adopt further restrictions on bond measure contributions by broker-dealers, and pledged a two-year moratorium against such contributions. Byers said the county will not hold dealers liable for past donations, but wants them to pledge not to do it in the future.

"We are not going backward to punish the guilty," Byers said.

Such a change would bring rules for bond measure campaigns closer to the MSRB Rule G-37 limits against contributing to politicians' campaigns.

The pledge letters "we have seen so far have been addressed to the MSRB," Byers said. "Frankly, that is where we would like them to go, but we haven't determined that yet."

The dozen firms making the pledge were Barclays Capital, Morgan Stanley, Bank of America Merrill Lynch, Citi, Wells Fargo Securities LLC., First Southwest, Goldman Sachs, JPMorgan, Loop Capital Markets LLC, Siebert, Brandford Shank & Co. LLC, Janney Montgomery Scott LLC and BMO Capital Markets, Inc.

Los Angeles County typically reviews and revises its pool of financial firms every five years. The review is currently underway and the new list will come out early next year, Byers said.

The county government issues school district general obligation bonds sold under the state education code, and the treasurer may act as an advisor on the deals. The county has 93 school districts. Districts can also go to market under the state government code, circumventing the county treasurer's role.

Los Angeles County, the Los Angeles County Public Works Finance Authority, the Los Angeles County Asset Leasing Corp., and the Los Angeles County Redevelopment Agency have issued approximately \$3.2 billion of long-term debt since 2000, according to Thomson Reuters data. The county also typically has a large tax and revenue anticipation note issue every year; in June it sold \$1 billion of TRANS.

The county treasurer's office has been in contact with most of the state's county treasurers, who support the policy, Byers said. It hasn't been in contact with all of the county's school districts - as the policy was just announced - but some of the smaller school districts have come out in opposition, he said.

The districts fear that the policy might limit their ability to hold successful bond elections, but Byers disagrees: "It just means the easy money will go away."

Under state law, school districts can't use public money to publicize bond elections, but the districts could hold press conferences and engage community groups, he said.

"When school districts have legitimate needs, it's not that hard to let the public know," Byers said.

The county treasurer's office also plans to notify State Treasurer Bill Lockyer and encourage him to adopt the same restrictions.

Tom Dresslar, a spokesman for Lockyer, said Los Angeles County officials have not yet contacted his office.

"We are considering what, if any, action to take with respect to our pools," Dresslar said. "Whatever action we take likely would cover not just underwriters, but also financial advisers and bond counsel."

The treasurer's office "wants to make sure any policy we adopt covers all the bases and targets the problem in an effective way," Dresslar said.

Lockyer continues to believe that the best way to fight the pay-to-play problem is to adopt statewide statutory restrictions.

Assembly Bill 621, which would have accomplished that by restricting donations from financial firms, stalled in the Senate Governance and Finance Committee this year.

"The aroma emanating from the school bond finance arena is not pleasant," Dresslar said. "You have district officials that have cozy relationships with finance professionals, who contribute to campaigns, then get no-bid contracts to conduct non-competitive bond sales."

The problem is not that underwriters and other finance professionals contribute to school bond campaigns, but that "they contribute or provide pre-election services, and then obtain underwriting business for the bonds, often under sole-source contracts entered into prior to elections. That creates, at least, the appearance of corruption."

The whole system is due for a "deep cleaning," Dresslar said.

[Reuters: Freddie Mac May Sue California City on Eminent Domain Loan Seizures.](#)

Freddie Mac (FMCC.OB), the government-owned mortgage finance company, on Wednesday said it is considering legal action against Richmond, California, if the city uses eminent domain to seize mortgages of local residents who owe more than their properties are worth in a bid to keep them in their homes.

The northern California city recently sent notice to the holders of more than 620 so-called underwater home mortgages in the city, asking them to sell the loans to the city. It would buy the mortgages for 80 percent of the fair value of the homes, write them down and help the homeowners refinance their loans.

"Our sense is that those so-called voluntarily loan sales would not be very voluntary," said Freddie Mac's general counsel William McDavid in a conference call with reporters to discuss the company's second-quarter financial results. "They're loan sales under pressure - in fact, under a threat of seizure by eminent domain. We would consider taking legal action."

Freddie Mac and its larger sister company, Fannie Mae, are some of the biggest buyers of private home-loan bonds. The two government-backed companies' finances would be affected if the eminent domain plan went forward and wiped out the worth of those bond investments.

"Fannie Mae and Freddie Mac are investors in these securities. This is an issue that we are discussing," said Denise Dunckel, a spokeswoman for the companies' regulator, the Federal Housing Finance Agency.

Both companies, operating under conservatorship since they were taken over by the government in 2008 during the financial crisis, would need the Federal Housing Finance Agency's permission to take legal action against the city of Richmond and possibly block the eminent domain seizures. The FHFA itself has previously raised concerns with an approach like Richmond's.

Using eminent domain in this fashion to force banks and other investors to sell mortgages is novel. Historically cities have used the power to force the sale of properties if they obstruct the construction of a project deemed beneficial to the wider community, such as a road or bridge.

Richmond is working with San Francisco-based Mortgage Resolution Partners, a private investment firm that has been pitching the plan to U.S. cities and municipalities for more than a year. MRP, raising money from private sources, would work with the city to obtain the financing to buy the distressed mortgages and restructure them. MRP would receive a fee for every troubled loan it restructured under the plan.

[Bloomberg: Pimco, BlackRock Seek to Bar California Mortgage Seizures.](#)

Pacific Investment Management Co., BlackRock Inc. (BLK) and Bank of New York Mellon Corp. are seeking a court order blocking Richmond, California, and Mortgage Resolution Partners LLC from seizing mortgages through eminent domain, saying the initiative would hurt savers and retirees.

The city's plan is unconstitutional, according to complaints filed yesterday by mortgage-bond trustees in federal court in San Francisco. The trustees, Wells Fargo & Co. (WFC) and Deutsche Bank AG, were directed to take the action by investors in the debt that also include Jeffrey Gundlach's DoubleLine Capital LP, said John Ertman, a partner at Ropes & Gray LLP. Bank of New York said in a separate complaint the beneficiaries of trusts it oversees include pension funds and mutual funds.

"Mortgage Resolution Partners is threatening to seriously harm average Americans, including public pension members, other retirees and individual savers through a brazen scheme to abuse government powers for its own profit," Ertman said in an e-mailed statement on behalf of investors.

The plan advanced last month with Richmond backing offers to buy 624 loans, making it the first city to push the idea so far forward. Those offers would need to be refused before the city could follow through with its mayor's vow to invoke its potential powers to force sales of the mostly non-delinquent loans, so that homeowners could get their debt balances cut to less than the current values of their properties.

'Cease Business'

The Federal Housing Finance Agency said today in a statement that it may direct Fannie Mae (FNMA), Freddie Mac and the Federal Home Loan Banks "to limit, restrict or cease business

activities within the jurisdiction of any state or local authority employing eminent domain to restructure mortgage loan contracts.”

Andrew Wilson, a spokesman for Fannie Mae, and Thomas Fitzgerald, a spokesman for Freddie Mac, said the companies were among the investors authorizing Wells Fargo and Deutsche Bank to sue. The government-controlled firms guarantee almost 70 percent of new mortgages.

The program would harm owners of mortgage bonds by paying them too little for loans, as well as damage communities by drying up lending, at least 18 trade groups representing asset managers, bankers, real-estate firms and builders have said in past statements. Costs to investors could exceed \$200 million just on loans in Richmond, according to the Wells Fargo complaint.

Court Scrutiny

Proponents of the plan including Cornell University law professor Robert Hockett and Steven Gluckstern’s Mortgage Resolution Partners, which is advising municipalities and lining up private funds that would profit as the buyer of the loans, dispute those claims. They have said that the plan will survive court scrutiny.

At least a dozen cities still dealing with the fallout of worst slump in home prices since the Great Depression are studying the eminent domain idea. Others include El Monte, California, North Las Vegas, Nevada, and Irvington, New Jersey. Communities such as San Bernardino County, California, and Chicago abandoned the plan after considering it last year.

Under the program that Mortgage Resolution Partners has pitched, a private investment fund would buy loans from bond trusts for amounts less than current property values. The prices would be based on financial models or comparable trades and sanctioned by courts.

The mortgages would then be reduced and homeowners refinanced into new debt insured by the Federal Housing Administration.

Interstate Commerce

Richmond’s plan would harm interstate commerce because lenders will be less willing to underwrite mortgages and investor confidence in the market for mortgage-backed securities and “by extension, the national housing market and national economy” would be undermined, according to the complaint by Wells Fargo and Deutsche Bank.

The plan is also discriminatory because it targets only certain loans, the trustees alleged. It violates California and U.S. constitutional protections against impairing private contracts and the taking of private property for public use without just compensation, according to the complaint.

Richmond Mayor Gayle McLaughlin didn’t immediately return a message left at her office today seeking comment about both complaints. Yesterday she declined to comment on specifics of the Wells Fargo lawsuit because she hadn’t seen it yet.

‘Another Stage’

“I continue to stand by this program and the benefits to our residents,” she said in a telephone interview. “We feel comfortable with the legality of this.”

Hockett, the Cornell professor, said the Wells Fargo lawsuit makes the same arguments he has previously called unsound.

"It's essentially another stage in their strategy to scare cities," Hockett said yesterday in a telephone interview. "The industry is essentially trying to head them off at the pass."

Mortgage Resolution Partners, which is based in San Francisco, has reviewed the Wells Fargo suit and is confident it can prevail in court, Gluckstern said in an e-mail.

"No investor in any trust will be made worse off by the sale of any loan. Rather, it is these trustees that are wasting trust assets at the expense of America's pensioners by pursuing fruitless litigation," Gluckstern said. "Sadly, the financial institutions that brought us this crisis are yet again part of the problem rather than part of the solution."

Foreclosures, Blight

The goal of the eminent domain plan is to help communities by fending off foreclosures that cause blight and create other costs, according to its supporters. The 32 loan servicers and bond trustees that received letters seeking voluntary sales of the Richmond loans were told they must respond by Aug. 13, said Mortgage Resolution Partners Chief Strategy Officer John Vlahoplus.

The initiative has targeted mainly the loans of borrowers who are current on their payments, which make up 444 of the initial batch in Richmond, where the city council still hasn't formally authorized the use of eminent domain. Mayor McLaughlin vowed to take the step on a July 30 call with reporters.

Richmond is a largely blue-collar city of 106,000 north of San Francisco with long ties to heavy industry where almost half of mortgages have higher values than the homes they finance.

Freddie Mac

The ultimate investors in the securities whose trustees sued yesterday "include state and local pension plans, 401(k) plans, college savings plans, insurance companies, mutual funds, university endowments, and government-sponsored enterprises" according to the Wells Fargo complaint.

Pacific Investment Management Co., known as Pimco, manages the world's largest bond fund, while BlackRock is the biggest asset management company. Bank of New York sued in its role as trustee of trusts created to hold the loans. The bank received a letter from Richmond demanding to purchase more than 100 loans from the trusts, the bank said in its complaint.

Freddie Mac (FMCC) is also unhappy with the "threat" of eminent domain being invoked, William McDavid, its general counsel, said yesterday on conference call with reporters. While loans in mortgage bonds guaranteed by the company and rival Fannie Mae aren't being targeted, the firms also own non-agency securities.

Under Water

Eminent domain, the right of governments to take private property for the public good while providing fair compensation to the owner, has typically been used to seize real estate, such as to build highways or parks.

Richmond's planned use is a legacy of the housing bubble that began to burst seven years ago, leaving millions of Americans owing more than the value of their properties even after prices began recovering last year.

About 25 percent of U.S. homes with a mortgage, or 13 million properties, were under water in the

first quarter of this year, according to Zillow Inc., a real-estate information firm. The housing recovery and foreclosures reduced the amount from 31 percent a year earlier.

At the same time, the share of mortgages held by bonds without government backing defaulting for the first time fell to a 5.2 percent annualized pace as of July data, from 7.5 percent a year earlier and almost 20 percent in 2009, according to a report yesterday by Amherst Securities Group LP.

The cases are Wells Fargo Bank v. City of Richmond, 13-3663, and Bank of New York Mellon v City of Richmond, 13-3664, U.S. District Court, Northern District of California (San Francisco).

WSJ: Muni-Bond Buyers Seeking Safety.

Investors in municipal bonds are turning to safer corners of the bond markets in the wake of Detroit's bankruptcy filing.

Three weeks following the city's filing with more than \$18 billion in debt—which came after years of economic decline and population exodus—its impact is still being felt.

After at least three Michigan municipalities decided to postpone their bond sales, Detroit and Michigan officials insist the problems should be isolated to the beleaguered city. But the bankruptcy has prompted some investors to move their money into higher-rated segments of the municipal-bond market.

The new premium these investors demand from some debt tied to the state stems in part from their concern about officials' insistence that Detroit bondholders should take losses on some of their debt and potentially agree to changes in terms on other debt.

Investors have yanked about \$4.4 billion out of weekly reporting muni mutual funds in the three weeks following Detroit's bankruptcy filing, according to Thomson Reuters unit Lipper FMI. During that same period, investors poured about \$3.3 billion into corporate investment-grade funds, according to Lipper.

Detroit is "treating bondholders like the enemy," said Dan Solender, director of municipal-bond management at Lord Abbett, who oversees about \$17.5 billion in munis. And given that stance, "it's harder to analyze risk" in the state, he said. He said his firm is being more cautious about investing in debt from Michigan local governments.

Within the muni-bond market, investment-grade debt issued by cities and states has fared much better than lower-rated debt since Detroit's July 18 filing, posting a negative return of 0.847%, according to data from Barclays. That compares with "junk"-rated municipal bonds' return of a negative-1.880% in the same period.

Investment-grade corporate bonds have seen a negative return of 0.143% since Detroit's filing, a better performance than the negative 0.847% return for high-grade munis. Munis rated triple-B, the lowest rung on the investment-grade scale, returned negative-1.864%, Barclays says.

Detroit's bankruptcy filing piled onto declines already under way in the municipal-bond market. Prices fell and yields rose in all bond markets in May and June, when officials at the Federal Reserve started discussing slowing an \$85 billion-a-month bond-buying program aimed at stimulating the economy. The selloff meant that higher-quality bonds offered more enticing yields, so municipal-

bond investors were already shifting away from lower-rated debt.

But when Detroit filed for bankruptcy, investors in the municipal-bond market became more anxious, in particular, about lower-rated, riskier bonds, as well the security of bonds sold by Michigan localities in general.

Over the past week, a third Michigan municipality postponed an offering, finding investors were demanding more compensation than the issuer wanted to pay. That was Saginaw County, Mich., which Thursday pulled a \$60 million bond sale meant to fund the county's pensions. Earlier in the week, Battle Creek, Mich., delayed its bond deal.

Detroit's bankruptcy filing "put a further scare into the marketplace," said Lyle Fitterer, managing director at Wells Capital Management, which oversees about \$34 billion in munis. "Why take the risk when you can get the yield in a higher-quality instrument?" he said. "There's definitely some of that going on."

"The trend has absolutely accelerated of late, and Detroit has played some part in that," said Tom Weyl, municipal strategist at Barclays, of lower-rated munis underperforming higher-quality ones.

Burton Mulford, portfolio manager at Eagle Asset Management, said his firm has received a lot of phone calls from concerned high-net-worth clients after Detroit's bankruptcy. He estimated the call volume was about three times the usual amount.

After seeing losses on their muni investments in May and June, "Detroit raised a red flag and brought up more questions," said Mr. Mulford, whose firm oversees about \$2 billion in munis. The city's bankruptcy filing "just added more skittishness."

Mr. Mulford said his firm doesn't own any Detroit bonds and is underweight debt from Michigan municipalities in general. "There has been a flight to quality in the muni market," Mr. Mulford said.

[WSJ: Detroit Has Wiped \\$13.8 Billion From S&P's Muni Index.](#)

Since Detroit filed the biggest municipal bankruptcy ever on July 18, the S&P Municipal Bond Index—a proxy for the broader municipal-bond market—has dropped 0.97%, as of Aug. 7. The index tracks about \$1.4 trillion worth of bonds, so the nearly 1% in negative return represents lost value of about \$13.8 billion.

The true lost value is likely larger, given that the index tracks only a portion of the \$3.7 trillion muni market.

J.R. Rieger, vice president of fixed-income indexes at S&P Dow Jones Indices, says the sharp drop cannot be attributed to only fears about rising interest rates, should the Fed wind down its bond-buying program as expected. Detroit's problems, and the ramifications it may have for the wider muni market, are a main factor, he said.

Rieger pointed out that the S&P U.S. Issued Investment Grade Corporate Bond Index actually recorded a modest 0.07% positive return since Detroit's bankruptcy filing.

Concerns have also been reflected in cash flows out of mutual funds: Investors have yanked about \$17 billion from weekly-reporting muni-mutual funds and exchange-traded funds over the past 10

weeks, according to Thomson Reuters unit Lipper.

Detroit's state-appointed emergency manager, Kevyn Orr, has proposed saddling some bondholders with significant losses, a somewhat alarming proposition in what is usually a safe and relatively sleepy market. Only a handful of major municipalities are in bankruptcy out of tens of thousands of towns, cities, counties and other units of government in the U.S.

"These are big distressed situations, and the bankruptcy cases are posing uncertainty in regard to how they will be resolved," Rieger said. "That could impact municipal investors nationwide."

Even so, Rieger said he was surprised at how poorly the index has performed since the city's bankruptcy. The index actually posted a positive return in the approximately two months after Jefferson County, Ala., filed a large bankruptcy case in November 2011.

"Detroit has been a distressed credit for quite some time," he said. "It's the power of that repetitive negative news that retail investors must be reacting to."

WSJ: Why You Shouldn't Throw Sewer Bonds Out With the Bath Water.

Don't flush your sewer bonds down the toilet just yet.

Municipal bonds that are paid by revenues from sewer systems have gotten some bad press in recent years. First, Jefferson County, Ala., filed for bankruptcy in 2011, saying it could not afford to pay back more than \$3 billion in debt tied to its sewer system. Now, Detroit has gone bankrupt as well, and emergency manager Kevyn Orr has floated a proposal that could change how sewer bondholders get paid back.

But ask any muni-bond manager, and they will tell you that sewer bonds normally rank among the safest types of muni bonds. Municipalities typically issue bonds backed by sewer revenues to make improvements to their sewer system. The thinking is that even if a municipality is facing financial distress, there will always be revenues from the sewer system to pay back the bonds. After all, everyone needs to use the bathroom.

Sewer bonds are often lumped with debt tied to other essential services, such as power systems or even toll roads serving major metro areas, and considered ultra safe.

"It's primarily services that you really can't do without," said James DiChiaro, a portfolio manager at Cutwater Asset Management, which oversees about \$3 billion in munis. "And generally speaking, a lot of those services comprise a small portion of any citizen's monthly income."

Another attractive quality to sewer bonds is that they have been afforded a special status in bankruptcy. The bankruptcy code says that investors who own "special revenue" bonds — which in the past have been considered to include sewer bonds — are entitled to still get paid from the revenues previously slated for bondholders.

Detroit has more than \$5 billion in bonds backed by its water and sewer system. Mr. Orr has put forth a plan that envisions these bondholders ultimately getting their money back, but perhaps in the form of new bonds.

Currently, Detroit's water and sewer system — which also serves surrounding suburbs — is run as a

city department. Mr. Orr's plan would involve creating a new municipal authority that could then lease the sewer system from the city. This lease payment could be made before money is set aside to pay bondholders. The idea is that there is more money in the water and sewer system than is needed to pay back investors, and Detroit could use the extra cash.

The proposal has miffed some bond investors, who say the city has no right to tinker with the sewer bonds, especially given the special protections in the bankruptcy code. If the city changes how the bonds are paid back, they say, that could spur other municipalities to break their promises as well.

Bill Nowling, a spokesman for Mr. Orr, said he believed the city's water and sewer bonds are still a good investment. He said the city ultimately intends to pay them back in full, and that Mr. Orr's plan is nothing more than a proposal at this point.

"The muni market might be seeing specters where there's not," Mr. Nowling said.

Overall, bond buyers note that sewer bonds remain safe, pointing to the fact that Detroit and Jefferson County are likely outliers. Jefferson County's staggering sewer debt was the product in part of corrupt bond deals that landed some local officials in prison. And Detroit, the center of the U.S. auto industry, was hit particularly hard in the recession.

"We do not have a different opinion on essential service bonds" in the wake of the bankruptcies, Mr. DiChiaro said. "We still regard them as one of the safest asset classes within the municipal sector."

NYT: A Plan to Avert the Pension Crisis

LOS ANGELES — IT isn't politically feasible for Washington to bail out Detroit, but President Obama and Congress must step in to avert the worst fiscal collapse in urban American history.

They must intervene, because symptoms of the municipal illness that made Detroit, with an estimated \$18 billion in liabilities, the largest city in American history to declare bankruptcy are showing up in other cities. Emergency response times are lengthening in cash-starved cities. Libraries, parks and recreation facilities are shortening their hours or closing. Potholes go unfilled, sidewalks unrepaired and trees untrimmed. All that makes urban life rewarding and uplifting is under increasing pressure, in large part because of unaffordable public employee pension and health care costs.

Do we want to live in a city like Detroit, where if you call 911, it takes nearly an hour to get a response? Will Washington sit by as this tragedy is re-enacted in one city after another and our urban standard of living falls to third world levels, with the streets around us resembling those in post-apocalyptic video games?

President Obama should propose, and push Congress to establish, a public employee pension reform program, similar to a plan proposed by the economist Joshua D. Rauh, now a professor of finance at Stanford's business school and a senior fellow at the Hoover Institution.

In our version of the plan, the program would essentially serve as an insurance agency. It would not bail out distressed local retirement plans. Instead, cities, and perhaps states, would be permitted to sell bonds to cover their pension liabilities, with the federal government guaranteeing repayment. Participants would pay fees — a kind of insurance premium — to finance the program, so there would be no net cost to Washington. The program would give cities access to low-cost, long-term

capital. But in exchange for what would amount to federal bond insurance, the cities would have to agree to certain reforms of their pension and health care programs for current and former workers. At a minimum, those reforms should include a single national standard for projecting returns on pension investments — remarkably, there isn't one — and negotiated reductions in current benefits.

Some will argue that the causes of Detroit's epic civic failure are unique: white flight on an unprecedented scale, the collapse of auto manufacturing, decades of inept, often corrupt, municipal government. One significant cause of its financial debacle, however, is unfortunately shared by an alarming number of other cities, and that's the burden of unaffordable pension and retiree health costs.

Detroit's municipal debt is around \$18.2 billion, or more than \$26,000 for each of its 700,000 residents. Employee pension and retiree health schemes account for \$9.2 billion of the liabilities. Until recently, officials thought the programs were fully financed. Now it appears they are short by at least \$3.5 billion. That's because Detroit consistently overestimated investment returns on its pension funds.

It is not alone in this kind of wishful actuarial accounting. California's giant state pension fund, the world's sixth largest, continues to assume it will earn 7.75 percent on its investments, even though its actual returns have been less than half that for a decade. Los Angeles continues to project similar annual yields on its investments, when the actual average returns are closer to 5 percent. As a consequence, the city's unfunded pension obligations probably will grow to around \$15 billion over the next four years.

According to Moody's, the credit-rating agency, Illinois's net public-employee pension liabilities now amount to \$133 billion, or 241 percent of the state's total annual revenues; in Connecticut, 190 percent; in New Jersey, 137 percent; and in New York, 17 percent.

America's state and municipal pensions concede that they are underfunded by more than \$1 trillion. If a more realistic expectation of returns on investment is pegged at 5 percent, then that collective liability climbs to \$2.7 trillion. Moody's further estimates that the median state has financed only 48 percent of its future pension liabilities. Already, about one-fifth of state general spending goes to pay for pensions and service debts, a proportion that will soar in coming years.

In California, where more than 20,000 state and local retirees receive annual pensions of more than \$100,000, the cities of San Bernardino, Stockton and Vallejo have filed for bankruptcy. Los Angeles's public employee pensions are inexorably pushing the city toward bankruptcy — perhaps within four years. Chicago now pays \$1 billion each year to its retired teachers alone. In New York City, pension costs have grown to \$8 billion from \$1.8 billion over the last 12 years.

A wave of municipal bankruptcies won't just decimate city services and retirees' lifestyles. They would also fundamentally undermine investors' confidence in the municipal bond markets.

Won't a federal insurance program simply create a "moral hazard" by making civic bankruptcy more attractive? There's little risk of that. First, Chapter 9 of the bankruptcy code is so onerous that it's hard to imagine any city pursuing it except as a last resort. Second, the pension reform provisions required to participate, however beneficial, would be so politically difficult to undertake that only municipalities in the most dire straits would sign up.

To be clear, we must avoid demonizing public employees and their unions. Concessions on their part should be negotiated within the collective-bargaining framework and not imposed unilaterally, as some governors have tried to do. Union leaders must embrace this process because it's the right

thing for their members' long-term interests. If they're not included in the process and changes are forced on them, the result will be social strife and years of legal challenge.

Mr. Obama, Congress, local politicians and labor leaders can keep that from happening. We should insist they do.

Richard J. Riordan, a Republican, was mayor of Los Angeles from 1993 to 2001. Tim Rutten was a journalist at The Los Angeles Times from 1972 to 2011.

FHFA Says GSEs May Cease Business in Towns Seizing Mortgages.

The regulator of Fannie Mae and Freddie Mac is considering directing the companies to stop doing business in communities that seize mortgages through eminent domain, the agency's general counsel said today in a memorandum.

The Federal Housing Finance Agency may also initiate legal challenges to eminent domain actions, Alfred M. Pollard, the general counsel, said in the memorandum, which was posted on the agency's website.

"There is a rational basis to conclude that the use of eminent domain by localities to restructure loans for borrowers that are 'underwater' on their mortgages presents a clear threat to the safe and sound operations of Fannie Mae, Freddie Mac and the Federal Home Loan Banks as provided in federal law," Pollard wrote.

The city of Richmond, California announced last month it is moving ahead with a plan to seize mortgages from investors and write down the loan balances to help borrowers at risk of foreclosure. The public benefit of the seizures is to fend off foreclosures that cause blight and create other costs for the community, according to the plan's supporters.

Other Cities

At least a dozen cities still dealing with the fallout of worst slump in home prices since the Great Depression are studying the eminent domain idea. Others include El Monte, California, North Las Vegas, Nevada, and Irvington, New Jersey. Communities such as San Bernardino County, California, and Chicago abandoned such plans after considering them last year.

The FHFA statement comes a year after the agency first requested public input on the issue, and a day after Fannie Mae (FNMA) and Freddie Mac joined investors authorizing a lawsuit to stop Richmond from seizing loans.

The eminent domain program is advocated by Mortgage Resolution Partners LLC, which would provide services and arrange for private investment funds that would profit by buying the loans for less than property values, and reworking them.

The FHFA is violating its conservatorship mandate and obligations to protect taxpayers by opposing the use of eminent domain to restructure mortgages, said Mortgage Resolution Partners Chief Strategy Officer John Vlahoplus.

"Instead of fighting loan sales, increasing risk, and wasting assets, they should support a rapid loan sell down and consequent risk reduction," Vlahoplus said in an e-mailed statement. "Those financial

institutions that reduce risk and their exposure to risky assets do well.”

Thomson Reuters: Muni Sales Next Week Could Be 2nd Largest of Year.

Want further proof that the municipal-bond market isn't slowing down because of the bankruptcy of one very large municipality, Detroit?

According to Thomson Reuters estimates on Friday, U.S. municipal bond sales next week are expected to rise to nearly \$10.24 billion from a revised \$7.16 billion this week. If all the deals price next week, this will mark the second-largest calendar so far this year.

Still, it's not as if Detroit's bankruptcy filing and rising interest rates isn't putting some pressure on this market.

According to Thomson Reuters, rising yields in the secondary market, especially in longer-dated maturities, cast a chill in the primary market this week, with the South Carolina Public Service Authority cutting its planned bond sale by 25 percent to \$1.34 billion.

The California Infrastructure and Economic Development Bank also has postponed indefinitely a \$195.8 million refunding revenue issue for the California Independent System Operator Corporation Project. On Thursday Michigan's Saginaw County become the third local issuer in the state to postpone a bond sale amid investors' concerns over Detroit's bankruptcy filing.

SIFMA Standard Forms and Documentation Library: Promoting Industry Transparency.

To promote transparency, efficiency and liquidity in the financial markets, SIFMA encourages the use of Standard Forms and Documentation. Check out the prepared tools available to you and your firm within SIFMA's extensive repository — recent additions to the library include an Institutional Suitability Certificate to comply with FINRA's Suitability Requirements and MSRB Rule G-17 Model Disclosure Documents.

MSRB Rule G-17 Model Disclosure Documents

SIFMA's G-17 Model Disclosure Documents are designed to be a starting point for disclosures concerning the underwriter's role, compensation, and conflicts, as well as regarding the material financial characteristics and risks inherent in certain complex transactions commonly recommended by underwriters.

- Model Underwriter Disclosures Pursuant to MSRB Rule G-17
- Model Fixed Rate Disclosure Risk Disclosures Pursuant to MSRB Rule G-17
- Model Floating Rate Notes Disclosures Pursuant to MSRB Rule G-17
- Model Variable Rate Demand Obligations (VRDO) Risk Disclosures Pursuant to MSRB Rule G-17
- Model Forward Delivery Bonds Disclosures Pursuant to MSRB Rule G-17
- Model Interest Rate Swaps Disclosures Pursuant to MSRB Rule G-17
- Model Tender Offers Disclosures Pursuant to MSRB Rule G-17

Master Agreement Among Underwriters (MAAU)

An agreement setting forth the legal relationships between syndicate members and permitting the efficient execution of one standardized agreement rather than the execution of separately negotiated legal contracts each and every time a firm joins a syndicate. For use with negotiated offerings of municipal securities.

2002 Version

- MAAU Master Standard Terms and Conditions – Negotiated Offerings of Municipal Securities
- MAAU Master Standard Terms and Conditions – Competitive Offerings of Municipal Securities
- SIFMA Proposed G-17 Model Language for MAAU Riders

1997 Version

- MAAU Master Standard Terms and Conditions
- MAAU Instructions, Terms and Acceptance
- MAAU Guidance Notes
- SIFMA Proposed G-17 Model Language for MAAU Riders

Additional Forms and Documents

- Best Practice on Disclosures Regarding Choice of Underwriters' Counsel in Municipal Securities Transactions (February 2013)

SIFMA members have been concerned about a practice in the industry in which an issuer may effectively require an underwriter to retain a specific counsel for a transaction, or recommend the underwriter choose from a limited pool of underwriter's counsel law firms. Underwriters need to be able to rely on their counsel's competence and confidential advice, as well as ensure that counsel has no conflicts of interest. SIFMA developed this best practice to provide guidance to the industry and facilitate fair, efficient and transparent municipal market transactions.

- Best Practices for NIIDS Testing and Implementation for Underwriters of Municipal Securities
- Best practices for underwriters of municipal securities in submitting new issue underwriting information to the Depository Trust and Clearing Corporation's (DTCC) New Issue Information and Dissemination Service (NIIDS).

Clarifying Statements for Municipal Securities Underwriters

Model documents SIFMA member firms may use to clarify their role and establish issuer expectations when working with municipal issuers and conduit borrowers.

- Master Selling Group Agreement

Intended for use in negotiated purchases and public offerings of municipal securities, whereby a manager and dealer wish to join together to form selling groups.

- Model Bond Purchase Agreement

Intended for use in connection with governmental tax or revenue-supported securities, including fixed, variable rate, auction and credit enhanced securities. Not intended for use in connection with conduit financing transactions.

SIFMA Municipal Securities Division Seeks Comments on Revised Draft of its Model Bond Purchase Agreement for Municipal Securities – October 12, 2011

- Instructions and Commentary
- General Provisions and Conditions
- Terms and Acceptance
- Model Joint Account Agreement

Created for the purpose of forming a joint trading account for the joint and several purchase and sale of municipal securities in the secondary market.

- Municipal Secondary Market Disclosure Filings
- A generic cover sheet for muni disclosure filings. Filings should be made to the Municipal Securities Rulemaking Board's (MSRB) Electronic Municipal Market Access (EMMA) website, www.emma.msrb.org.
- Public Finance Issuer Advisory: Mechanical Aspects of Municipal Bond Sale Practices

Intended to advise state and local government bond issuers to review certain mechanical aspects related to their municipal bond sale procedures to ensure that local and state governments issue bonds in the most effective way possible.

- Recommendations for Communicating with Beneficial Owners of Defaulted Municipals

A joint trade association release, in consultation with The Depository Trust Company (DTCC). The Joint Recommendations provide practical advice to issuers, their counsel, nominee holders, and agents of issuers on how to get notices on defaults through to beneficial owners in the era of book-entry-only bonds. They provide procedures for issuer control of the communications process and make recommendations about the format of notices, the payment of reasonable expenses by the issuer, and the provision of notices by the issuer for retransmission through the chain of nominee holders.

These documents are available at:

<http://www.sifma.org/services/standard-forms-and-documentation/municipal-securities-markets/>

WSJ: Detroit Bankruptcy May Spell Trouble for Other Distressed Municipalities.

A Michigan county's decision to postpone a \$53 million bond sale highlights the difficulty fiscally strapped issuers everywhere may face in the wake of Detroit's record bankruptcy filing, investors said.

Portfolio managers say they are more cautious now about buying bonds from local governments in Michigan and may demand higher interest rates to lend them cash. Genesee County, Mich., on Thursday shelved an offering after potential buyers wanted much higher yields than the county was willing to pay, said people familiar with the offering.

But some also say their leery extends beyond the state's borders, to other local governments

struggling with their finances in the wake of the recession. Indeed, some investors say the Motor City's filing on July 18 acted as a fresh reminder for them to look at all holdings again and reassess risk.

"With attention on Detroit, it only heightens attention... on other distressed issuers," said Jim Colby, senior muni strategist and portfolio manager at Van Eck Global. Investors should demand higher yields from these municipalities, given the uncertainty surrounding Detroit's bankruptcy and how much bondholders will ultimately get repaid, Mr. Colby said.

"You could argue with Detroit that the whole [muni] world is turning upside down," he said.

One key test comes in the coming week, when Puerto Rico's electric and power authority plans to sell about \$600 million in debt. The deal is the first from an issuer in the commonwealth this year as the island continues to struggle with a sluggish economy and a high unemployment rate.

The bonds have ratings that are barely investment grade. Puerto Rico bonds are widely held in the municipal-bond market because interest on them is exempt from federal, state and local taxes. They also offer relatively higher yields than other muni debt because of the island's fiscal troubles.

The Puerto Rico electric deal "will certainly be a bellwether" for lower-rated muni credits, said Gary Pollack, managing director at Deutsche Asset & Wealth Management. Already, he said investors were demanding a higher yield premium for other lower-rated local government bonds. He said his firm was reducing exposure to such bonds.

Detroit's bankruptcy, as well as Chicago's multinoth downgrade last month due to its pension issues, "is a reminder for investors to do additional homework," Mr. Pollack said. "You have to dig deeper."

Puerto Rico's electric authority isn't the only lower-rated borrower wanting to sell bonds in the coming week, according to Ipreo LLC. Chicago is also planning a \$247 million debt sale for O'Hare International Airport, a deal with ratings in the lowest investment-grade category. Indiana Finance Authority is selling about \$38 million in debt in a junk-rated charter-school deal, while there is also a nonrated \$37 million North Carolina senior-living deal on tap, Ipreo said.

Sharon deGuzman, senior portfolio manager at Baird Advisors, said she has noticed a change in investors' attitudes recently, especially with Detroit's bankruptcy filing.

Before, investors' appetite for additional yield was so voracious that lower-rated, riskier munis were generally outperforming those with higher ratings. But that wasn't the case in July, when Detroit filed for bankruptcy. Lower-rated munis didn't perform as well as higher-rated munis, she said, citing Barclays indexes.

Detroit was a "gut check," she said.

Investors have yanked about \$17 billion from weekly-reporting muni mutual funds and exchange-traded funds over the past 10 weeks, according to Thomson Reuters unit Lipper FMI. Benchmark muni yields have also risen while prices have fallen, as investors fret about the possibility that the Federal Reserve will siphon off its support of the bond markets sooner rather than later. Year-to-date, munis have seen a negative total return of 3.66% on Barclays muni index.

By KELLY NOLAN

SIFMA Calls for Review of SRO Structure.

SIFMA today sent a letter to the Securities and Exchange Commission to request a review of the regulatory structure of broker-dealers, exchanges, and the self-regulatory model.

“SIFMA supports a holistic review of U.S. equity market structure to ensure safe, sound and efficient markets that investors can have confidence in,” said Randy Snook, executive vice president. “A part of that review should focus on SRO structure, because the markets have changed to the point that the current structure of the self-regulatory model is widely viewed to be outdated and in need of reform.”

In today’s markets, securities exchanges and broker-dealer trading venues perform essentially identical functions. Nonetheless, the status of exchanges as self-regulatory organizations (SROs) has not changed, even as the exchanges have evolved from member-owned utilities to for-profit businesses, as well as active competitors with their broker-dealer members.

In its letter to the Commission, SIFMA identified key areas it believes the SEC should consider in its review, but noted the review should not be exclusive to those areas.

What is an Exchange and Why Is It an SRO? An exchange has two separate statutory functions: (1) an exchange acts as a marketplace for the trading of securities; (2) an exchange acts as a self-regulatory organization overseeing its members. In today’s reality, the interests, incentives and functions of the member-owned cooperative exchanges of 1934 bears little resemblance to those of the current for-profit exchanges. Eliminating exchange’s SRO status would streamline regulatory processes and make self-regulation more efficient by centralizing regulation.

Exchanges Compete with the Broker-Dealers they Regulate. Combined with the transformation of exchanges into for-profit enterprises in search of ways to expand their businesses, exchanges and broker-dealers have become direct competitors in many aspects of their businesses. Most prominent is the competition for order flow between exchanges and broker-dealers. In this competitive dynamic, the policy of having exchanges regulating broker-dealers has become outmoded.

Competitive and Regulatory Disparities. There are a number of competitive benefits flowing from exchanges’ status as SROs, including limitations on liability, market data revenue, and ability to design market structure developments. In addition, exchanges are not subject to some of the significant regulatory requirements applicable to broker-dealers, such as best execution, supervisory controls, and financial responsibility. At the same time, SIFMA recognizes that exchanges are subject to unique regulatory requirements, including the requirement to submit rule changes for their business practices for SEC approval, fair access requirements, and ownership restrictions. SIFMA welcomes a discussion of these issues from both perspectives.

Funding of Self-Regulation. Broker-dealers are subject to numerous regulatory fees from SROs. For many exchanges, regulatory fees are intended to offset the exchanges’ cost of outsourcing regulation to other SROs – such as FINRA-effectively duplicating costs on member firms. Currently, there is no way to assess the reasonableness the regulatory funding model without greater transparency into SROs’ existing regulatory fees as well as their actual regulatory expenses. SIFMA urges the Commission to consider requiring SROs to make this important information publicly available on a regular basis.

A copy of SIFMA’s letter can be found at the following link:
<http://www.sifma.org/issues/item.aspx?id=8589944673>.

Moody's: Detroit Bankruptcy May Change How Other Distressed Cities Approach Obligations.

Detroit's bankruptcy filing is profoundly meaningful for the small number of local governments in the US that are financially distressed, says Moody's Investors Service, as it may create precedents for how they will deal with long-term liabilities. For the vast majority of the rated local government universe, over 99% of which are rated investment grade, the impact will be limited.

Moody's says that Detroit's bankruptcy, assuming bankruptcy protection is granted by the bankruptcy judge, could influence market expectations and issuer behavior at the fringe of municipal credit: those at risk of default or municipal bankruptcy. Moody's only rates 34 local governments below investment grade, out of a universe of more than 7,500 rated entities.

"Bankruptcy may become more appealing to other stressed local governments if Detroit succeeds in reducing pension benefits and discharges most of its general obligation debt," says Moody's Managing Director for Public Sector Ratings Anne Van Praagh in the report "Detroit Bankruptcy May Change How Other Distressed Cities Approach Their Pension and Debt Obligations."

"If Detroit is bogged down in years of expensive proceedings and fails to restore solvency or materially restructure its liabilities, other distressed issuers would be unlikely to emulate Detroit's approach," says Moody's Van Praagh.

Even should a local government decide to emulate Detroit's approach, obtaining bankruptcy protection in the first place can be very difficult. Bankruptcy remains a long and onerous process, and the outcomes for other cities will be uncertain even if Detroit emerges as a tone-setter.

As for municipalities not currently in distress, the implications of the Detroit bankruptcy are limited.

"Detroit is an outlier. Although many of Detroit's problems are common, the magnitude of its problems is not. Other cities in the US have undergone post-industrial depopulation and an erosion of the tax base, and now carry debt burdens that are heavy relative to the remaining tax base and population. But no large city lost as much as Detroit," says Moody's Van Praagh.

Moody's expects the number of local governments in severe distress to remain small. Since 2010, Moody's has expected the default rate among local governments, historically minimal, to increase and for strong post-default recoveries to decrease. However, both changes will be marginal.

In the years following the financial crisis of 2008-09, the majority of local governments continued to make tough decisions that allowed them to balance their budgets and meet their debt and pension obligations, says Moody's, despite substantial loss of housing market values, weak or moderate economic performance, and persistent pressure on revenues and spending.

Moody's does not expect other major US cities to enter the same "downward spiral" that Detroit did.

Reuters: Muni Board Watching General Obligation Debt in Detroit Case.

The municipal bond market's self-regulator on Friday said the Detroit emergency manager's proposed treatment of general obligation bonds in the city's bankruptcy case risks changing how

investors view what has long been considered the safest class of municipal debt.

Kevyn Orr, Detroit's state-appointed manager, has said that general obligation bondholders will remain unsecured creditors in the \$18.5 billion bankruptcy filing.

"You have a long history of ... what everyone thought a GO bond was or what it meant to have a GO bond," said Jay Goldstone, chairman of the Municipal Securities Rulemaking Board. "That whole landscape could change."

The MSRB, which writes the rules for the market that the Securities and Exchange Commission enforces and operates a centralized system for posting bond information, said it discussed Detroit's filing for bankruptcy, including its public pension and debt, but decided not to take any action.

"At this point in time we are in an observation mode and as things evolve the board will revisit and decide what role - if any - there may be," said Jay Goldstone, chairman of the board, during a call with reporters on Friday, describing board members as "the industry experts."

Detroit has an estimated \$18.5 billion in debt and liabilities it is seeking to resolve under Chapter 9 bankruptcy protection. Last week, the city filed for the largest municipal bankruptcy in U.S. history.

Under the Dodd-Frank financial reform law, the MSRB became a much more powerful operation, with increased membership and a new mandate to protect public entities, including pension plans.

Still, it remains a "self-regulatory organization," led by representatives from financial firms, banks and municipalities instead of federal officials, and it is unclear if it could have much influence over the filing.

The board's most likely steps are releasing notices that explain how its rules apply to the situation, or working to draft new rules inspired by the outcomes of the case.

Goldstone said anyone could submit a "friend of the court" brief or letter in the Detroit bankruptcy proceedings, but the MSRB did not decide to do so at its meeting.

Asked if the MSRB had reached out to the Detroit pension plans in light of its mandate, he said "the board has not been in contact directly with anyone in Detroit."

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For more information, Moody's researcher subscribers can access this report at http://www.moody.com/viewresearchdoc.aspx?docid=PBM_PBM156771.

NYT: Cities Need to Weigh Costs of Private Partnerships.

Chicago's 36,000 parking meters were leased to an investor group backed by Morgan Stanley.

Donald Cohen is the executive director of In the Public Interest, a resource center on privatization and contracting.

DealBook recently published a piece by Kent Rowey that makes a troubling argument for selling public services and infrastructure to Wall Street banks and other corporations. Under the guise of making recommendations for Detroit, Mr. Rowey tried to sell the idea that auctioning off our most vital services and assets to for-profit companies is a simple win-win solution for strapped governments.

It sounds simple, but the real track record of public-private partnerships is fraught with problems.

Mr. Rowey holds up the example of Chicago's 36,000 parking meters that were sold in a 75-year lease to an investor group backed by Morgan Stanley as a success. In fact, Chicago taxpayers,

investors and mayors across the country will tell you that not only was it an unmitigated disaster, it is also Exhibit A in the folly of blindly giving up taxpayer control of services.

An after-the-fact investigation by the city's inspector general concluded that the decision to enter the lease contract lacked "meaningful public review" and neglected the city's long-term interests to solve a short-term budget crisis. Specifically, it found that "the city was paid, conservatively, \$974 million less for this 75-year lease than the city would have received from 75 years of parking-meter revenue." That's nearly \$1 billion that could have been used for better police and fire protection, longer library hours and many other services that would benefit the public good rather than private profits. By Dec. 31, 2009, Chicago had only \$180 million left from the \$1.15 billion parking meter deal, forcing the city to consider alternative sources of revenue rather than relying on long-term reserve funds generated by the parking meter lease.

Parking rates increased to as much as \$8 for two hours. The initial contract required seven-day-a-week paid parking. The city was able to negotiate out of that requirement but in exchange had to extend paid parking until 10 p.m. Downtown business owners have blamed the increase in rates for a decrease in economic activity.

Taxpayers are further harmed by the contract's fine print, which says that they must reimburse Morgan Stanley and its Qatar-based business partner for any time the space is used for anything other than parking — including parades and festivals. The city is prevented from performing routine road maintenance that would occupy a parking space on all but a few days a year without paying a penalty.

Perhaps most egregious, Chicago cannot build parking lots for the entire duration of the contract because they might compete with the outsourced parking meters.

In fact, the "noncompete" and "compensation" clauses mean the city won't be able to make, for 75 years, fundamental economic development, land use or environmental policy decisions — anything that would affect the revenue of the parking company. Roderick Sawyer, alderman for Chicago's Sixth Ward, has called this parking privatization scheme "outrageous for taxpayers, undemocratic, and un-American."

Public-private partnership deals across the country are riddled with similar problems. In the suburbs of Denver, a 99-year contract prevents affected municipalities from making improvements to nearby roads that might compete with the privatized road and interfere with the corporate profits.

Mr. Rowey contends that infrastructure assets are "relatively straightforward to value" and represent a reliable, steady source of revenue. Not so.

In 2010, San Diego County's privatized South Bay Expressway filed for bankruptcy, three years after it opened late and over budget. The for-profit company running the toll road blames the recession for its low traffic, but drivers have publicly blamed the company's steep toll increases.

A privatized toll road in Texas wasn't meeting the project revenue targets. Fewer drivers were using the costly road. In an attempt to compensate for the shortfall, the state approved a speed limit of 85 miles an hour for a 41-mile stretch between Austin and San Antonio. Similarly, Virginia officials had hoped that privatized express lanes on the 495 Beltway would generate badly needed cash for the state. Once again, traffic patterns failed to match rosy projections and the project is losing money. Last month, the state increased the speed limit to 65 miles an hour, hoping to lure more drivers and generate more revenue.

A 2009 report in the American Journal of Public Health studied traffic fatalities in the United States from 1995 to 2005 and found that more than 12,500 deaths could be attributed to increases in speed limits on all kinds of roads. These perverse incentives cause government to change speed limits simply to generate profits for infrastructure investors. Those are public decisions that should be driven by public goals, not private profit.

Cities, counties and states should enact common sense reforms that ensure taxpayers get their money's worth when one of those entities enters a public-private partnership. Public agencies should require that an independent audit show an actual taxpayer savings before outsourcing a service or asset (a similar law to this has operated with great success in Massachusetts since 1993). They should also outlaw fine-print "noncompete" and "compensation" clauses that prevent public officials from making decisions to advance the public good.

There is no doubt that we need to rebuild and retool American infrastructure for the 21st century. It is essential for our economic competitiveness, our efforts to stem the effects of climate change and to create a better quality of life for us all. And doing so will create thousands of jobs for middle-class American families. But it is equally as important that cities and states fully consider the costs and benefits of attracting private investment in public infrastructure and ensure that public goals and the public interest remain in full control.

BY DONALD COHEN

[National Governors Association Urges Preservation of Municipal Bond Exclusion.](#)

Lawmakers should preserve the municipal bond interest exclusion and the state and local tax deduction to avoid disrupting infrastructure investment and to protect states from federal encroachment, the National Governors Association said in a July 23 letter to leaders of the Senate Finance Committee.

July 23, 2013

The Honorable Max Baucus

Chairman

Committee on Finance

United States Senate

Washington, D.C. 20510

The Honorable Orrin Hatch

Ranking Member

Committee on Finance

United States Senate

Washington, D.C. 20510

Dear Chairman Baucus and Senator Hatch:

On behalf of the nation's governors, we write to urge the Senate Finance Committee specifically, and the Congress generally to preserve the exclusion from income on interest earned from municipal bonds in comprehensive tax reform. We also urge Congress to maintain the deductibility from federal income for state and local taxes.

In anticipation of comprehensive federal tax reform, the nation's governors earlier this year released guiding principles, which are attached. The principles anchor our position that preserving these original elements of the federal tax code are critical to help grow the economy, ensure tax code fairness, and promote other important policy objectives.

Preserve Municipal Bond Interest Exclusion

Governors believe that federal statutory and regulatory policies should neither increase bond issuance costs to states and local governments, directly or indirectly, nor diminish retail and institutional market demand for bonds issued by states and local governments.

Eliminating or placing income caps on itemized deductions and exemptions would have the unintended consequence of chilling supply and demand for municipal bonds. It would also limit the flexibility of state and local governments to adjust tax policy in response to uncontrollable economic pressures, which could among other outcomes increase risk concerns for bondholders. Individual and retail investors in municipal bonds would seek higher yields to offset ending the exclusion or imposing a deductibility cap and both would lower municipal bond supplies because state and local issuers, especially small and occasional issuers, could not afford higher interest rate costs.

Governors also believe that the preservation of public financing — notably tax-exempt financing — is necessary because it is the primary method for states to raise capital for a wide range of infrastructure and public projects. States and local governments own and operate the vast majority of the nation's infrastructure systems and contribute nearly 75 percent of the annual cost to operate and maintain them. If issuing municipal bonds becomes cost-prohibitive for states and local governments because of changes to the federal tax code, then the likelihood of financing new infrastructure projects falls because the alternatives include higher taxes and user fees, or just shelving proposed projects, which would result in lost jobs and reduced economic growth because of declining infrastructure capacity.

The federal tax code should encourage expansion, not contraction, of financing options because there is no effective substitute bond program or direct federal appropriation that could replace the robustness that the municipal bond market provides to the broad range of municipal issuers.

Eliminating or limiting the interest exclusion on interest for outstanding municipal bonds could also create market disruptions, including with new issuance sales, because ending the exclusion breaches the implied promise from the federal government that the exclusion would remain during the life of outstanding bonds. This could trigger call provisions in bond indentures putting state and local issuers at financial risk.

Eliminating the exclusion would hurt all bondholders, not just those in high tax brackets because the value of all outstanding bonds would fall. In contrast to the assumptions by supporters of eliminating the interest exclusion, investors would not likely rebalance their portfolios fully into taxable bonds, but instead would seek other ways to shield investment income from taxation, which would lower federal tax revenue estimates from eliminating or capping the interest exclusion. The mere discussion about altering the tax treatment of municipal bonds injects uncertainty and creates risk

concerns for investor who will demand risk premium on future bond issues.

Alternatively, the central argument for eliminating the municipal bond interest exclusion is fiscal efficiency. Efficiency proponents argue that the current process for setting municipal bond yields generally leads to higher rates than what higher-income taxpayers would actually demand as investors. This spread represents lost federal tax revenue that benefits high-income investors primarily rather than accruing to the state and local issuers in lower borrowing costs. Proponents argue that instead of tax-exempt bonds, a taxable bond program with a direct federal subsidy to issuers that covers a portion of interest paid investors would be more efficient. The temporary Build America Bonds (BABs) program authorized under the 2009 Recovery Act was a direct subsidy bond program.

In addition to the counter-arguments above against taxable bonds as a substitute, the fact the BABs subsidy is subject to the sequester and the congressional appropriations process would only add to the uncertainty — and thus the costs to state and local issuers — of replacing the current exemptions with taxable bonds. This is particularly troublesome for those issuers from smaller states and communities that would face increased debt issuance costs if the only option to finance public projects was reliance on a taxable and tax credit market.

Governors remind Congress that federal tax policies and tax expenditures serve public policy purposes that are not necessarily captured in revenue and spending numbers. To help avoid unintended consequences from federal tax reform, federal and state partners should work together to determine whether the policy benefits of particular federal tax expenditures exceed their budgetary costs before making final decisions. According to federal and private sector estimates, the interest exclusion will reduce federal revenues by \$43 billion in fiscal year 2014. The exclusion, however, is an attractive incentive for investors that will help states and local governments issue an estimated \$400 billion in new bonds for capital projects in fiscal year 2014.

Protect State and Local Tax Deductibility

Governors also believe that no federal law or regulation, including their interpretation and implementation, should preempt, limit, or interfere with the constitutional or statutory rights of states to develop and operate their revenue and tax systems.

State linkages to the federal tax code remain strong and eliminating federal deductibility for state and local property, sales, and income taxes could limit the ability of state and local governments to adjust tax policy in response to uncontrollable economic pressures, which could increase concerns of risk for bondholders. It would effectively increase marginal tax rates for taxpayers that, absent an offset for equity purposes, could create an economic drag.

Shifting the intergovernmental balance of income taxation in such a manner could damage administrative viability and limit state control of their tax systems because of federal encroachment into the traditional tax base of states.

Refresh Federalism

Federal tax reforms should not simply shift costs or impose unfunded mandates onto the states.

[S]tate and local governments increasingly have been treated like ‘just another special interest group’ rather than as a partner in a federal system of government. . . . The federal government must recognize that its judicially unfettered power to control the tax exemption of state and local government bonds must be exercised with the full recognition of the impact on state and local

taxpayers as well as on the federal Treasury. . . . State and local governments cannot fulfill their responsibilities to provide public services and meet federal standards and mandates without the cooperation of the Congress and the Administration.

Written nearly 25 years ago by the bipartisan Anthony Commission on Public Finance, whose membership included Democratic Governor Bill Clinton of Arkansas and Republican Governor Carroll Campbell of South Carolina, those words remain germane today.

We do not believe that it is the intent of Congress through comprehensive tax reform to undermine the ability of state and local governments to meet the needs of the citizens we all serve. Instead, we are confident that, like the Anthony Commission stated: "the overwhelming majority of members of Congress are sympathetic to the needs of state and local governments and wish to promote their ability to borrow on an effective and efficient low-cost basis."

Sincerely,

Governor Tom Corbett

Chair, Economic Development and

Commerce Committee

Governor Steven L. Beshear

Vice Chair, Economic Development

and Commerce Committee

National Governors Association

Washington, DC

[SIFMA Implores Michigan To Change Tack on Detroit.](#)

The Securities Industry and Financial Markets Association warned Michigan Gov. Rick Snyder that the approach he is backing in Detroit's bankruptcy will cost cities across the state, and urged him to uphold the city's unlimited-tax general obligation bond pledge.

SIFMA sent a letter Thursday, the day of Detroit's historic Chapter 9 filing, to Gov. Rick Snyder and Michigan Treasurer Andy Dillon, warning them that treating Detroit GOs as unsecured will likely drive up borrowing costs for issuers across the state, and imploring them to abide by the legal securities of different bonds.

SIFMA's letter to Snyder and Dillon notes that the state's constitution provides that repayment of voter-approved bond debt is guaranteed.

Treating the debt as unsecured could have a major ripple effect, the industry association said.

"We believe that any such treatment will have long lasting negative impact on the ability of Michigan's municipalities to obtain financing on favorable terms," SIFMA general counsel Ira Hammerman wrote in the letter, saying investors may try to sell their Michigan paper and bond

buyers may be reluctant to buy Michigan GOs in the future.

“Additionally, actions to diminish or impair or alter the rights of bond holders and their expectation to receive monies described as pledged in offering documents could have material consequences by creating uncertainty and confusion in the enter municipal securities market,” Hammerman said. “We implore you to be sensitive to the potential impacts of your actions on the investors in the various classes of Detroit’s municipal securities, municipalities in Michigan and their future borrowing ability, and taxpayers in Michigan. We believe it is possible to navigate this financial crisis without hurting the credibility of Michigan municipal bond issuers in the market in the future.”

by: CAITLIN DEVITT

NYT: Public-Private Partnerships Could Be a Lifeline for Cities.

Cities like Detroit with crumbling infrastructure and deteriorating public services could find help from private investors.

Detroit is fighting for its fiscal survival. Over the last four years, the city has spent \$100 million more each year than it has collected. Long-term liabilities are estimated to be as high as \$20 billion. Gov. Rick Snyder of Michigan installed an emergency manager, who most assume is preparing for a Chapter 9 filing, which would be the largest municipal bankruptcy in United States history.

In May, the manager, Kevyn Orr, was considering selling parts of the permanent collection at the Detroit Institute of Arts to pay creditors. Mr. Orr later backed off that threat, but no doubt he wanted to scare city fathers into getting serious about averting financial disaster. But new worries followed that he would have to unload the city’s collection of 62 classic cars.

Detroit’s plight may be extreme, but its problems are increasingly common in cities across the United States. Municipalities are struggling to make public payroll, maintain basic services or meet pension fund obligations. Many of the hard choices Detroit has to make will be repeated in towns in the Midwest, Rust Belt, California and throughout the Northeast.

In truth, Detroit does not have to part with its Diego Rivera murals or its vintage Mustangs and Cadillacs. Instead, it should be taking an inventory of revenue-producing public assets — including on-street and off-street parking systems, water systems, toll bridges, solid waste disposal plants, utilities and airports — to lease or divest with help from private partners willing to invest capital in improving them.

Public-private partnerships are the ideal solution for the fiscal problems plaguing many American cities. In a so-called P3 transaction, private equity investors make a large up-front payment to run a public service or utility — often for hundreds of millions of dollars. In return, they gain a concession to operate the service under a contract that can last for decades.

Gaining much needed cash and operating efficiency are prime incentives for municipalities to undertake such transactions. Chicago entered into a concession for 36,000 parking meters a few years ago through a 75-year contract valued at more than \$1 billion. Besides streamlining the costs of running the citywide program, the new concession exposed abuses of handicapped parking permits and led to the passage of a law preventing abuses. Today, the Chicago Metered Parking System is considered one of the world’s best.

Does Detroit's lurch toward bankruptcy make it a less-desirable candidate for a public-private transaction? Not necessarily. A municipality that has already filed Chapter 9 may have greater impetus to privatize infrastructure assets to restructure its balance sheet just like any business trying to work through insolvency.

P3 deals are also effective for cities on the brink. Not only can they generate substantial revenue to stave off defaults, but they need not involve an outright sale of assets. Ownership of the services often remains with the city, avoiding the prospect of a fire sale. As for cities in good financial shape, they should consider private partnerships as a means of undertaking long-term civic improvements at a time when the fiscal roof isn't leaking.

How does a city ensure that it's receiving fair value in a P3? These deals are subject to external market forces. Bidders for public infrastructure assign a value based on prospects for long-term revenue collection — will there be enough drivers crossing a toll bridge or parking their cars on city streets? In reality, infrastructure assets are in general relatively straightforward to value and represent a long-term, income-producing annuity for the right investor.

Privatization often ignites fears of price-gouging by Wall Street. In fact, your corner grocery store or nail salon has more power to raise prices than a private equity fund operating a public service. The assets at the center of these deals — parking garages, utilities, toll roads — operate under tight regulatory regimes. Rates are adjusted according to inflation and can't be raised without an arduous process of public hearings and agency approvals. Bayonne, N.J., contracted a 40-year concession for its water and waste system through a partnership with Kohlberg Kravis Roberts and United Water, which abides by a strict scheduled rate protocol.

Some people have a knee-jerk aversion to allowing private enterprise to manage public works. The truth is that cities have terrible track records in maintaining their bridges and roadways. Gas and electric utilities have long been run by private entities. If a city can trust private business to operate its nuclear power plant, it has nothing to fear in allowing an investment fund to manage its parking meters.

Privatizing municipal services is not a hand-off of the public trust. The assets in a P3 rely on millions of paying customers for their revenue stream, not city coffers. If the assets remain in the hands of near-bankrupt municipalities, crucial services and infrastructure will become melting ice cubes financed by a vastly shrinking tax base.

Harrisburg, Pa., has been teetering on the edge of bankruptcy for several years, having to service \$370 million in debt tied to a trash incinerator built a decade ago. Had the incinerator been developed through a concession with a private investor, Harrisburg's balance sheet would look a lot brighter today.

What about jobs? Don't private operators of public infrastructure torch contracts with municipal unions? In fact, the jobs needed to run these services remain unionized after a P3, typically governed by collective bargaining terms. Yet private concessions frequently create jobs through capital programs that had been sidelined by broke city governments.

Public-private partnerships have gotten a bad rap because of some highly publicized failures. In 2008, when Gov. Ed Rendell of Pennsylvania tried to lease the state's turnpike to an infrastructure fund, the legislature killed the \$12.8 billion deal. In Pittsburgh, the city council rejected a \$500 million bid for a municipal parking concession that would have more than covered a \$350 million shortfall in parking revenue.

These failures did not reflect inherent problems with the P3 structure — the transactions were derailed because of political grudges and fear-mongering. The reality is that government agencies are so constrained they can't meet their responsibilities to operate and maintain — much less build new — public infrastructure. P3s regularly replace aging infrastructure and provide state-of-the-art services. The private operator of the Chicago parking meter system replaced all coin operated meters with credit card devices, which will soon feature pay-by-cellphone options. This would not have been possible had the city continued to manage the meters.

This should be a golden age of public-private partnerships — the need exists in cities across the country. And the capital is there, from private investors seeking long-term returns. American infrastructure has fallen behind countries like France, Italy, Spain, Portugal, Poland, Hungary and countries that have long embraced privatization of urban systems. Ironically, the United States has become an emerging economy when it comes to developing P3 projects — in which opportunity needs to be matched with political will and bold thinking to undertake.

Ultimately, Detroit and other stressed cities don't have much choice. They must land on solid ground and use new revenue to pay off existing debt. The marvel of public-private partnerships is that a significantly reduced debt load and shift of responsibility to the private sector can allow a city to turn to other priorities, like buying more textbooks for students or enhancing local parks that are a city's true public trust. Divesting noncore assets may be the best way for many towns — not just Motown — to regain their momentum.

NYT: Possibly Unfair, but Not Necessarily Fraudulent.

When someone has access to a service that is not equally available to others, the immediate response is often to say, "That's not fair!" And when the securities markets are involved, the first thought seems to be that any informational advantage is not only unfair but potentially fraudulent.

Of course, there are advantages everywhere. Airlines sell access to early boarding, and you can buy a pass at Universal Studios to skip the lines. Few seem troubled that someone who bundled millions of dollars in donations receives an invitation to an inaugural ball while common contributors might receive a token souvenir.

While we are accustomed to paying extra for things that were once free, like checked baggage on airlines, when it comes to the public markets for stocks, bonds and commodities, the reaction to those buying preferential access is to cry foul.

That became clear last week when New York's attorney general, Eric T. Schneiderman, announced an agreement with Thomson Reuters concerning a closely watched economic indicator. Thomson Reuters agreed that it would no longer sell access to the University of Michigan's consumer confidence index to high-frequency trading firms two seconds before other subscribers. Mr. Schneiderman described this as a step toward creating a "level playing field" in the markets by ending an "unfair business practice."

His office is investigating whether other firms are violating the law, particularly with regard to New York's broad Martin Act, in how they sell data to subscribers who can trade in advance of its public release. And Mr. Schneiderman is not the only one looking at disclosures of this type of information.

Senator Charles E. Grassley sent a letter to the University of Michigan asking questions about its arrangement "to allow preferential access" to the information. DealBook reported that the Securities

and Exchange Commission was also investigating how Thomson Reuters released manufacturing data milliseconds before its public disclosure, giving high-frequency trading firms an opportunity to profit on it.

Although it is natural to think that having access to information that influences the markets before others is always wrong, the laws on fraud do not go that far. Instead, they focus on whether someone has been deceived, either through a misstatement or by a failure to disclose information.

The Martin Act, adopted in 1921, is considered one of the broadest antifraud laws available to police the securities markets. It does not require proof of intentional misconduct, and there is even a possibility that a misdemeanor violation could be proved without showing any intent — known as strict liability. That gives Mr. Schneiderman a powerful tool to go after companies like Thomson Reuters for disclosures that affect the market.

But the core of any violation is still about proving fraud, which includes not just false statements but also any “deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale” of securities. A 1926 decision by the New York Court of Appeals on the scope of the Martin Act stated that the law reaches acts “which do by their tendency to deceive or mislead the purchasing public.”

Is selling access to proprietary information to those willing to pay a premium a species of fraud when it allows traders to reap profits at the expense of those unwilling to pay the premium?

Thomson Reuters and others who selectively disclose information to subscribers are not hiding what they do. Indeed, it is the exact opposite — they tell the world that only those willing to pay will get the advantage of an early peek at the information.

There is a tiny universe of potential customers who would want access to financial data two seconds ahead of others. No individual would ever be able to take advantage of that time period, but high-frequency traders certainly can. As James B. Stewart reported, dropping the two-second advantage last week resulted in a steep drop in the amount of trading in the milliseconds before the broader release of the index.

Some informational advantages are fraudulent, as the recent spate of insider trading cases shows. Unlike companies that sell an informational advantage, however, the key to insider trading is keeping the information confidential and not letting anyone know you are using it to profit. It is the failure to publicly disclose the information before using it that brings about the violation, not just the fact that the information is confidential.

Still, it appears anomalous that someone at Thomson Reuters who used its confidential market information without permission to trade profitably would be guilty of insider trading, but the company can sell that same advantage to a select few willing to pay for it without violating the law. The difference is that insider trading requires proof of a breach of fiduciary duty, so that the proprietor of the information can do whatever it wishes so long as it does not deceive the investing public.

In a famous case in the 1980s, *Carpenter v. United States*, the Supreme Court upheld the conviction of a former Wall Street Journal reporter for trading on confidential information about companies before it was published. While the reporter breached his fiduciary duty, the court noted that The Journal had a proprietary interest in the information its reporters gathered, and could do with it as it saw fit.

Consumers of the information sold by media companies would not be subject to any claim of fraud because they are not trading on it in breach of a duty. When a company obtains the information through legitimate means, like the agreement Thomson Reuters has with the University of Michigan to distribute its index, then there is no violation of any duty by selling advance access to the data.

The S.E.C. does have a rule in place, Regulation FD, which requires public companies to disclose information to everyone at once and not just to select recipients. But this rule applies only to internal corporate information and not to the type of research data about the economy that is sold by companies.

The issue then is whether Mr. Schneiderman or the S.E.C. can police these types of arrangements by companies that sell information they obtain legally. It is notable that, even though the two-second advantage has stopped, Thomson Reuters continues to sell the information five minutes before its release to the general public, undermining the idea that any early disclosure is somehow fraudulent.

There is no broad mandate for the government to ensure that the markets are “fair” or that they offer a “level playing field” without any informational disparities, at least under the fraud laws. While fraudulent transactions are certainly unfair, simply asserting that buying access to information in advance of others is somehow unfair does not necessarily make it illegal.

The issue may be more about how high-frequency trading firms can take advantage of information in just a few milliseconds to garner profits far beyond what might have been possible before computerized trading. If that is the case, then the focus should be on policing how these firms trade rather than cracking down on the sale of information to those willing to pay. Otherwise, perhaps the airlines should not be allowed to let so many people board ahead of me.

Bond Insurer Sues Credit-Rating Agencies.

Bond insurer ACA Financial Guaranty Corp. sued the major credit-rating firms for allegedly falsely representing that their letter-grade ratings were free of conflicts of interest.

The lawsuit is the second fraud lawsuit filed against the firms in as many weeks and comes as the Justice Department’s lawsuit against Standard & Poor’s Ratings Services is gathering steam. The liquidators of two Bear Stearns Cos. hedge funds sued S&P, Moody’s Investors Service and Fitch Ratings last week on nearly identical claims.

The ACA lawsuit, like the Bear Stearns case, appears to be timed to beat the statute of limitations for fraud cases in New York state, which is six years, say lawyers not involved in the case. The three major rating firms began their downgrades of hundreds of mortgage-linked securities in July 2007.

ACA sued S&P, Moody’s and Fitch in New York State Supreme Court on Tuesday, seeking \$359 million in damages, according to a filing. The filing, like the Bear Stearns filing, is a four-page summons and notice, not a full-fledged complaint.

“In carrying out their fraud,” the filing alleges, the rating firms “falsely represented that relevant credit ratings reflected their true current opinion regarding the credit risks” the securities presented. The rating firms “falsely represented that the ratings provided were objective, independent, and uninfluenced by any conflicts of interest,” the filing alleges.

Spokesman for S&P and Fitch both said the allegations were without merit and the companies would

defend themselves vigorously. A spokesman for Moody's and a lawyer representing ACA didn't immediately respond to requests for comment.

Spokesmen for Moody's and Fitch didn't immediately respond to requests for comment. A lawyer representing ACA didn't immediately respond to a request for comment.

ACA is tangled in another crisis-era lawsuit.

An ACA executive is expected to take the stand in the civil trial of former Goldman Sachs Group Inc. executive Fabrice Tourre that has captured Wall Street's attention this summer. The Securities and Exchange Commission claims Mr. Tourre lied to investors about the risk of a crisis-era deal, a charge he denies.

ACA acted as the portfolio-selection agent on that deal.

ACA's lawsuit against the credit-rating firms comes as the U.S. federal government's case against S&P is gathering momentum. A U.S. district judge ruled Tuesday that the government's fraud case against S&P could proceed, rejecting S&P's request that he throw out the entire lawsuit.

[Water Agencies Urge Against Limiting Tax-Exempt Bond Financing of Water Systems.](#)

Limiting or ending tax-exempt municipal bond financing of drinking or waste water systems would result in higher costs for consumers and impede water infrastructure investment, according to a July report from the National Association of Clean Water Agencies and Association of Metropolitan Water Agencies.

http://www.amwa.net/galleries/loginfo/AMWA-NACWA_MuniBondAnalysis_July13.pdf

[WSJ: Detroit Bankruptcy Plan Called Unfair to Bondholders.](#)

The bond market's main trade group warned Michigan's governor that Detroit's bankruptcy plan unfairly punishes bondholders.

The Securities Industry and Financial Markets Association, the bond market's main trade group, warned Michigan's governor that Detroit's bankruptcy plan unfairly punishes bondholders whose debt is supposed to be guaranteed under state law.

In a letter Thursday, the bond-market trade group told Gov. Rick Snyder and state Treasurer Andy Dillon that the bankruptcy "could have potentially significant, negative municipal securities market implications," including raising borrowing costs for municipalities across the state. The letter was signed by Sifma General Counsel Ira Hammerman.

Detroit filed for the largest municipal bankruptcy in history Thursday with estimated liabilities of about \$18 billion, overtaking Jefferson County, Ala., which filed in November 2011 with about \$4 billion in debt.

Sifma is taking issue with Detroit's emergency manager Kevyn Orr's proposed treatment of some of

the city's "unlimited tax general obligation bonds," which would be repaid at pennies on the dollar under a restructuring plan Mr. Orr presented in June.

Such treatment "ignores the appropriate priority that should be given to these bonds," Sifma said. The Michigan Constitution also states that some of Detroit's bonds are guaranteed, it said.

General-obligation bonds are viewed as one of the safest types of muni investments because they are backed by a government's "full faith and credit" pledge to raise taxes as necessary to repay the bonds. That backing as well as their tax-exempt status have made those types of municipal bonds popular, particularly among individual investors.

The group warned that bondholders might sell other Michigan municipal debt and be reluctant to buy debt from Michigan cities and towns, "causing the cost of financing infrastructure projects to rise."

"We understand Detroit has serious financial issues," but hurting bondholders will only provide a temporary salve, the letter said.

Sifma added that other states have considered alternatives to help their distressed localities, including enacting laws that protect local government debt, "to ensure that the markets' perception of what investors are due matches the outcome."

Sifma's outcry follows similar complaints recently from some Detroit creditors. Bond insurer Ambac Assurance Corp., which backs the principal and interest payments of some of the city's bonds, said last week that the city's proposed treatment of general-obligation bonds "is harmful to Detroit and the interest of taxpayers in Michigan." It added a "successful revitalization" of Detroit will depend on access to "cost-effective financing," and "such access will be needlessly imperiled as a result of the emergency manager's approach."

In a report last month, Nuveen Asset Management, which owns some of the city's debt, said Mr. Orr's proposed actions could be replicated in one or more of Michigan's other distressed cities or towns, also hurting bondholders .

The firm estimated that nearly 10% of Michigan's population lives in a community that is under the control of an emergency manager or is under some stage of state oversight due to its fiscal problems.

[WSJ: Some Detroit Bonds Hit by Bankruptcy Filing.](#)

General-Obligation Bonds, Considered Among Safest, Take Hit After Being Targeted for Cuts

Some Detroit bond prices fell sharply on Friday, as the municipal-bond market took a hit one day after the city filed the largest municipal bankruptcy ever.

Debt tied to Detroit's retirement system traded on Thursday, before the city's bankruptcy filing, at 38.5 cents on the dollar, according to Electronic Municipal Market Access. On Friday morning, the bid price, or the price that a dealer is willing to pay for the debt, was listed at 37 cents on the dollar, a 1.5 cent decline, said Gary Pollack, managing director at Deutsche Asset & Wealth Management.

A general-obligation bond issued by the city traded at 84.575 cents on Friday, down from 95 cents

on Thursday, even though that particular bond carries insurance, according to the EMMA website.

Bond investors are particularly rankled that the city appears poised to seek significant cuts on general-obligation bonds, which are backed by a municipality's taxing authority. Previously, this debt has been considered one of the safest types of munis.

Overall, yields on highly rated, long-dated muni bonds were up 0.11 percentage point Friday, according to a benchmark scale from Thomson Reuters Municipal Market Data. Prices move inversely to yields, so a higher yield indicates a lower price. The price move "is a reflection of some uncertainty in the market right now," said Domenic Vonella, managing analyst at MMD.

"The weakness today could be attributed to a number of things, but Detroit, Chicago, those are a couple of the bigger concerns in the market right now," said Mr. Vonella, also referring to a decision by Moody's Investors Service this week to downgrade Chicago's credit rating.

Mr. Pollack said that although Detroit's troubles had been well-telegraphed, the bankruptcy filing "is not a positive news item, and at a time when people are withdrawing money from bond funds to begin with, it makes me nervous as an investor." Mr. Pollack, who oversees \$12 billion in investments, said he didn't hold Detroit bonds.

Muni investors said Detroit's bankruptcy petition could hurt demand for bonds from all Michigan localities. Michigan Gov. Rick Snyder authorized Detroit's bankruptcy filing, and it is expected that bondholders stand to take significant losses. The governor also previously appointed an emergency manager, Kevyn Orr, who has steered the city into bankruptcy court.

The Securities Industry and Financial Markets Association, a trade group of securities firms, banks and asset managers, took issue with the proposed treatment of the general-obligation bonds, which would be repaid at pennies on the dollar.

In a letter Thursday, the group implored Gov. Snyder to "act deliberately and be aware that your actions ... could have potentially significant, negative municipal securities market implications."

In Portage, Mich., which is planning to sell \$3.13 million in general-obligation bonds next week, finance director Daniel Foecking said he didn't think the bankruptcy would derail his city's sale. Mr. Foecking, whose city of about 46,000 is about 140 miles west of Detroit, acknowledged the filing could result in slightly higher interest rates for Portage, but he didn't think the increase would be significant.

Mr. Foecking pointed out there are key differences between Detroit and Portage. For one, Standard & Poor's gives Portage a double-A rating. Detroit's rating is single-C.

"It's been my personal philosophy, when you start budgeting, the first thing you do is factor in debt service," Mr. Foecking said.

Some investors said the filing, though not necessarily a surprise, seemed almost out of character for the state.

"Michigan has been touted for years as one of the most bond-friendly states out there," said Robert Miller, senior portfolio manager at Wells Capital Management, which oversees \$32 billion in munis. "That reputation is shot."

Mr. Miller said his firm didn't own any general-obligation bonds, but it did have some exposure to Detroit's sewer bonds. He said he felt more comfortable owning the sewer debt because the sewer

system serves not just the city, but the surrounding area. Those bonds are backed specifically by sewer-system revenues.

Nonetheless, Standard & Poor's downgraded the city's water and sewer bonds to double-B-minus earlier in this month. And on Friday, S&P placed those bonds on CreditWatch negative. The general-obligation bonds were previously at double-C, but were lowered to single-C on Thursday after the bankruptcy.

"Why would you own a Michigan general-obligation bond if the state's letting Kevyn Orr take a very aggressive approach to existing debtholders?" said Anthony Valeri, fixed-income strategist at broker-dealer LPL Financial. "We would certainly caution investors about investing in Michigan GOs. Or if you do, that you're compensated for the risk."

Not all investors were overly perturbed. Matt Dalton, chief executive of Belle Haven Investments, said his firm was still comfortable holding bonds from Michigan municipalities, despite the harsh line Mr. Orr is taking with some bondholders.

"The state has had a good history of fiscal oversight of communities and they've already done a lot for Detroit," said Mr. Dalton, whose firm oversees about \$1.6 billion in assets and owns some Detroit school-district debt, as well as of the city's water and sewer bonds.

WSJ: Bondholders, Public Pensioners Square Off in Detroit.

The bankruptcy case in Detroit could be titled Bondholders v. Pensioners.

The city's emergency manager has said his goal is to spread the pain around. That means goring two sacred cows: general obligation debt and public employee pension benefits.

Both sides are fighting fiercely to prevent that from happening, with each warning of dire consequences.

Last month bondholders winced at the restructuring plan floated by Detroit Emergency Manager Kevyn Orr, who proposed breaking the city's promises to general obligation bond holders.

Backed by the full faith and credit of the issuer, general-obligation debt is regarded as the gold standard of the municipal bond market. But under Mr. Orr's plan, bondholders would stand to lose about \$500 million.

That's just a small part of the \$11.5 billion in unsecured debt that Mr. Orr put on the chopping block. But it set off investor alarms.

"We believe breaking the promise to GO bondholders and treating all unsecured creditors equally could set a dangerous precedent with far-reaching implications — in Detroit, in Michigan and beyond," wrote Peter J. Hayes, managing director and head of the Municipal Bonds Group for BlackRock, in an op-ed in Thursday's Detroit Free Press.

"This is Wall Street's worst nightmare," Richard Brodsky, a former Democratic New York assemblyman who is advising the mayor of Yonkers, N.Y., on managing the city's finances, told Law Blog. "They have to sit at the table like an equal with the unions and the taxpayers."

Pushing back just as hard against the restructuring plan are Detroit's unions and the city pension boards, which sued to block Thursday's bankruptcy filing.

Slashing retiree health-care benefit plans is one thing. Cutting pension payments to active and retired employees would be a deeply traumatic development for public-sector unions in Detroit and beyond. Estimating a \$3.5 billion shortfall in the city's two retirement funds, Mr. Orr has said the city has no choice but to roll back pension benefits.

Like New York, Michigan is constitutionally prohibited from "diminishing" pension benefits already granted to current and retired workers. But federal law could very well trump state law here. The question is whether a federal judge would approve it.

It's all part of Mr. Orr's goal of shared sacrifice. "He really has made enemies with everyone," Stephen Eide, a public-finance analyst at the Manhattan Institute, a conservative think tank in New York City, told Law Blog. "He's made good on that approach."

Two More Wisconsin Cities Weigh Redemptions of New CREBs, BABs.

The cities of Kaukauna and Oshkosh Wis. have announced they can redeem taxable direct-pay bonds because their redemption provisions were triggered by federal subsidy reductions that went into effect in March.

The cities disclosed the potential redemptions in event notices filed with the Municipal Securities Rulemaking Securities Board's EMMA system on July 1 and 2.

Kaukauna issued \$25.35 million in taxable new clean renewable energy bonds in 2012. It also issued \$3.665 million of taxable electric system revenue Build America Bonds in 2010, of which about \$3.29 million remains outstanding, and another \$6.775 million of taxable electric system revenue BABs the same year, of which \$6.025 million remain outstanding.

Oshkosh issued \$5.74 million in taxable water revenue BABs in 2010, of which \$5.55 million remain outstanding.

Kaukauna and Oshkosh are the latest in a handful of issuers who have announced their intent to take advantage of their extraordinary redemption provisions to refund their direct-pay bonds because their subsidy payments were reduced by 8.7% from the \$85 billion in federal sequestration budget cuts for the current fiscal year.

The Bond Buyer first reported in April that at least 12 small Wisconsin cities were weighing their options for redeeming their BABs or other direct-pay debt. Eleven of those issuers were clients of advisory firm Ehlers Inc., which considered redemptions at par plus accrued interest. Ehlers Inc. also advised Oshkosh. Baird was underwriter and Chapman and Cutler LLP was bond counsel for Oshkosh.

Quarles & Brady LLP served as bond counsel on those 12 original transactions. The firm also bond counsel for the Kaukauna's new CREBs. Hutchinson, Shockey, Erley & Co. was underwriter.

Kaukauna wrote in its new CREB event notice that it "has determined that the extraordinary redemption provision has been triggered," but added: "At this point, the governing body of the issuer has not taken any action to redeem the obligations but may do so in the future."

The obligations are subject to redemption prior to maturity, in whole or in part, at the option of the issuer, on any day, at a redemption price equal to 100% of the principal amount redeemed plus accrued interest to the date of redemption, both the Oshkosh and Kaukauna notices said.

The new CREBs were issued to pay a portion of the costs of a hydroelectric project, according to bond documents. Kaukauna Utilities historically operated a hydroelectric plant on the Fox River. The project was to decommission a more than 100-year-old powerhouse and another powerhouse built in 1928 in order to construct a new powerhouse 150 feet upstream from the two locations.

The project would modify the power canal and install two new identical 3.6 megawatt turbines. The estimated cost for all related hydroelectric improvements was \$37 million, according to bond documents.

The BABs were issued for the acquisition of a hydroelectric generating facility and funding the reserve account.

New CREBs are taxable bonds that can be used either as direct-pay or as a tax-credit bond. CREBs are used by state and local governments, as well as public providers and electric cooperative companies, to finance renewable energy projects. Their subsidy payments are equal to 70% of interest costs.

In March the Treasury Department, in coordination with the Internal Revenue Service's chief counsel's office, announced they would issue guidance for a new process of allocating unused volume cap authority for new CREBs.

The new process will emphasize the allocation of volume-cap authority to issuers who demonstrate a readiness to timely issue bonds to finance projects. The Treasury Department has not yet issued the guidance.

Oshkosh wrote in its event notice that the city made the interest payment on the bonds on July 1 in full with the direct pay subsidy it received along with other available funds. Therefore there is no interest payment delinquency on the bonds.

"At this time, the city has not made any decision whether or not to redeem the bonds, but reserves its right to do so," the notice said.

Oshkosh's BABs were issued to provide funds for the public purpose of financing improvements and extensions to the city's water system, bond documents said.

BABs were first issued in 2009 as part of the American Recovery and Reinvestment Act but expired in 2010. Almost \$188 billion of BABs were issued since they were created.

by: JENNIFER DEPAUL

[WSJ: Investors Yank Money from Municipal-Bond Funds.](#)

June's \$13.5 Billion Outflow Is Second Largest on Record

Investors yanked \$13.5 billion from mutual funds that invest in municipal bonds in June, according to Lipper FMI, a retreat that is making it harder for several cities, states and towns to raise money.

Individual investors are big buyers of municipal bonds for their tax-free status and their usually stable prices. But as Treasury bond prices fell last month, sparking a broad bond market rout, some of the largest mutual fund companies managing municipal bond funds saw huge amounts of money march out their doors.

June's outflow is about 2.2% of the \$680.7 billion managed by the funds and the second largest monthly outflow of cash from the market on record, said Matt Lemieux, senior research analyst at Lipper, which has been tracking fund flows since 1992.

The selloff sent borrowing costs higher for municipalities, causing some to delay plans to raise money. The yield on 10-year, triple-A-rated municipal debt rose to 2.74% Tuesday from 2.08% on June 3, according to Thomson Reuters Municipal Market Data. The 2.74% yield is near levels last seen two years ago.

The Coatesville Area School District in Pennsylvania wanted to refinance \$25 million of debt about three weeks ago but waited to see if rates would decline, said Tom Kozlik, director at investment bank Janney Montgomery Scott LLC, which is an underwriter of the bond sale. Rates have stabilized somewhat, and the deal is rescheduled for Wednesday. A Coatesville school district representative couldn't immediately be reached for comment.

Health-services company Geisinger Health System of Danville, Pa., has put plans to sell \$284.4 million of bonds on a "day-to-day" status, "waiting to determine whether attractive fixed rates will return," said Timothy Fitzgerald, vice president of treasury management at the company.

The pace of redemptions from funds is mellowing as benchmark interest rates pause amid a two-month march higher, said fund managers, but big investor withdrawals mean they must sell bonds quickly, hurting prices further.

Managing investor redemptions was difficult, said Alex Grant, who manages two mutual funds totaling about \$700 million in assets for RS Investment Management Co. He got through the end of the month and the end of the second quarter in part because he "was sitting on some cash," he said.

Investors saw returns suffering in June as trading became trying. Barclays's municipal bond index saw a negative return of 2.83% last month, the biggest loss since September 2008, when the index saw a negative total return of 4.69%.

Vanguard Group Inc., which has about \$100.6 billion in municipal bond assets, saw the most money exit its municipal bond funds last month, about \$2.3 billion, Lipper said. The funds had enough cash reserves to meet investor redemptions, said spokesman John Woerth, adding the company's money-market funds saw money pour in.

OppenheimerFunds Inc., Fidelity Management & Research Co. and Nuveen Fund Advisors Inc. each saw more than \$1 billion exit their municipal bond funds, Lipper said.

OppenheimerFunds' municipal bond fund assets total about \$33.3 billion, while Fidelity's are \$29.3 billion and Nuveen's are about \$26.7 billion, according to Lipper.

Christine Thompson, chief investment officer of Fidelity's bond group, said its funds met investors' demands for redemptions, in part because the firm ensured it had cash on hand. Representatives for OppenheimerFunds and Nuveen declined to comment.

The June pullback is only surpassed by a \$16.6 billion outflow in December 2010, when investors were spooked by banking analyst Meredith Whitney's predictions of large numbers of defaults by

states and municipalities, a projection that so far has been unfounded.

The outflow figure includes weekly and monthly reporting of open-ended municipal bond mutual funds as well as exchange-traded funds. Lipper said more than 95% of the funds it tracks have reported June data.

WSJ: With Palo Alto on Board, OpenGov Aims for Transparency in Dozens More City Governments.

When the managers of the City of Palo Alto cast around last year for technology that could power their initiative to open up the municipal budget to the public, the options were meager.

To implement its vision, Palo Alto managers met with founders of a fledgling startup, now called OpenGov, that offered to develop a new system from scratch that would gather all of the city's financial data and organize it into visually appealing and clear graphics, giving the viewer, whether a citizen or a city employee, insight into spending trends or budget overruns.

"If you are transparent and accountable, you build trust," said Jonathan Reichental, chief information officer for the city, about the reasons Palo Alto chose to open up its books. It also had to comply with a state law mandating a 10-day response from local governments to citizen requests for information. There are "a lot of people involved, and a lot of cost involved" in compliance, said Mr. Reichental.

Open data, he said, "cuts out the middleman" and allows interested parties to find what they are looking for online on their own.

The founders of OpenGov are well familiar with the problems and opportunities of using technology for government transparency through their work at California Common Sense, a nonprofit they had founded and run. The startup set to work on the project for the City of Palo Alto, for free, in exchange for collaboration with the city. It also worked three other beta partners in California-Saratoga, Salinas and Monterey.

The resulting product led to awards for the city managers, and is now the basis of a software-as-a-service offering that OpenGov is rolling out to municipalities across the country, including South Orange, N.J., as well as Palo Alto neighbor Mountain View.

In the meantime, OpenGov raised \$7 million from investors Formation 8, Founders Fund, Valiant Capital, Thrive Capital, and angels, as VentureWire reported recently.

"Local governments spend more money than the federal government on [information technology]," said Zachary Bookman, chief executive of OpenGov. "It's one of the largest software markets in the world."

Using the technology, citizens can find information on firefighters' salaries and compare them to those of the police force, for example, in a few clicks of the button, instead of having to rummage through cumbersome PDF files, the standard for city budget information.

This year marked the first time when all 50 states post their checkbooks online, up from 32 in 2009, according to research by Frontier Group and U.S. PIRG Education Fund. But "only a small fraction" of municipalities currently have this level of information about their spending and budgets online,

said Phineas Baxandall, of U.S. PIRG, or U.S. Public Interest Research Group, who co-wrote recent reports on open data in local governments. Municipal open-data initiatives are accelerating.

Such efforts, found Benjamin Davis, of think tank Frontier Group, are saving cities and states money, instances of which he has documented in his research. For example, "if other companies can see the payments [a city makes] to other companies, it creates a more competitive bidding atmosphere," said Mr. Davis. There's also a greater push from bipartisan public interest groups, he said. Finally, "we now live in this age when there's mobile banking, we have so much information at the click of the mouse, it only makes sense that governments should follow suit."

Even as there's a greater willingness, the market is still thorny. It might be hard to identify the right person in the government who is most receptive to the idea of opening up the books, as the interest stems from very different departments in each instance. "Sometimes it's the legislative, sometimes it's executive, sometimes it could be a [result of a] competition between two independently elected executives," said Mr. Baxandall, about the sources of open-records initiative in the local governments he has researched.

Most importantly, not every bureaucrat is ready to open up the kimono in the philosophical sense. Giving citizens "unfettered direct access feels a little uncomfortable [to some officials]," said Mr. Reichental of the City of Palo Alto. "Change is uncomfortable. I think that, more than anything, is what holds people back." And sometimes legislation might intervene rather than encourage opening up the records. The current budget bill in California, in fact, is making compliance with its open records act optional.

OpenGov, for its part, sees a large market, partly because its product is cheap, and partly because it's early days in open government and the benefits will become more apparent and accounted for.

Down the line, said Mr. Bookman, the company hopes to offer a capability for municipalities to compare their spending and budgets to other similarly sized cities around the country.

"Technology won't replace good decision making and good planning," said Mr. Bookman, but it could serve as a tool.

WSJ: Detroit Sues Bond Insurer Amid Effort to Reach Deal With Creditors.

The cash-strapped city of Detroit has filed suit against a bond insurer it alleges is standing in the way of an agreement it is trying to strike with some of its largest creditors.

The suit, filed in state court on Friday, is part of an ongoing effort by the city's powerful emergency manager to streamline the process for a potential bankruptcy by cutting as many deals as possible before any court filing, which could come in a matter of months. A filing by Detroit would be the nation's largest municipal bankruptcy.

In the latest skirmish, the city filed suit against Syncora Guarantee Inc., a bond insurer, over access to the city's casino tax revenue estimated at \$170 million a year. The city claims Syncora improperly told a bank controlling the funds to keep the money from Detroit.

The city sees the insurer as a roadblock to a proposed deal to pay UBS AG and Bank of America Merrill Lynch more than 70 cents on the dollar on nearly \$340 million in secured debt, according to people familiar with the matter. In exchange, the city would get back \$11 million a month in tax

revenue from the city's three casinos originally used as collateral to back the debt.

The pending deal would be the first time a debtor with the city has agreed to new terms since Emergency Manager Kevyn Orr took office in March. Mr. Orr may have a tougher time reaching agreement with the city's unsecured creditors who he has offered roughly 10 cents on the dollar.

In the middle are insurers like Syncora Guarantee trying to recoup as much as they can of what the city owes. The insurer is concerned that it may have to make up the difference between what the city is willing to pay its secured creditors and the amount originally owed by the city, according to a person familiar with the matter.

Syncora also insures other debt associated with the city, another person familiar with the matter said.

The offices for Syncora were closed on Friday and a spokesman did not immediately respond to a request for comment.

Wayne County Circuit Judge Jeanne Stempien issued a temporary restraining order saying the casino money could be released to the city and set a hearing for July 26, according to the emergency manager's office.

In 2011, the city had used the casino tax revenue as collateral to secure swap agreements, interest-rate bets the city made with Wall Street banks years ago in the hopes of avoiding higher rates. Detroit's swap agreements are tied to \$1.4 billion in bonds the city issued to help address funding shortfalls in its pension funds. In court papers, the city argues that Syncora will not be harmed by the release of the funds because it does not have a right to control them.

Mr. Orr has said Detroit needs significant and fundamental debt relief to shore up the city's finances and avoid bankruptcy. Such relief could include extending the time period for debt repayment, reducing interest rates or cutting the principal owed. The city has already skipped a debt payment of almost \$40 million in June, saying it was unsure whether it could continue to make payments on more than \$2 billion of secured debt.

The total bill for the city's long-term liabilities is nearly \$20 billion, and the city is now insolvent, according to Mr. Orr. Mr. Orr's proposal also calls for using the savings from the cuts to invest \$1.25 billion in public safety and blight removal to revive a city beset by a dwindling tax base, entrenched crime and population loss.

Talks between the city and its creditors will continue next week. Mr. Orr's team will take about 40 representatives of creditors on a bus tour of some of the city's most blighted areas in a effort to demonstrate the severity of the crisis in the city of 700,000.

By MATTHEW DOLAN

[Flexible Bond Funds Offer Harbor as Rates Rise.](#)

Funds with the flexibility to pick and choose among all categories of bonds are attracting investors' money—some of it at the expense of their more constrained peers—as fears of rising interest rates increase.

"I think the risk of losses from rising interest rates is at the top of most advisers' minds," said Nadia Papagiannis, director of alternative fund research at Morningstar Inc.

In many cases, investors are shifting money out of core bond funds into these so-called nontraditional bond funds, which have more tools available to navigate the now-treacherous bond environment, she said.

Investors, who since 2008 funneled billions of dollars into bond funds to avoid stocks and other riskier assets, have poured more than \$21.46 billion into nontraditional bond funds this year through May 31, up from \$5.82 billion in 2012 and \$9.9 billion in 2010, according to Morningstar.

Interest rates have come into focus in recent weeks as investors try to gauge if or when the Federal Reserve will wind down its debt-buying program. The mere speculation has already prompted a spike in Treasury yields.

Rising rates mean big cuts to a bond's principal. But unlike core bond funds, which own U.S. investment-grade bonds, managers of unconstrained or "go-anywhere" bond funds have the ability to invest in a wide variety of fixed-income investments, including emerging-market, convertible, and municipal bonds.

Pimco Unconstrained Bond Fund (PUBAX), for example, normally seeks a duration—a measure of interest-rate sensitivity—from negative three years to positive eight years. The longer a security's duration, the more sensitive it is to interest-rate risk.

The Pimco fund can invest in a diversified fixed-income portfolio, including municipal bonds, mortgage-backed securities, U.S. government agencies, sovereign issues, convertible bonds, preferred securities and reverse purchase agreements, among other investments. It can also invest without limitation in derivative instruments, such as options, futures contracts and swap agreements.

The flexibility afforded managers of such funds makes it doubly important that advisers vet them well.

Avani Ramnani, director of financial planning and investment management at Francis Financial, said she has been using the Pimco Unconstrained Bond Fund for about a year.

"There's been fear of inflation kicking in for a long time," said Ms. Ramnani, whose New York firm manages just under \$100 million. "It's really, really important for a portfolio to have that fixed-income exposure, but also the flexibility to get the right fixed-income exposure."

In a very conservative portfolio, she may invest as much as 15% of a client's assets in the unconstrained fund. But for a very aggressive equity-oriented portfolio, she might invest 2% or 3% of assets in the fund. She prefers to use the fund's institutional shares, which charge expenses of 0.90%, for clients when possible.

Yield is difficult to obtain in this environment, Ms. Ramnani said. She nevertheless considers the combination of yield and return when weighing a fund. The Pimco fund yields 2.85%, and has gained about 1.6% in the 12 months through Wednesday, while the Barclays U.S. Aggregate Bond Index has lost 1.2%, according to Morningstar.

For a client in retirement, the goal is to create a diversified portfolio and then determine the best place from which to take distributions, Ms. Ramnani said. With this year's huge stock gains, it made sense to take profits. In another year, higher bond yields may provide the needed cash, she said.

Beth Gamel, co-founder and executive vice president at Pillar Financial Advisors Inc., began using the JPMorgan Strategic Income Opportunities fund (JOSAX) in 2011 in combination with more traditional bond funds for clients who had relatively large allocations to taxable bonds.

For others, she had for years paired an intermediate-term or core bond fund with a shorter-duration bond fund. But last year, she saw the need for a tactical fund that could be more responsive to the bond market's changing conditions, and began using the JPMorgan fund more widely.

"Someone who has a requirement within their fund to be shorter duration isn't all of a sudden going to bring that duration down to six months or own different kind of instruments in their portfolio," as the opportunities fund can, said Ms. Gamel, whose Waltham, Mass., firm manages \$603 million.

The fund's opportunistic approach, along with its one-year duration, provides protection on the downside and some participation on the upside, Ms. Gamel said. She feels confident that William Eigen, the fund's manager and a former hedge-fund manager, is capable of moving in and out of different markets effectively.

The fund yields 3.3%, and has gained 5.5% in the 12 months through Wednesday, according to Morningstar.

Among the nontraditional bond funds Ms. Papagiannis of Morningstar likes are Driehaus Active Income (LCMAX), Driehaus Select Credit (DRSLX) and BlackRock Global Long/Short Credit (BGCAX).

[Experts: Muni Community Should Have No Problem Making Case to Save Exemption From 'Blank Slate'.](#)

The Senate Finance Committee's top two tax writers asked their 98 colleagues on Thursday to submit detailed proposals justifying which tax breaks should be kept in the code as they move forward on comprehensive tax reform.

Committee chairman Max Baucus, D-Mont., and ranking minority member Orrin Hatch, R-Utah., called for a "blank slate" approach to tax reform, stripping all existing tax deductions, exemptions and credits including the tax exemption for municipal bonds from the code.

"This blank slate is not, of course, the end product, nor the end of the discussion," Hatch and Baucus wrote in a "dear colleague" letter to senators. "Indeed, we both believe that some existing tax expenditures should be preserved in some form. But the tax code is also littered with preferences for special interests."

Both Baucus and Hatch are meeting with their respective members this afternoon to discuss the plan, sources said. Senators have until July 26 to submit their proposals.

Baucus and Hatch said "special attention" will be given to bipartisan proposals. They said they plan to operate from the assumption that all special provisions are "out" unless there is clear evidence that they help expand the economy, make the tax code fairer or effectively promote other important policy objectives.

Mike Nicholas, chief executive officer of the Bond Dealers of America, said that the muni bond tax exemption accomplishes at least two of those three issues.

"You think about infrastructure, jobs, or capital improvement growth, Nicholas said. "That's been done for 100 years by issuing tax exempt debt." Nicholas added that if the goal is to simplify or make the tax code more fair, "the muni bond tax exemption is not one of the extra layers that has made the code more complicated. It has been in the tax code since there was a tax code."

Chuck Samuels, a lawyer at Mintz Levin, Michael Decker, managing director of the municipal securities group at SIFMA and other market participants said the muni bond community should have no problem making the case on the merits of the tax exemption so that it will be retained.

To aide senators with their submissions, the nonpartisan Joint Committee on Taxation and the Finance Committee staff analyzed the relationship between tax expenditures and the current tax rates if the current level of progressivity is roughly maintained.

"The blank slate approach would allow significant deficit reduction or rate reduction, while maintaining the current level of progressivity," Baucus and Hatch wrote. They warned that each tax preference inserted back into the code reduces the amount of deficit reduction or revenue that could go towards lowering individual and corporate tax rates. "As we work to craft a tax reform bill, we will bear these trade-offs in mind," they wrote. The letter omits how much revenue the plan would raise or how low they aim to get tax rates.

Some market participants were skeptical. "There are so many details that need to be filled in that we are not optimistic that the Senate could act in this Congress," said Lars Etzkorn, program director for the National League of Cities' center for federal relations, who expressed support for a simplified tax structure and the plan's "noble" policy goals. "The clock is ticking and time is limited for the Senate to act."

Etzkorn said he hoped that the Senators would include state and local groups like the NLC in the conversation because there could be serious consequences with a comprehensive overhaul.

"If the muni bond exemption was eliminated it would be detrimental to home towns," Etzkorn said. "We don't need a local tax increase as part of federal tax reform."

The framework is similar to the "Zero Plan" used by the National Commission on Fiscal Responsibility and Reform in 2010, co-chaired by Erskine Bowles and Alan Simpson. The Bowles-Simpson Zero Plan would establish three individual income tax rates of 8%, 14% and 23%. It would repeal all individual and corporate tax expenditures and would tax capital gains and dividends as ordinary income.

by: JENNIFER DEPAUL

B of AML, PFM Top First-Half Tables

Bank of America Merrill Lynch remained the leading senior manager of municipal bonds in the first half of 2013, outpacing its competitors by a considerable margin.

The bank was credited with underwriting 208 issues, totaling \$25.1 billion by par amount, according to Thomson Reuters data. That number is slightly down from the 238 issues totaling \$25.6 billion that B of A worked on during the first half of 2012.

The decline is part of the broader 11.5% decrease in total amount of municipal market long-term

issuance. Despite the decrease, B of A increased its market share from 13.4% last year to 14.8% this year.

The bank also came in first place among senior managers working on both negotiated issues, with \$17.2 billion in par value, and competitive issues, with \$8 billion. B of A was also the top co-manager on all issues.

The top four underwriters remained unchanged compared to the first half of 2012, with JPMorgan coming in second, followed by Citi and Morgan Stanley. Wells Fargo jumped up to fifth place from sixth, while Goldman Sachs dropped to seventh from fifth.

JPMorgan worked on 172 issues totaling \$19.7 billion, for an 11.6% market share. Last year the firm worked on 198 issues totaling \$22 billion with an 11.5% market share.

Paul Palmeri, managing director and head of public finance at JPMorgan, said the firm has continued to focus on its banking efforts and capital commitment over the past few years.

"We've continued to improve our banking coverage by leveraging our industry specialists with geographic expertise," Palmeri said.

In addition to slightly increasing its total market share, JPMorgan also increased its market share of negotiated issues to 11.2% from 10.4% last year. The firm worked on 110 negotiated issues, totaling \$14.6 billion, keeping its number two spot. In the competitive issue category the firm dropped to third place from second last year, with 62 issues totaling \$5.1 billion.

Among co-managers, JPMorgan jumped to second place from sixth last year, with 168 issues totaling \$5.6 billion.

Within specific industries, the firm has made significant strides in the transportation, utilities, healthcare, and higher education sectors, Palmeri said. JPMorgan focuses on those four industries, as well as general municipal finance and housing.

Palmeri said there's still a tremendous amount to get done both on the new money side and on the refunding side.

"Both on the taxable and tax-exempt side a number of deals have been temporarily sidelined, and with a bit more rate stability, we're confident that those deals will come to market," Palmeri said.

Third-ranked underwriter Citi was credited with 207 issues totaling \$18.7 billion during the first half. Citi also came in third place among negotiated issues, and second place among competitive issues.

RBC Capital Markets jumped two spots from last year to sixth place, credited with 347 issues totaling \$10.4 billion.

While the industry total declined during the first half of the year, RBC actually saw an increase in the total value of issues it worked on from the \$7.8 billion during the year before. The firm also saw its market share increase to 6.2% from 4.1%.

Among negotiated deals, the firm jumped to fifth place from eighth place last year, with 333 deals totaling \$9.9 billion.

Mark Maroney, head of the RBC U.S. rates, municipals and securitized products business lines, said

that RBC's goal is to be among the top five underwriters of negotiated deals.

"We've had a nice mixture of our local middle market business with some large issuer transactions throughout the first half of the year," Maroney said. "You can tell by the number of transactions that we've been busy with 333 negotiated deals."

Some of the larger deals RBC worked on this year included a \$540 million transaction for Denver Public Schools, \$372 million for Dallas Fort Worth Airport, and a \$328 million Phoenix excise tax deal.

"If you look across our activity we had a broad base of business across the United States," Maroney said. "There were some large issuer deals out west, in Colorado, Texas and California, and also in the middle markets, in particular, in Texas and Pennsylvania. We've had a good number of deals sprinkled across the U.S."

Among financial advisors, Public Financial Management Inc. kept its number one spot on the Thomson Reuters table. The firm worked on 398 issues during the first half of the year, totaling \$18.8 billion and a 15% market share.

"It's nice to have these kinds of results and so consistently, but they're not the beginning and the end for how we measure ourselves," said John Bonow, chief executive officer of PFM. "It's our client satisfaction and the trust our clients have in us that really matters to us."

Behind the firm's consistent success is a focus on building, earning, and keeping the trust of its clients, as well as helping them navigate through tough times, especially during the last five or six years, he said.

"I think our clients know that we've got solutions to offer them, not just better mechanics or a better mouse-trap," Bonow said. "Over time it's our ability to focus on solutions and be comprehensive in our advice that has caused many of our clients to be with us for decades, and many more to come our way as these challenges arise for them."

Bonow said the first half of the year was typified by the dramatic decline in interest rates, before the last few weeks in June, as well as new regulations in the money market. The low interest rate environment allowed PFM to help its clients lower their borrowing costs to take advantage of the refinancing market.

The firm also experienced recent expansion in the Northwest region with its acquisition of SDM Advisors, a Seattle-based advisory firm. Bonow said PFM is well-structured at present and is looking more toward internally-generated growth, and not necessarily looking for further acquisitions. Though, he added, PFM is always alert for opportunities.

Bonow said he believes the challenges for the industry include new regulations and the overhang of retiree-related costs, such as pensions and other post-employment benefits.

"We've got groups focused on solving those problems systematically for our clients so that they have sustainable finances going forward and I think that's where the growth is going to come from in our industry—the ability to be a comprehensive advisor to municipalities and non-profits," Bonow said. "And if debt transactions occur because they're prudent and they're a good piece of the financial management puzzle, then I think we're well-positioned to assist clients there as well."

The top four financial advisors remained the same as the first half of 2012, with Public Resources Advisory Group coming in second place, FirstSouthwest third, and Lamont Financial Services Corp

coming in fourth.

by: TONYA CHIN

Reuters: U.S. Investment Industry Groups Scuffle Over Ethics, Costs.

Wall Street's brokerages would spend an average of \$8 million each to implement a plan being considered by the U.S. Securities and Exchange Commission to impose higher ethical standards on brokers who give financial advice, according to estimates by the securities industry's largest trade group.

The Securities Industry and Financial Markets Association will present its figures to the SEC in a letter on Friday, the last day for interested parties to respond to a sweeping public request for information that could help the agency determine whether to impose a new standard, known as the so-called fiduciary rule.

SIFMA's findings and others could further delay the standard that has been long discussed and deferred by the SEC. At issue is a long-running controversy about the differences in responsibilities toward clients for securities brokers, who register with the self-regulatory Financial Industry Regulatory Authority, or FINRA, and registered investment advisers, or RIAs, another type of financial adviser overseen by the SEC.

Imposing traditional fiduciary standards for investment advisers on brokerages could mean big changes for the industry's business practices, such as possibly disclosing to investors when the "best" investment choices are available elsewhere.

Typically, brokers are compensated by sales commissions and must only meet a "suitability" standard by suggesting investments that are suitable for their clients. But RIAs, typically paid by clients, must be fiduciaries - they must put their clients' interests above their own at all times. The SEC is considering whether to streamline those standards through a new rule.

Developing and maintaining new compliance procedures to adhere to a fiduciary rule - everything from training staff to monitoring transactions - would run an average of \$5 million per firm during the first year, Kevin Carroll, SIFMA associate general counsel, said in an interview with Reuters.

A potentially new broker disclosure brochure under consideration by the SEC would cost each brokerage, on average, about \$3 million to develop and update during the initial year, he said.

SIFMA has faced criticism that it is pushing the SEC to adopt a fiduciary standard in name only, because it wants rules that would accommodate traditional brokerage business practices, such as selling brokerage-branded funds that can be more expensive than alternatives.

Some Washington insiders are skeptical that the SEC will ever develop a fiduciary rule for brokers, given intense lobbying by the industry. On Tuesday, for example, the National Association of Insurance and Financial Advisors (wrote in a letter to the SEC that imposing a fiduciary standard on brokers would make their services pricier for middle class investors. NAIFA represents insurance agents who also sell securities.

The group developed the figures based on estimates it collected from 12 large firms and six regional firms. While the identities of those firms are unclear, SIFMA's membership includes the largest

brokerages, such as Morgan Stanley and Bank of America Corp.'s Merrill Lynch unit.

The \$8 million estimate represents a fraction of each firm's annual budget.

At least one fiduciary advocate is skeptical of SIMFA's figures. A \$3 million price tag for a brochure of disclosures is "questionable on its face," said Knut Rostad, president of the Institute for the Fiduciary Standard, a group that promotes imposing a traditional fiduciary standard on brokerages.

The Investment Adviser Association, which supports imposing a traditional fiduciary standard on brokers who give investment advice, is concerned about how the agency's process for reviewing the varying ethical standards may affect SEC-registered advisers. The discussion in the SEC's data request "appears to favor imposing the broker-dealer regulatory regime on investment advisers," wrote David Tittsworth, the group's executive director.

A spokesman for the Financial Planning Coalition, a trade group that also supports imposing a traditional fiduciary standard on brokers who give investment advice, said it will file a letter with the SEC on Friday. He declined to comment on SIFMA's remarks.

WSJ: Though Colorado and Washington Allow Recreational Marijuana, Many Municipalities Are Seeking to Bar Businesses Selling It.

Like Coloradans as a whole, voters in Colorado Springs voted to legalize recreational pot last fall. Nonetheless, their city leaders held a packed public meeting Thursday to seek opinions on whether local businesses should be able to sell it.

Colorado Springs, the state's second-largest city with roughly 426,000 residents, is one of numerous municipalities in Colorado that are considering opting out of part of the state's new marijuana law. The legislation allows anyone 21 and older to possess and grow pot in small amounts but also gives local authorities the right to bar pot plantations and stores.

More than two dozen cities and towns, including Calhan and Woodland Park near Colorado Springs, have already prohibited marijuana retail stores, according to the Colorado Municipal League, a lobbying group for the state's cities. Others, like Aurora outside of Denver, decided to postpone a decision on whether to allow sales. In Denver, leaders want to allow pot sales, but have said they want to push back the starting date for new businesses other than medical-pot outlets.

The opt-out clause included in the Colorado pot law doesn't exist in Washington, which also legalized recreational pot last November. But local officials there have some control over rules such as licensing and zoning, and some are using that authority to keep pot shops at bay.

Richland, a city of roughly 49,000 people in southeastern Washington, passed an ordinance that requires marijuana stores to comply with federal laws, for example, which is impossible because of pot's continued federal status as an illegal substance.

Local power to determine how the marijuana trade operates, or whether it exists at all, will likely be included in measures that pot advocates attempt to pass in other states as they seek to broaden pot legalization.

Part of the reason some municipalities in Washington and Colorado have been reluctant to allow pot sales, experts say, is uncertainty over how those states will handle the new marijuana market. Both

are still setting up regulatory systems for recreational pot.

In Washington, where rules won't be finalized until August, applicants for pot licenses have a 30-day window in September to file paperwork that is supposed to include where they plan to set up shop. That means jurisdictions would have only about a month to study the state's rules and come up with their own in time for locals to apply for licenses.

"It's going to be a little bit bumpy as we roll out this new legalized system," said Brian Smith, a spokesman at the Washington State Liquor Control Board, which is now tasked with also regulating marijuana.

In Colorado, a pending issue is taxation of pot, which will be used to fund the state marijuana enforcement agency. Voters in November are set to vote on a 25% tax rate proposed by lawmakers. Until then, local officials won't know what kind of resources state officials will have to oversee marijuana businesses.

The discussion in Colorado Springs is complicated by local politics. The city at the base of the Rocky Mountains is home to large socially-conservative groups that are against marijuana use, but is also a stronghold for libertarians, who view pot smoking as a personal freedom government shouldn't interfere with.

In El Paso County, where Colorado Springs is located, voters passed the marijuana amendment by only 10 votes, 141,696 to 141,686. The Colorado Springs City Council is expected to take a vote on pot stores next month.

Keith King, the council's president, said he favors a moratorium, but added that the council is evenly divided between that option, a ban and allowing sales.

Mayor Steve Bach, who doesn't have a vote, wants a full ban. He and others in the business community said allowing sales amounts to endorsing marijuana use, which would alienate military facilities and religious nonprofits that make up a large portion of the local economy.

"We have to give a message to our employers that we are not going to promote a drug that is federally illegal," Mr. Bach said.

But others said prohibiting sales would deny expansion opportunities to the 50 or so medical-pot dispensaries in the city, which would have the first shot at recreational licenses, and go against the town's traditional hands-off approach to government. "This is more than just about pot," said Liz Oldach, who chairs the local chapter of the Libertarian Party of Colorado. "It's about freedom."

The prospect of a ban in one of the state's biggest cities isn't discouraging the activists that pushed for legalization. "Marijuana will be legal for adults...regardless of whether businesses are allowed in their localities," said Mason Tvert, a spokesman for the Marijuana Policy Project.

[NYT: A Legal Blow to Sustainable Development.](#)

Lost amid the Supreme Court's high-profile decisions on affirmative action, voting rights and same-sex marriage was another ruling that may turn out to have a profound impact on American society. The court handed down a decision on Tuesday that, in the words of Justice Elena Kagan, will "work a revolution in land-use law."

While that may sound obscure, the decision in *Koontz v. St. Johns River Water Management District* will result in long-lasting harm to America's communities. That's because the ruling creates a perverse incentive for municipal governments to reject applications from developers rather than attempt to negotiate project designs that might advance both public and private goals — and it makes it hard for communities to get property owners to pay to mitigate any environmental damage they may cause.

The court's 5-to-4 decision, with Justice Samuel A. Alito Jr. writing for the majority, arose from an order issued by a Florida water management district denying an application by Coy A. Koontz Sr. to fill more than three acres of wetlands in order to build a small shopping center. The district made clear that it was willing to grant the permit if Mr. Koontz agreed to reduce the size of the development or spend money on any of a variety of wetlands-restoration projects designed to offset the project's environmental effects. Because Mr. Koontz declined to pursue any of these options, the district denied the permit.

Mr. Koontz, who is now deceased, went to court and claimed that the permit denial constituted a "taking" under two Supreme Court precedents, *Nollan v. California Coastal Commission* and *Dolan v. City of Tigard*. These cases established that when the government approved a development subject to certain conditions, like a requirement that a developer dedicate an easement to the public, the conditions would be deemed an appropriation of private property unless the government could show a logical relationship and a "rough proportionality" between the conditions imposed and the projected effects of the development.

The Florida Supreme Court rejected Mr. Koontz's takings argument on two grounds. First, it interpreted *Nollan* and *Dolan* as being limited to cases in which the government has issued a permit subject to a condition — not in those in which a permit has been denied. Second, it ruled that *Nollan* and *Dolan* applied only when the government's condition took an interest in some tangible property (like demanding an easement, for example), not when a government imposed a generalized requirement on someone to spend money.

In what can fairly be described as a blockbuster decision, the Supreme Court has reversed the Florida court on both points.

Leaving the majority's legal reasoning aside, the Supreme Court's ruling is likely to do some serious real-world damage. As Justice Kagan correctly explains in her dissent, the decision will very likely encourage local government officials to avoid any discussion with developers related to permit conditions that, in the end, might have let both sides find common ground on building projects that are good for the community and environmentally sound. Rather than risk a lawsuit through an attempt at compromise, many municipalities will simply reject development applications outright — or, worse, accept development plans they shouldn't.

"Nothing in the Takings Clause requires that folly," Justice Kagan said. But arguably it does now.

As for the second part of the majority's ruling, that *Nollan* and *Dolan* apply to permit conditions requiring the general expenditure of money, that will also have unfortunate consequences. Cities and towns across America routinely attach fees and other payment obligations to permits, for example, to support wetlands mitigation banks, to finance roads, to pay for new schools or to build affordable housing.

While, to be sure, such mandates must be reasonable under the Constitution, the revolutionary and destructive step taken by the court in *Koontz* is to cast the burden on the government to justify the mandates according to the heightened *Nollan-Dolan* standard. This is contrary to the traditional

court approach of according deference to elected officials and technical experts on issues of regulatory policy. Moreover, this heightened standard will result in a huge number of costly legal challenges to local regulations.

Consider the challenges of waste disposal. Many communities impose development-impact fees on developers if a proposed project would require expanding waste-disposal sites or building new ones. Before Koontz, a developer could raise a constitutional challenge if the charges were unreasonable, but judges typically deferred to local governments in such cases.

After Koontz, developers have a potent new legal tool to challenge such charges because now the legal burden of demonstrating their validity is on the communities themselves.

In the wake of this under-the-radar ruling, the cost of protecting a community from a harmful building project now lies not with the developer but with the local residents and taxpayers. It's hard to fathom that the framers of the Constitution would call this either fairness or justice.

Reuters: Cash Hard to Raise as Fed Jars Credit Markets.

Prospective borrowers ranging from U.S. companies to county governments on Monday shelved a raft of deals to raise new capital or refinance debt as a suddenly uncertain interest rate environment dented demand.

In the municipal bond market, half a dozen deals aimed at raising collectively more than \$300 million were postponed, while several companies pulled plans to refinance syndicated bank loans. Corporate bonds, meanwhile, passed a fourth day with no deals brought to market, either in the risky high-yield sector or the safer investment-grade sphere.

Raising capital has been challenging to say the least since last Wednesday when Federal Reserve Chairman Ben Bernanke sent interest rates soaring by outlining a plan to wind down the central bank's massive stimulus program.

Known as quantitative easing and consisting of \$85 billion a month in bond purchases, the program was instrumental in a rally of bonds, equities and commodities, and had driven interest rates to record lows. But since Bernanke's comments last week, the yield on the benchmark 10-year U.S. Treasury Note has shot up 37 basis points, briefly touching a two-year high of 2.67 percent on Monday.

"We need to have panic selling (in Treasuries) out of the way and a stable level on the 10-year Treasury," before the new-issue market can return, said Scott Schulte, senior investment-grade corporate bond syndicate manager at Citigroup.

That needs to be followed by borrowers willing to sell bonds at higher yields than they had to under the Fed's easy-money regime.

Corporate bonds had been flying off the shelves until recently as companies looked to refinance at record low rates and yield-hungry investors were ready to sign checks. Since Bernanke first floated the notion last month of a pull back from bond buying, corporate bonds have fallen hard and are now down for the year by 3.74 percent on a total return basis, according to the Barclays investment-grade index.

"The level to which investment grade corporate bonds are interest rate sensitive will certainly be an eye-opener to many total return investors when they open up their quarterly statements on June 30," said Edward Marrinan, head of Royal Bank of Scotland's US research.

Said CrediCorp Capital CEO Christian Laub: "What we know is that we won't see cheap financing like we did in the early half of the year."

MUNI BOND SALES STALL; LOAN REFINANCINGS SHELVED

Municipal issues have also slowed to a crawl, with bond sales worth \$331 million postponed on Monday. That brought the total value of deals shelved since mid-June to \$2.6 billion.

A steep price drop in the \$3.7 trillion municipal bond market has lifted yields on bonds due in 10 and 30 years to levels not seen since 2011.

"Public officials do not want be the ones selling a deal at yields which result to be top of the market," said a municipal bond analyst who declined to be named. "They prefer to wait for the market to calm down and become more stable before pushing ahead with their sales."

Loop Capital, a muni bond underwriter, recently cut its estimate for 2013 muni issuance to \$360 billion from \$400 billion, but Loop Managing Director Chris Mier said they may cut their forecast more if present conditions persist.

Still, the two big munis deal of the week remain on the calendar for now: \$1.3 billion each from the state of Illinois and the city of Los Angeles.

The Economist: What Do the Woes of Detroit Mean for Muni Bonds?

Choosing the bleakest statistic from a report issued by Kevyn Orr, Detroit's emergency manager, on his city's financial health is like choosing the wettest raindrop in a monsoon. It could be the \$1.3 billion general-fund deficit Detroit is forecast to run, absent restructuring, by the 2017 fiscal year. It could be the \$200m revenue decline since 2008, the roughly \$3.5 billion in unfunded pension liabilities or its \$5.7 billion in non-pension retiree liabilities.

On June 14th Mr Orr announced that Detroit would miss a \$40m unsecured-bond payment, and proposed a restructuring that would mean some holders of the city's unsecured debt receiving pennies on the dollar. If creditors reject Mr Orr's offer bankruptcy looms. Detroit would be the largest-ever American city to go bust, but hardly the first. In recent years issuers of municipal bonds that have filed for Chapter 9 protection from creditors have included Stockton, Vallejo and San Bernardino in California; Central Falls, Rhode Island; Jefferson County, Alabama; and Harrisburg, Pennsylvania. Others have defaulted without going bust. America's \$3.7 trillion muni-bond market has long had its doomsayers. Is this their moment?

The situation remains grim. According to the National League of Cities, an advocacy group, American cities in 2012 experienced their sixth straight year of constant-dollar declines in general-fund revenues. Year-on-year sales-tax collections rose modestly in 2012 but income-tax collections fell for the third year in a row. So did property-tax collections, despite a recovery in housing markets; assessed values, which determine property-tax rates, usually lag the market by at least 18 months. Cash reserves have fallen by almost 50% since 2007 to 12.7% of expenditures, their lowest level since 1996. (The picture is a bit rosier for states, which tend to have more flexibility in raising

revenue than cities do.)

Borrowing costs are going the wrong way. Municipal-bond yields have been rising in anticipation of the Federal Reserve scaling back its bond-buying. American municipal-bond funds saw billion-dollar outflows during the weeks ending June 5th and June 12th. Some may also be worried by Barack Obama's proposal, released in his budget in April, to limit the tax-exempt status that most municipal bonds enjoy (although getting that passed would require a degree of backbone currently absent from American politics).

None of this means a wave of defaults is around the corner, however. Assured Guaranty, a municipal-bond insurer, has exposure to roughly 11,000 different municipal bonds; it expects to take losses on fewer than 12. The high-profile cases of Detroit and Jefferson County are idiosyncratic. Detroit has been shedding population for years, and the decline of its car industry has destroyed its tax base. The woes of Jefferson County—which this month proposed a plan to emerge from bankruptcy that also involved creditors taking losses—stemmed from a sewer project that stank of corruption and mismanagement.

Bart Mosley, a co-president of Trident Municipal Research, calls these cases “exceptions that prove the rule that state and local-government credits are solid...[and] highlight the extent to which state and local governments have been much more fiscally responsive” than the federal government during the crisis. Mr Mosley points to narrowing yield spreads over the past two years between A-rated and AAA-rated municipal bonds as evidence that fear of default has been priced in.

The concern for the municipal-bond market is less about an imminent deluge of defaults, and more about the lasting precedents set by places like Detroit. Cities and states face huge long-term pressures from health-care costs and pension obligations. Investors are used to seeing governments raise taxes and cut spending to ensure repayment. They are learning that “full faith and credit” has its limits.

Advisors Focusing More on Government Policy.

Government policy is becoming a more prominent topic of conversation between financial advisors and their clients, according to a recent study as well as anecdotal reports — and remarks by the Federal Reserve chairman last week on the future of the Fed's stimulus policy have spurred even more discussions about government policy.

“When Bernanke says what he says, it becomes a top-of-mind topic of discussion for us,” says Paul Tramantano, chief executive of Constellation Wealth Advisors in New York. But Constellation isn't adjusting portfolios in response, he cautions: “Our clients' portfolios are positioned the way we want them to be.”

Concerns about government policy ranked second among the most popular topics of conversation — behind portfolio rebalancing but ahead of portfolio performance, retirement concerns and estate planning, according to Russell Investments' latest quarterly Financial Professional Outlook survey.

And among topics initiated by clients, government policy tied for the top spot with concerns about the stock market, advisors reported.

The increasing concern with government policy “is an interesting shift for advisors,” the Russell report states. “We believe the most likely reason ... is interest rates. We believe that as long as the

Fed maintains its current interest rate policy, advisors should be prepared to continue having similar conversations with clients.”

While advisors at New York-based Altfest personal Wealth Management generally do not bring up government policy with clients, they welcome the conversation when clients initiate it, says Karen Altfest, co-principal of the firm.

“Sometimes they need to be reassured, and sometimes we have to check the accuracy of what they thought they heard,” Altfest says. “But it’s a good opportunity to listen to them and hear their concerns. They bring up something that’s on their mind like health care which we didn’t hear about before.”

The Russell survey also found that nearly 90% of advisors are optimistic about their ability to attract and retain clients this year, primarily through referrals.

With Few Young Recruits, Advisor Workforce Shrinks.

Despite rankings that say being a financial advisor is one of the best careers, people are leaving the industry faster than they join. Cerulli Associates says U.S. advisors have decreased 1.3% during the past year, and contraction is expected through 2016. The average age of an advisor is 51, and most expect to retire at 68.

There’s a shortage of younger advisors entering the field, and it’s only going to get worse. Firms need to beef up their training programs and explore new sources of talent.

Wendy started out as a sales associate for a wirehouse in the Southeast. After four years in that role, she was encouraged by the advisor she worked for to get licensed as an advisor. She had already established solid relationships with clients and knew she could learn the rest of the business. After working for three years as a junior, Wendy decided to take the clients that she had built on her own, and now eight years later, Wendy has a successful book of business with nearly \$150 million in assets under management.

But this scenario is rare in this industry. Several studies have been published warning of the impending shortfall of advisors entering the field, and the growing percentage of baby boomer advisors nearing retirement.

Over the past year, advisor headcount has declined by 1.3 percent, according to Cerulli Associates, due to terminations, retirements and advisors exiting the industry by choice, and Cerulli expects the decline to continue through 2016. Meanwhile, the average age of an advisor was 51 in 2012, with most looking to retire at 68.

Despite the fact that the financial advisor profession is consistently ranked as one of the top career paths, college graduates are reluctant to enter the field because of the high failure rate of those who have gone before them. And for females, despite their natural fit for the job as relationship-oriented multi-taskers, the largely male dominated culture has kept far too many away. According to the CFP Board, not only are women not entering the profession, more are leaving it, possibly because of a lack of network, mentors and sponsors, negative stereotypes, and competing priorities.

Before the financial crisis of 2008, the big firms all offered strong training programs and actively recruited into them. While the big firms are now starting to reinvest in those programs to increase

the percentage of successful graduates (historically only 40-50 percent), programs lack the attention and resources required because management does not completely embrace them as fertile ground for growing top talent. In an attempt to mentor younger advisors, management sometimes partners them with senior producers, but many of these junior advisors end up feeling like indentured servants—essentially building someone else's brand and book—not a business of their own.

It is my belief that business-minded, second career professionals—especially women—are an appropriate place to mine for talent. These folks, perhaps a decade older and more seasoned than their newly graduated counterparts, can be CPAs, MBAs, attorneys, etc. They have a natural Rolodex, maturity and life experience. Client sales associates, too, should be nurtured and encouraged to move into advisor positions given their front line support experience, industry knowledge and ability to hit the ground running. But to attract all of these potential candidates, firms need to have better compensation models to incent them, structured mentoring programs and women's networking groups.

While there is a serious advisor shortfall, there is also a deep bench of talent sitting on the industry sidelines. Take Cindy, who started out as a teacher. After teaching for three years, Cindy determined that she wanted to build a business of her own. She had friends who were financial advisors, and she believed that she could transfer many of her skills to that profession, make a far greater living, and build a clientele of professional women. Today, Cindy is in her second decade as a wirehouse advisor with nearly \$750 million in AUM. She has a robust support staff, which enables her to focus on her core competencies and spend time with her three children.

Between young people not choosing financial services as a career and firms not having enough young talent to meet their growing needs, the industry has reached a critical point. Let's see if firms answer the call.

Higher Yields May Boost Bond Insurers.

The bond insurance industry is one segment of the municipal market that stands to benefit as interest rates continue to rise.

Assured Guaranty Ltd., one of the two active bond insurers in the municipal market, has already noticed increasing interest in its product in the relatively short period since rates have gone up, according to Robert Tucker, head of investor relations and communications.

"As interest rates rise and credit spreads widen, we would expect an increase in demand for bond insurance as investors become less focused on yield alone and increasingly incorporate the benefits of insurance in their investment decisions," he said.

The bond insurance industry was all but wiped out during the financial crisis, which left Assured Guaranty as the only active bond insurer for years to follow. At its peak, the industry was responsible for insuring more than half of muni bond issuance in a year. Last year, only 3.5% of new issues carried insurance. Low interest rates, among other limiting factors, have prevailed for the past four years, reducing both investment income for insurers and the amount of absolute spread available for issuers to fund insurance.

Interest rates have finally reversed direction in recent months, taking off Thursday in response to Federal Reserve chairman Ben Bernanke's comments that hinted the Fed may start tapering its bond purchasing program by the end of the year. Following Thursday's close, yields on the Municipal

Market Data triple-A scale were up 90 basis points in 10-year maturities, and 104 basis points in 30-year maturities since May 1, with much of the increase taking place since June 3.

“Higher rates probably increase our opportunity to save issuers money as a logical consequence of wider spreads between credits,” said Sean McCarthy, managing director and chief executive officer of the newest bond insurance company, Build America Mutual, which launched in July.

“That said, today in any interest rate environment, BAM’s success is primarily driven by providing greater access for small- to medium-sized issuers, who benefit from the name recognition and liquidity the AA/stable guaranty provides.”

National Public Finance Guarantee Corp., MBIA Inc.’s municipal-only insurer, also said rising interest rates would be a positive for bond insurers.

“As rates rise and spreads widen, insurers will be better positioned to create value for more issuers while charging premiums sufficient to achieve an acceptable return on the capital deployed,” said Adam Bergonzi, a managing director at National.

The currently inactive bond insurer is a subsidiary of MBIA Inc. and was formed in 2009 when MBIA separated its municipal bond insurance business from its other, mostly asset-backed business. National has been preparing to re-enter the market, and the company has said it expects to do so sometime in the near future.

“Over a longer period of rising rates, debt buyers can be expected to become increasingly selective, as they will have more options to satisfy their investment goals,” Bergonzi said. “And as the market becomes more discerning over credit, insurance becomes compelling in a greater number of circumstances.”

Until recently, yields had been declining to historic lows, creating a challenging environment for the declining bond insurance industry. With borrowing costs already very low, municipal bond issuers find the bond insurance product — which provides credit enhancement to help issuers save on borrowing costs — less valuable.

In November of 2012, the Bond Buyer 20-bond index — a selection of mostly double-A general obligation bonds maturing in 20 years — dropped to 3.29%. That was its lowest level since Sept. 2, 1965, when it was also 3.29%.

Interest rates ended 2012 lower than they began at 1.72% in the 10-year, and 2.83% in the 30-year. The 20-bond index was at 3.58% as of Dec. 27, slightly down from the beginning of the year, when it was at 3.83%.

“It’s a positive development,” said Alan Schankel, managing director at Janney Capital Markets. “I don’t think there will be an overnight change, or a rush to embrace insurance because rates are a little higher, but in general, it’s a positive point for insurers and one of the things they need going forward to grow their business and grow their market share.”

In assigning ratings to bond insurers, credit rating agencies have cited the low interest rates as a limiting factor in bond insurers’ ability to generate new business.

Standard & Poor’s, for example, has assigned Assured Guaranty a financial strength rating of AA-, saying the company has a strong competitive position and strong capital, but limited business growth prospects due to the low interest rates.

Moody's Investors Service rates the company lower at A2, also citing the low interest rates, among other factors.

Analysts at Moody's say the rise in interest rates is a positive sign for the industry, but it also has to overcome other problems.

"There are two primary reasons why new business volume has been so low," said James Eck, vice president and senior credit officer at Moody's. "One is the low absolute interest rate environment, which has led some issuers to feel that since they're able to issue at such low rates, the additional savings from bond insurance either aren't there, or do not produce meaningful savings. The other potential reason is general investor skepticism of the value proposition."

Stanislas Rouyer, associate managing director in the financial institutions group at Moody's, said that the investor skepticism is based on the fact that the industry almost disappeared during the financial crisis and that, until recently, there has only been one active bond insurer.

"Now, with BAM being active, and National possibly re-entering the market, there is more of an industry," he said. "More players appears to be a good thing for the industry overall. It gives more of a sense of the durability of the product."

The other issue that causes investor skepticism is the legacy exposures of guarantors. Situations like Detroit remind people of the risks in the industry, Rouyer said. But at the same time, they can also highlight why the product is useful.

Schankel also believes events in Detroit, as well as Jefferson County and other troubled municipalities, will help illustrate the value of bond insurance. He says that time is also a factor that will help the industry to grow.

"The further away we get from 2008 and those bad memories of insurance, I think the better opportunity insurers will have to penetrate the market, at least on the retail level," he said, adding that he doesn't think the industry will ever return to the 57% market share it saw in 2005.

Standard & Poor's analysts said in a July 12 report that the bond insurance industry could see its market share of insured new issues return to 20% to 30% in a "normalized interest-rate environment."

However, in the current environment, yields aren't quite there yet.

Matt Fabian, a managing director at Municipal Market Advisors, noted that while yields have increased, they have only risen 1% in the last few months.

"This isn't nearly what we're talking about when we say that higher yields would help the insurers," he said. "Getting back to more 'normal' yields, at least for when the insurers had their heyday, might take another 1% or more."

In addition to a waning investor acceptance, the industry has a few structural factors working against it as well. These include the movement away from direct retail ownership to funds and separately managed accounts, rating recalibration, and the reduction in the use of variable-rate and other products that depended on insurance, Fabian said.

"Lack of issuance, in particular longer fixed rate bond issuance, and the severe downward pressure on underwriting fees" are other limiting factors, he added. "These don't leave a lot of room to pay an insurer for their services."

by: TONYA CHIN

NYT: Cost of Public Projects Is Rising, and Pain Will Be Felt for Years.

States and cities across the nation are starting to learn what Wall Street already knows: the days of easy money are coming to an end.

Interest rates have been inching up everywhere, sending America's vast market for municipal bonds, a crucial source of financing for roads, bridges, schools and more, into its steepest decline since the dark days of the financial crisis in 2008.

For one state, Illinois, the higher interest rates will add up to \$130 million over the next 25 years — and that is for just one new borrowing. All told, the interest burden of states and localities is likely to grow by many billions, sapping tax dollars that otherwise might have been spent on public services.

The same concerns about rising rates that have buffeted the world's stock markets recently have also affected the market for municipal bonds. The muni market, despite a modest rally on Wednesday, is headed for one of its worst months in years.

Much as home mortgage rates are making home buying a bit more costly as they rise, so, too, are the rates at which states and cities borrow money. Public officials — and taxpayers — may feel the effects for years. Perversely, the places with the greatest distress are likely to see their borrowing costs rise most.

Over the last few days Georgia, Philadelphia, the Metropolitan Transportation Authority in New York and others have delayed sales of new bonds, citing the precipitous plunge in prices that is driving up interest rates.

Gov. Pat Quinn of Illinois attributed the extra cost to the state's failure to shore up its finances, particularly its rickety pension system. Illinois has the lowest credit rating of any state, and as interest rates rise they tend to rise fastest for the weakest borrowers.

"Borrowing money when you're already in debt doesn't seem like a good idea to me," said Felicia Hill, a 44-year-old Chicago woman who wondered how the state could bear the rising cost. "I think it could have waited, when we have bigger problems in Illinois."

The sell-off in the municipal bond market has followed the general rout in the overall bond market, which was set off when Ben S. Bernanke, the chairman of the Federal Reserve, indicated that the strength of the economic recovery might allow the central bank to pull back on its \$85 billion--month bond-buying program earlier than anticipated.

The Fed was not buying municipal bonds, but the market reacted anyway. Investors expected interest rates to rise, and because prices move in the opposite direction, the values of the municipal bonds they already held dropped.

Investors apparently started selling, not wanting to be the last one out. That caused a flood of bond sales. For the week ended June 19, \$3.368 billion flowed out of mutual funds that hold tax-exempt municipal bonds, according to the Investment Company Institute. The outflow for the previous week was \$3.236 billion.

Such sell-offs tend to hit the municipal bond market hard because it has many individual investors who buy bonds to hold them, either directly or through mutual funds, rather than financial institutions that trade them quickly.

"The mutual fund's customer has proven to be fickle in these volatile periods, and you get the sticker-shock effect," said Chris Mauro, the head of municipal bond strategy at RBC Capital Markets. The trend starts to feed off itself and can last for a long time, he said. "As they liquidate, there's pressure on the mutual funds to raise cash, which puts more selling pressure onto the market."

Some analysts thought the sell-off was made worse by the actions of Detroit as it flirted with bankruptcy. The city's emergency manager, Kevyn Orr, proposed inflicting severe losses on its bondholders earlier this month as he struggled to keep the city from declaring what would be the largest municipal bankruptcy in history. That prompted investors to sell Detroit bonds, and raised questions about whether Detroit's approach could set an example that other distressed cities would follow.

Some local governments that had planned to issue bonds this week decided to wait and see whether the market improved. But Illinois was among those that could not afford to wait. It had been conserving money by delaying road maintenance and the building of new schools.

Abdon Pallasch, an assistant state budget director, cited in particular the risk of delaying reconstruction of the city's commuter rail system in hopes of obtaining better rates on the bonds, which have a total value of \$1.3 billion. He said service had been halted on the Red Line, Chicago's oldest, inconveniencing 80,000 commuters a day.

Mr. Pallasch said that state finance officers had calculated the state's \$130 million market penalty by comparing the rate Illinois will pay on these bonds with the rates being paid on similar bonds issued by states with AA ratings. That, he said, was Illinois's credit rating before the state's pension problems boiled up.

Illinois has shortchanged its pension system for many years and has now fallen so far behind that it cannot catch up without diverting money away from other programs. Governor Quinn has tried several times without success to push pension overhauls through the legislature. Moody's Investors Service downgraded the state's credit to A3 in June, soon after one failed legislative effort, and Fitch went to A-, the equivalent in its ranking system.

Although those ratings are the lowest of any state, they are still several notches above junk grade.

Governor Quinn said that the state was paying an average interest rate on the bonds of 5.042 percent. He called on lawmakers to enact pension changes "by July 9, so we can stop the bleeding, prevent future downgrades and jump-start Illinois's economy."

Daniel Berger, senior market strategist for Thomson Reuters Municipal Market Data, said the pension-related downgrades cited by the governor were important factors but not the only ones.

He said that market conditions had driven the interest rate on a typical 10-year municipal bond up by more than one percentage point since the beginning of May. The rate for longer-maturity bonds were more than 1.25 percentage points higher.

"He's ignoring the adverse market conditions," Mr. Berger said.

BY MARY WILLIAMS WALSH

SIFMA: Fatal Flaws in Markup Research Paper.

A research paper released last week suggests that widespread violations of MSRB fair pricing rules are rampant in the municipal market. Scratching just below the surface, however, reveals serious flaws in the methodology and assumptions underlying the authors' conclusions.

First, the paper does not provide any indication as to how the authors determined markups on municipal bond transactions. The authors indicate that they use data collected by the MSRB under their Real-Time Transaction Reporting System. However, RTRS data does not separate out markups, which need to be inferred from trade price information. Without knowing how the authors used trade price data to determine markups, it is nearly impossible to replicate their calculations or determine their validity.

Second, the authors pay virtually no attention to the Financial Industry Regulatory Authority's robust examination and enforcement system for detecting unfair pricing activity and sanctioning violators. Rooting out fair pricing violations is a key element of virtually all FINRA municipal examinations.

Third, the authors state that "the MSRB instructs members to calculate markups on municipal bond trades as the difference between the prices charged to the customer and the prevailing market price and to calculate markdowns as the difference between the prices paid to investors and the prevailing market price. The broker-dealers' contemporaneous cost of acquiring...the bonds through inter-dealer trades or offsetting trades with investors establishes a presumption of the prevailing market price." In fact, MSRB rules do not include any such instruction. The citation provided by the authors refers to draft MSRB interpretive guidance which was never adopted. Rather, MSRB Rule G-30 requires dealers to buy or sell securities "at an aggregate price (including any mark-down or mark-up) that is fair and reasonable." The MSRB's fair pricing rule does not directly set guidelines or standards for markups and does not use the concept of contemporaneous cost.

Fourth, in their discussion of markups, the authors take no account of fundamental issues such as costs to dealers of financing and hedging inventories and servicing customer accounts and for market movements that could account for differences in the prices at which dealers purchase and sell securities. One of the examples cited by the authors involves an inventory position which, according to the authors, a dealer acquired then sold off in a series of customer trades over a four-week period. Without analyzing those specific bonds, generally the authors fail to address questions such as how market benchmarks performed over that period and what the dealer's cost of financing and hedging that inventory over four weeks was.

Moreover, a key issue the authors neglect throughout the paper relates to the cost of servicing customer accounts. The markup earned by a dealer on a single sale must often cover the cost of servicing that customer position, including periodic valuations and statements, possibly for decades.

Fifth, the authors overstate the portion of outstanding municipal securities held by individuals. Citing SIFMA data, the authors state that "one half of the \$3.7 trillion in municipal bonds outstanding at the end of 2012 was directly held by individual investors." Our data on holdings of municipal securities come from the Federal Reserve Board's "Flow of Funds" publication, which tracks holdings of "households," not individuals. Moreover, "households" are a residual category, meaning that household holdings really reflects the holdings of any category of investors not otherwise accounted for, including individuals but also including others. In addition, a growing portion of the municipal market held by individuals is owned through separately managed accounts,

which are professionally managed and generally buy and sell bonds in block-size transactions.

Sixth, the authors make no distinction between trades involving fee-based accounts and traditional brokerage accounts. This distinction is important because with a fee-based account, because a dealer earns periodic fee revenue based on the size of the account, markups on transactions can be smaller. With traditional brokerage accounts, all the dealer's revenue is derived from markups on customer sales, so markups must be larger to account for dealer costs of servicing accounts. Including markups on trades involving fee-based accounts makes the average and median markups smaller than they would be on trades involving only traditional brokerage accounts. For an "apples-to-apples" comparison, the authors should have analyzed markups on fee-based and traditional accounts separately.

Seventh, the authors' proposals for addressing perceived shortcomings in municipal securities pricing rules are deeply flawed. They suggest a municipal securities pricing rule based on "dealers' contemporaneous cost," an elusive concept in a market like ours where most bonds trade very infrequently. When a dealer buys a bond that remains in inventory for weeks, the dealer's "cost" relative to current market pricing is often almost impossible to determine. That is the reason the MSRB has successfully administered a rule based on fair pricing rather than markup regulation for decades.

Finally, Mistery Deng and McCann are not independent academics but rather professional witnesses closely affiliated with plaintiffs and claimants in securities litigation and arbitration cases against broker dealers. It should come as no surprise that their conclusions suggest significant numbers of pricing violations against investors, potentially leading to actions in which the authors would have a financial interest.

Enforcing fair pricing standards in a thinly traded market like that for municipal securities is difficult and complex. Determining fair prices is often subject to interpretation, and intelligent and informed market professionals can and often do disagree about the value of a bond at particular time. While it is appropriate for regulators to periodically review pricing rules to ensure customers' prices are fair, and academic research can help inform that process, there is no systemic mispricing of customer transactions as the authors claim.

by: Michael Decker

Michael Decker is a managing director and co-head
of the municipal securities group at SIFMA.

Moody's: Detroit Default, Plan, Break Ground in Muni Market.

Detroit's default and debt-restructuring plan are precedent-setting in the U.S. municipal market, Moody's Investors Service said on Monday, because the city is looking to bondholders, as well as labor unions and pensioners, to share the pain.

The city on Friday defaulted on a \$39.7 million payment on certificates of participation and presented a plan to restructure its finances.

"The restructuring plan is unconventional and precedent-setting in the municipal market. It builds a strong case for insolvency, girding the city for a tough fight with creditors of all types," Moody's said

in a statement.

The proposal by Emergency Manager Kevyn Orr calls for unsecured creditors to take a pro rata share of \$2 billion of new limited recourse participation notes, which would be issued to replace approximately \$11 billion of unsecured obligations.

"The substantial reduction offered to unsecured creditors, the extent of the city's financial stress and the complexity of the city's debt add to the uncertainty of many classes of debt ultimately recovering their investment," the rating agency added.

On Thursday, before the city's announcement, Moody's downgraded several classes of Detroit debt to Caa2 with a negative outlook.

Moody's also said the plan is unusual as it proposes similar treatment of various debt security types.

It noted that Orr did not propose a plan for creditors who are considered secured, such as the debt of the city's water and sewer enterprises or the city's general obligation debt, which is enhanced by state aid and claims relative to interest rate swaps. However, the latter are subject to negotiations.

"The plan appears to treat the general obligation and pension obligation certificates similarly, which would be a break from tradition," Moody's said.

Standard & Poor's, which on Friday downgraded the city to CC from CCC minus, said it was sure to cut the rating further.

Detroit's Orr: Investors in Bonds Headed for Haircut Should Have Known.

If you bought Detroit debt without making sure it came with support from credit enhancement or a revenue lien, you will now pay the price, Detroit emergency manager Kevyn Orr says.

"If you lent money to an insolvent city that has been going insolvent as openly and notoriously as possible since 2000, and you don't have a security interest, then you are an unsecured creditor," Orr told The Bond Buyer in a telephone interview Tuesday. "This has been building for decades and decades. They understood the risk."

Orr's comments come days after he unveiled a comprehensive but controversial restructuring plan that relies on slashing the city's unsecured debt. Orr wants to issue \$2 billion of notes to pay off holders of \$11.4 billion of unsecured debt on a pro rata basis.

He said he should know within 30 days whether he will file a Chapter 9 bankruptcy.

The plan puts \$650 million of the city's unlimited- and limited-tax general obligation bonds on par with \$5.7 billion of retiree health care, \$1.5 billion of pension certificates, and a newly assessed \$3.5 billion unfunded pension liability. Orr, a corporate bankruptcy attorney who worked on the Chrysler restructuring, said his decision to lump GO bonds in with debt like unfunded retirement liabilities and POCs reflects "traditional categories."

"For those that were apparently unsecured, they were all treated equally," he said. "We've been saying since the beginning that our thinking, our methodology, is to treat all claimants equally within their class."

The restructuring plan was not vetted by the state and came solely from his office, said Orr. It does not reflect a formal position by the state on the classifications of a local government's debt.

"We have not talked to the state about this, and the state has no obligation to us on this proposal. This is our proposal," he said.

The treatment of \$650 million of the city's GOs — out of a total of \$1.1 billion of GOs — as unsecured surprised many in the municipal market, who note that unlimited-tax GOs are typically considered among the safest products in the market.

Orr countered that assessment, saying UTGOs are no more than "the safest unsecured debt" in reality.

"I know the whole moral argument," he said. "But unsecured claimants always say, 'It's not me'."

The banks that are counterparties on the city's eight interest-rate swaps hedging \$1.4 billion of pension certificates, for example, were savvy enough to demand a lien on casino revenues in 2009 when it became clear Detroit would have a hard time making the payments, he said.

"The factors that have gone into underwriting since 2000 reflect the acute deterioration," said Orr.

As part of the restructuring plan, Orr announced an immediate moratorium on repayment of all unsecured debt, starting with a \$39.7 million payment due Friday on the pension COPs.

Holders of the COPs have the ability to sue the city in state court over the default. If they win, the court would order a judgment levy forcing the city to raise taxes to generate new money to cover the debt payments.

But Orr cautioned that a lawsuit could push the city closer to a Chapter 9 filing.

"We expect to have intense negotiations that would forestall any lawsuit," he said. "Any lawsuit would cause us to reassess our plan to try to pursue an out-of-court settlement. If I were the parties, I would not run to the courthouse."

Detroit will continue to default on unsecured debt, including its GOs, that comes due during negotiations, Orr said. It will also continue to make payments on the debt it considers secured, while negotiating with creditors on a restructuring or refinancing aimed at providing the city relief on its annual debt service burden.

Secured debt totals about \$7 billion, including \$5.9 billion of water and sewer revenue bonds and \$480 million of GOs. Nearly all the debt carries bond insurance.

Orr said he expects to meet with bondholders later this week and next, with some meetings in person and some on the telephone. It should become clear within the next 30 days whether the city will file for Chapter 9 bankruptcy.

"That doesn't necessarily mean we're going to file in 30 days," he said. "If we're making progress, we'll continue to negotiate."

The emergency manager said he's not focused on the impact the default or proposed haircut may have on other Michigan issuers or the broader municipal market.

"Frankly, my focus is on the obligation I have for the city of Detroit," he said. "I cannot really take

into account the potential impact it may have [on the municipal market].”

He added that he doubts the city’s default or a bankruptcy would stain other local governments or the state itself.

“Detroit is such a unique situation,” he said. “Detroit is so clearly insolvent that for anybody to impute anything on another municipality because of Detroit is wrong.”

Orr said he’s not worried about future access to the markets when the city may badly need borrowed money.

“My experience is once you get a debtor in a position with better cash flows and lower debt, that they’re more credit worthy,” he said.

The restructuring plan included a new assessment of the city’s pension liability that boosts the unfunded figure to \$3.5 billion from about \$640 million. Orr has a meeting set with labor to discuss cuts on Thursday, and would not go into detail ahead of the meeting on the new pension figures, which are based on more conservative investment and amortization assumptions.

“There’s no mysteries here,” he said, “It’s straightforward math.”

He also declined to comment on the notion that the restructuring plan favors unions and employees over bondholders, saying only that labor feels as strongly as bondholders that they are facing unfair sacrifices.

“If you ask unions, this is yet another Wall Street bailout,” Orr said.

“I can’t be governed by perception — only by the reality of where we are,” he added. “I understand different people are going to be upset, but at the end of the day we tried to adhere to the benefits of the bargain they cut.”

Orr said he is negotiating with creditors on a class-by-class basis. The city may enter into separate — confidential — agreements with creditors of the same class, he noted.

“There may be times when different people want to cull themselves from the herd, and we may enter into confidential settlements with those folks,” he said. “We reserve that right.”

As to whether the city can expect help from the state or the federal government, directly or indirectly, Orr said it’s unlikely.

“Let me put it this way: It’s been made clear to me that we are on our own,” he said. “The cavalry is not coming.”

by: CAITLIN DEVITT

CUSIP Global Services Projects Continued Growth in Bond Issuance.

“The dual trend of low interest rates and a slowly improving economy is creating a perfect storm for new debt issuance,” said Richard Peterson, Director, Global Markets Intelligence, S&P Capital IQ. “The jury is still out on how long that environment will last, but for now, all signs are pointing to increases in issuance over the next several weeks.”

The full press release is available at:

http://img.en25.com/Web/StandardandPoors/CUSIP%20Issuance%20Trends%20May%202013_PR.pdf

National League of Cities Comments on Proposed Regs on Health Insurance Provider Fee.

Clarence Anthony of the National League of Cities has commented on proposed regulations (REG-118315-12) on the annual health insurance provider fee under the Affordable Care Act, seeking clarification that governmental employers who self-fund their benefit plans on a pooled basis, and the pools in which they participate, fall under the self-insured employer exclusion and, thus, aren't covered entities subject to the fee.

June 3, 2013

The Honorable Daniel Werfel

Acting Commissioner

Internal Revenue Service

CC:PA:LPD:PR (REG-118315-12)

P.O. Box 7604

Ben Franklin Station

Washington, DC 20044

RE: Health Insurance Providers Fee Notice of Proposed Rulemaking — Comments and Request to Testify

Dear Acting Commissioner Werfel:

The National League of Cities ("NLC") on behalf of cities and towns throughout the country appreciates the opportunity to provide comments to Treasury and the Internal Revenue Service ("Treasury") on the Notice of Proposed Rulemaking ("Proposed Rule"), Health Insurance Providers Fee, as published in the Federal Register on March 4, 2013 (78 Fed. Reg. 14034), and subsequently corrected on March 22, 2013 (78 Fed. Reg. 17612). Many of these cities and towns have joined together to form public entity health care pools to provide health care insurance coverage to their employees. Without the benefit of these pools, many of these entities would not be large enough to self-insure and all would face either larger or more unpredictable costs to provide these essential benefits.

Section 9010 imposes an annual fee on covered entities engaged in the business of providing health insurance for any U.S. health risk. ACA §§ 9010(a)(1) and (c)(1). Generally, section 9010 provides that the term "covered entity" does not include: (1) any employer to the extent the employer self-insures its employees' health risks; (2) any governmental entity; (3) certain nonprofit entities that do not engage in certain political activities and receive more than 80-percent of revenues from

Medicaid, Medicare, and SCHIP; and (4) non-employer established VEBAs.

While the Proposed Rule defines the term “governmental entity” to include political subdivisions of a state, it does not include instrumentalities of a governmental entity. 78 Fed. Reg. at 14042.

The preamble notes that instrumentalities that provide health insurance may qualify for other exclusions under section 9010, such as the exclusion for employers that self-insure their employees’ health risks. 78 Fed. Reg. at 14037. Treasury invites comments on the types of instrumentalities, if any, that would be covered entities under the general definition and the extent to which they would qualify for exclusions consistent with the statute. Our detailed comments are below.

We also request an opportunity to testify at the public hearing on June 21, 2013.

I. Background

NLC is the country’s largest and oldest national organization serving over 19,000 cities and towns throughout the country and 49 state municipal leagues. Founded in 1924, NLC helps city leaders build better communities through federal advocacy, research, and information sharing between and among cities and towns and state municipal leagues.

State municipal leagues are intergovernmental organizations comprised of member cities and towns within a state. They were formed and operate to improve the operations of their municipal government members and promote the welfare of citizens of those municipalities by facilitating and coordinating research and programs that (i) advance the efficient and effective operations of member municipalities, (ii) promote governmental efficiency and effective governance, and (iii) coordinate and effect advocacy and communications with the legislative, administrative and judicial branches of state and federal governments on issues affecting member municipalities.

Many governmental entities are authorized under state law to join together to self-insure health benefits for their employees through risk-sharing pools, trusts or other group arrangements (collectively, “Pools”). These entities are operated exclusively for the benefit of the municipal employers. An NLC affiliate, the NLC Risk Information Sharing Consortium (“NLC-RISC”) is an association of state municipal league intergovernmental risk-sharing Pools in thirty-four states. NLC-RISC member Pools offer property, liability, workers’ compensation, unemployment, and/or employee benefit programs to their combined 16,000+ member cities, towns, counties and other local government entities.

NLC-RISC member Pools are universally exempt from tax under Code § 115 or as VEBAs under Code § 501(c)(9). Many have private letter rulings recognizing that they perform an essential government function on behalf of their municipal participants with all of a Pool’s income accruing solely for the benefit of their participating public employers and not for private interests.

Those Pools that provide health benefits to local government employees and their families are all comprised of governmental entities that would be excluded from the fee were they to provide health benefits through their own separate health plan, under both the governmental entity exclusion and the self-insured employer exclusion. In many cases, cities and towns are too small to effectively self-insure some or all health benefits for their own employees. Thus, when cities and towns join together to provide health coverage through a Pool, they enjoy economies of scale, which helps to lower the cost of the coverage for both the municipalities and their employees. They also enjoy enhanced stability by having a larger risk pool.

On behalf of cities and towns throughout the country who have joined together to form public entity

health Pools, we submit this comment letter to request an express exclusion for these Pools in the final rule. Although we believe Pools fit within the self-insured employer exclusion (or VEBA exclusion for those Pools that are VEBAs), they are instrumentalities of governments and thus are not included in the governmental entity exclusion under the Proposed Rule. We are concerned that without an express inclusion in the definition of governmental entities not subject to the fee or an express exclusion from the fee as self-insured employers, the Pools or the municipal employers covered under a pooled arrangement could be interpreted as being covered entities subject to the fee.¹

We believe that the overarching intent of Congress is to exclude governmental entities that self-insure their employees' health benefits from the health insurer fee. This is evident by the existence of both the governmental entity exception and the self-insured employer exception. These exceptions should apply whether the governmental entity provides the self-insurance alone or does so jointly with other governmental entities through a Pool.

II. Recommendations

We recommend that Treasury define governmental entity in the final rule to expressly include a Pool through which political subdivisions jointly self-insure their employees' health benefits.

Alternatively, we recommend that Treasury specifically include Pools, and the governmental entities that self-insure their employees' health risks through Pools, in the self-insured employer exclusion.

1. Governmental Entity Exclusion

Treasury should expressly include Pools in the definition of governmental entity. ACA § 9010(c)(2)(B) broadly excludes any governmental entity from the definition of covered entity. However, the Proposed Rule narrows the definition of governmental entity to not include instrumentalities of states or local political subdivisions. 78 FR at 14042.

In the discussion of instrumentalities in the preamble to the Proposed Rule, Treasury refers to instrumentalities within the meaning of Rev. Rul. 57-128. That revenue ruling confirmed the tax-exempt status for federal employment tax purposes of an interstate association of several state insurance departments. In the ruling, the IRS applied a six factor test in determining whether the association was an "instrumentality of one or more states or political subdivisions." All Pools satisfy this six factor test, and therefore are either instrumentalities of their public entity participants or are intergovernmental agencies in their own right under state law. Thus, it appears that Pools may not be exempted from the definition of covered entity as "governmental entities" under the Proposed Rule.

Pools are comprised of counties, municipalities, school districts, authorities and other local political subdivisions and are established under state intergovernmental cooperation laws. Their sole purpose is to provide health benefits to the employees and employees' dependents of their municipality participants. As a result, they have been recognized by the IRS as performing an essential government function on behalf of their participants — with all of their income accruing solely to their participating governmental employers — and are therefore exempt from taxation under Code § 115(1), in accordance with Rev. Ruling 90-74, 1990-2 C.B. 34.

Not excluding Pools from the definition of covered entity because they may also be deemed governmental instrumentalities is inconsistent with the rationale for their Code § 115 tax exemption, as expressed in Rev. Ruling 90-74, which states in pertinent part that:

Political subdivisions insure against casualty risks and other risks arising from employee negligence,

workers' compensation statutes, and employee health obligations. Insuring against these risks satisfies governmental obligations. Any private benefit to employees from insuring against these various risks is incidental to the public benefit.

* * *

[T]he income of an organization formed, operated, and funded by one or more political subdivisions (or by a state or one or more political subdivisions) to pool their risks in lieu of purchasing insurance to cover their public liability, workers' compensation, or employees' health obligations is also excluded under section 115(1) if private interests do not, except for incidental benefits to employees of the participating states or political subdivisions, participate in or benefit from the organization.

(Emphasis added). See Rev. Rul. 90-74, 1990-2 C.B. 34. Based on this published ruling, the Service has issued numerous section 115 private letter rulings to state or municipal health insurance funds for active and/or retiree health benefits.

Thus, as governmental instrumentalities or agencies that perform an essential government function, Pools should not be treated any differently under ACA § 9010 than the governmental entities that use them to provide health benefits to the governmental entities' employees. Pools are funded solely by local taxpayers and governed by public officials on a tax-exempt, non-profit basis. Like the governmental entities that use them, Pools should not be subject to the health insurer fee. We therefore respectfully request that the final rule expressly include this type of governmental "instrumentalities" in the definition of governmental entity.

We note that this approach would be consistent with the definition of government entity in the Code § 4980H employer shared responsibility proposed rule, which defines government entity as expressly including any "agency or instrumentality" of "a state or political subdivision thereof." See 78 Fed. Reg. 241. We see no reason why the health insurer fee should depart from the commonly used definition of government entity.

2. Self-Insured Employer Exclusion

We strongly support Treasury expressly including Pools in the definition of governmental entity excluded from the health insurer fee. Alternatively, Treasury should expressly include governmental entities that use Pools, and the Pools themselves, in the definition of self-insured employer.

Section 9010 and the Proposed Rule provide that the term "covered entity" does not include any employer to the extent that the employer self-insures its employees' health risks. ACA § 9010(c)(2)(A); 78 Fed. Reg. at 14042. The Proposed Rule defines self-insured employer as an employer that sponsors a self-insured medical reimbursement plan within the meaning of Treas. Reg. § 1.105-11(b)(1)(i), including plans that do not involve shifting risk to an unrelated third party, as described in Treas. Reg. § 1.105-11(b)(1)(ii). 78 Fed. Reg. at 14042.

The local governments that comprise a governmental risk-sharing Pool jointly fund their employees' health benefits plans on a pooled basis in which they share the risk and do not shift the risk to a licensed health insurer or other unrelated third party. The government participants are inextricably bound to the Pool and each other by the intergovernmental obligations they assume for the establishment and funding of the Pool itself. With ultimate governing authority and financial accountability for each Pool vested in its public entity participants, those Pools are not unrelated third parties (or health insurers).

As explained earlier, the way Pools operate and how they are funded make their participating

governmental employers “self-insured employers” within the meaning of Treas. Reg. § 1.105-11. For that reason, we respectfully request that the final rule clearly provide that governmental employers who self-fund their benefit plans on a pooled basis, and the Pools in which they participate, both fall within the self-insured employer exclusion and thus are not covered entities subject to the health insurance fee.

* * *

We appreciate the opportunity to comment on the Proposed Rule. If you have any questions, please contact Carolyn Coleman, Director, Federal Relations, 202.626.3023, coleman@nlc.org or Erin Rian, NLC-RISC Program Manager, 202.626.3122, erian@nlcmutual.com.

Sincerely,

Clarence E. Anthony

Executive Director

National League of Cities

Washington, DC

FOOTNOTE

1 We note that as governmental entities, Pools are not MEWAs under ERISA § 3(40) and thus, should not be included within the definition of “covered entity” as MEWAs.

More Issuers Contemplate BAB Redemptions.

More issuers are lining up to redeem Build America Bonds early after interest subsidy payments were reduced as a result of across the board spending cuts by Congress.

A review of event notices by The Bond Buyer showed eight issuers have indicated in the last month that they are likely to take advantage of extraordinary redemption provisions to refund BABs, half of them school districts located in Ohio. In May the state’s capital city, Columbus, said it planned to refinance approximately \$368.7 million of BABs issued in 2009 and 2010, making it one of the first issuers to make such a redemption of BABs because of the so-called sequestration cuts.

Issuers Begin Calling BABs Due to Sequestration

In March, \$85 billion of the federal budget cuts went into effect and cut the 35% interest subsidy rate the Treasury Department had promised to pay issuers by 8.7%. In April, issuers began announcing their intent to redeem BABs, cutting off a stream of interest income to investors.

Market analysts have said they expect issuers to continue to examine whether the options to refinance their BABs are economically beneficial and produce a savings.

“There was an enormous variation in the way call language was written in these deals,” said Chris Mier, managing director of analytical services at Loop Capital Markets. “But the ones with the par call language are being called.”

Mier said there has been some investor frustration with these calls. While it is the right of the issuer to decide about the cuts, most “investors feel they got sandbagged by the Treasury Department because of the risk of sequestration or the cut was clearly not properly disclosed by the federal government,” he said. “The federal government acted like this was never going to happen and here it has happened.”

The Board of Education of the Brunswick City School District in Ohio notified bond holders on the Municipal Securities Rulemaking Board’s EMMA system May 29 that they had the option to authorize the provision on \$15.46 million of BABs but had not chosen to do so yet.

The district said it received a notice from the Internal Revenue Service on May 13 about the reduced interest payment on the bonds. The district said that it had already received a reduced payment from the Treasury consistent with the sequestration cut but that it would not affect its ability to pay the interest payment due on June 1.

The BABs were used to renovate and construct school and transportation facilities at eight different schools within the district, according to the official statement. Peck Shaffer & Williams LLP was bond counsel. Stifel Nicolaus was underwriter.

The Austintown Local School District in Youngstown, Ohio adopted the extraordinary redemption provision on May 29 but has not determined whether it will proceed to sell, issue and deliver the refunding bonds to all or any part of the \$12.655 million in BABs. Those bonds were used to pay the local share of school construction under the state of Ohio Classroom Facilities Assistance Program, the official statement said.

RBC Capital Markets was underwriter. Squire, Sanders & Dempsey LLP was bond counsel.

The Keystone Local School District in Lagrange, Ohio also notified bond holders on June 4 about the possibility to refinance \$5.8 million of Series 2010B BABs. On June 3, the Board of Education of the School District adopted a resolution acknowledging the reduced interest subsidy payment and its option to redeem the bonds. The district also has not determined if it will proceed to refinance the bonds. Squire, Sanders & Dempsey LLP was bond counsel. Robert W. Baird & Co. Inc. was underwriter.

The Eaton Community City School District in Preble, Ohio announced its intent to authorize the redemption of \$3.77 million of BABs on May 29 to its bond holders. RBC Capital Markets was underwriter. Peck, Shaffer & Williams LLP was bond counsel.

Separately, the Washington County Housing and Redevelopment Authority in Woodbury, Minnesota announced its intent to refund \$7.7 million of recovery zone economic development bonds issued in 2010.

The city of Manhattan, Kan., said it was contemplating exercising its extraordinary optional right to redeem \$33.14 million of Series 2009-2 BABs.

The Independent School District in South Washington County, Minn., announced to bond holders on June 3 that the extraordinary redemption provision had been triggered on \$4.365 million of qualified zone academy bonds.

And finally, the Rock Island County Metropolitan Mass Transit District announced that the Board of Trustee met on June 18 to consider redemption of \$10.29 million of Series 2010B BABs.

BABs expired at the end of 2010. Almost \$188 billion of BABs were issued since they were created in

2009 as part of the American Recovery and Reinvestment Act.

by: JENNIFER DEPAUL

WSJ: Jefferson County Debt Plan Is Costly.

Escaping the largest U.S. municipal failure could leave Jefferson County, Ala., in an even deeper hole.

The county's plan to emerge from bankruptcy protection hinges in part on the sale of \$1.9 billion of new debt this fall to refinance debt tied to its troubled sewer system. But some observers call terms of the new debt onerous.

Jefferson County, Ala., taxpayers stand to repay nearly \$6.9 billion over the term of a debt deal.

The proposal for the refinancing, which has been approved by a majority of county commissioners, includes a set of bonds that schedule larger debt payments in the later years of the financing. About \$474 million are a type of debt called capital-appreciation bonds. Such bonds have been derided by California's treasurer as "terrible" for their backloaded payments, and Michigan has banned their sale by municipalities.

All told, Jefferson County taxpayers would stand to repay nearly \$6.9 billion over the four-decade term of the financing, more than three times the amount the county initially plans to borrow. That is perhaps billions more than they would pay under a plan whose payments would be more evenly distributed, said a potential investor.

Municipal bonds sold to fund water and sewage projects often cost the issuer no more than two times the initial amount borrowed after about 30 years. At current interest rates, a home buyer with good credit can expect to pay less than double the cost of a home over the life of a 30-year mortgage.

But, more-traditional financing for Jefferson County's sewer system "would have required higher initial sewer rate increases," said Jefferson County Commission President David Carrington. "Our rates need to be reasonable."

Jefferson County plans to pay for the new debt with sewer revenues, which will come from rate increases for its sewer-system customers. Sewer bills are expected to increase about 7% annually for the first four years under the deal, according to the county's agreement with debtholders.

Some observers wonder if the county will be able to meet the obligations stacked up in later years. "It's future taxpayers that bear the risk of the higher payments down the road," said Richard Ciccarone of McDonnell Investment Management, whose firm purchases municipal bonds and oversees an \$8 billion portfolio of them.

The new debt is needed to complete an agreement signed this spring between Jefferson County officials and investors holding \$3.1 billion of debt linked to the sewage-system upgrade. The deal, which helps the Alabama county put behind it the largest municipal bankruptcy in terms of debt outstanding in U.S. history, came after hedge funds and other creditors forgave \$1.2 billion of sewer debt. The new bonds would refinance much of the remaining debt. The county filed for Chapter 9 bankruptcy protection in November 2011.

The county's proposal to sell the debt could be formally approved by a judge as early as November. If the plan is allowed to proceed, the debt is likely to be sold to investors as early as then. In addition to the capital-appreciation debt, the \$1.9 billion package includes \$1.42 billion of bonds that pay interest periodically, according to county documents. Jefferson County has the option to buy back some of the bonds after 10 years.

With capital-appreciation bonds, buyers agree to forgo regular interest payments in favor of receiving accreted payments near the end of the bond's maturity. The bonds were designed to help rapidly growing areas in states such as Texas and Florida where school districts need to borrow money fast to expand their campuses, but they want to make sure future residents share in the cost burden.

Because the bonds push payments to future taxpayers, California Treasurer Bill Lockyer called capital-appreciation bonds "terrible deals" that are the "equivalent of payday loans." He proposed a statewide moratorium this year. Some California school districts using capital-appreciation bonds will repay 10 times or more than the original amount they borrowed, the treasurer said.

The Jefferson County proposed repayment ratio is higher than a typical muni sewer bond. The Detroit water and sewer department sold about \$660 million in debt last year but will only pay about two times that amount back to bondholders over the 26-year life of its debt, Mr. Ciccarone said. That ratio was similar for some 30-year debt sold by the Birmingham, Ala., waterworks board earlier this year.

Robert Brooks, a finance professor at University of Alabama, said he found Jefferson County's proposed refinancing deal troubling because the projected sewer revenue growth rate it assumes to pay for the bonds—which for many years is at least 3%—seems ambitious, because the sewer system has only had declining revenue in recent years.

"Those numbers certainly couldn't be based on history," he said. "Three percent seems unreasonably high."

By KELLY NOLAN and KATY STECH

[NYT: In Embattled Detroit, No Talk of Sharing Pain; A bankruptcy in Detroit would have no precedent, despite an unusual flurry of municipal bankruptcies after the financial crisis.](#)

When New York City threatened to declare bankruptcy in 1975, the idea so terrified everyone that it forced the city, its workers and its recalcitrant bankers to sit down and find ways to share the pain.

Now another large city, Detroit, appears to be on the brink of filing for bankruptcy, but there is little talk of sharing the pain. Instead, the fiscal crisis in Michigan is setting up as a gigantic clash between bondholders and city retiree.

The city's proposals, which could give some bondholders as little as 10 cents on the dollar, are making some creditors think they would be better off in bankruptcy. They see the specter of a federal judge imposing involuntary losses as less ominous than it was for New York.

"The haircut is so severe," said Matt Fabian, a managing director of Municipal Market Advisors, "I think it's scaring them into bankruptcy, rather than away from bankruptcy."

But city retirees, facing the prospect of sharply reduced benefits whether in bankruptcy or under Detroit's restructuring proposal, think they stand squarely on the moral high ground because despite the poverty of many current and retired members, they have already offered big concessions.

"It's not the employees that are costing the city money," said Edward L. McNeil, an official with the American Federation of State, County and Municipal Employees who is leading a coalition of 33 unions that will be affected by any restructuring of Detroit's debts, which total roughly \$17 billion. Just last year, he said, those unions offered concessions that could have saved the city hundreds of millions of dollars a year. But Detroit "botched the implementation," he said.

And Michael VanOverbeke, interim general counsel for the general workers' retirement plan, said bondholders were investors hoping for returns, who should expect "a certain amount of risk."

"Planning for retirement and working for employers was not an investment into the market," he added. "These are people who are on a fixed income at this point in their life. They can't go back to work and start all over again." He said it was unthinkable to cut retirees' pensions outside of bankruptcy.

A bankruptcy in Detroit would have no precedent, despite an unusual flurry of municipal bankruptcies after the financial crisis. Rhode Island hurriedly passed a law giving municipal bondholders priority over other creditors, including retirees, just before the small city of Central Falls filed for bankruptcy. That helped Central Falls resolve its bankruptcy quickly, but no one thinks Michigan could pass such a law. In Jefferson County, Ala., a large majority of the financial trouble grew out of debt issued to rebuild a sewer system, not pensions or other employee benefits. The rights of public workers and bondholders are in conflict in the bankruptcy of Stockton, Calif., but that case is not yet far enough along to be of any guidance to Detroit.

With talks on labor issues scheduled for Thursday, municipal bond market participants say one of their main concerns is that the city's proposal would flatten the traditional hierarchy of creditors, putting say, a retired librarian on par with an investor holding a general obligation bond. That does not square with the laws and conventions of the municipal bond market, where for decades small investors have been told that such bonds are among the safest investments and that for "general obligation" bonds cities could even be compelled to raise taxes, if that's what it took to make good. The "full faith and credit" pledge was supposed to make such bonds stronger than the other main type of muni — revenue bonds, which promised to pay investors out of project revenue.

Public finance experts have warned that broad societal problems could follow a loss of faith in municipalities' commitments to honor their pledges. In a major report on the state of the muni market last year, the Securities and Exchange Commission warned that communities would find it increasingly costly to raise money, throwing into question the time-honored practices of building and financing public works at the local level.

Detroit's proposal shows how much things have changed since the days when the municipal bond market consisted of two types of debt and little else. The emergency manager, Kevyn D. Orr, issued a complicated list of debts with a wide range of gradations, with general obligation bonds now inferior to revenue bonds.

Mr. Orr classified Detroit's general obligation bonds into two groups — secured and unsecured — with the secured ones backed by outside sources of money, like state aid or federal block grants. The unsecured bonds are those that rely only on Detroit's "full faith and credit" pledge. As a practical matter, much of Detroit's bond debt is insured, so bondholders will feel no immediate pain as the

city moves forward with its planned defaults. But the bond insurers have the right to do battle in the bondholders' place, and other market interests are likely to join them.

Mr. Fabian said bondholders knew perfectly well that Detroit was broke and could not raise taxes and fees enough to cover all its bonds, but were still shocked by the proposed treatment.

"It's not that people just want to get more money out of Detroit," he said. "It's the violence that's being done to the city's capital structure. It creates a new paradigm for investing in Michigan bonds."

In the past, he said, the ratings agencies included the various debt structures in their evaluations of municipal bonds. An "unlimited-tax general obligation bond," for instance, might be rated one or two notches higher than a "limited tax" version of the same bond. Investors would look at the rating, know what they were getting and pay more for the safer debt.

"Michigan is saying all that will go out the window," Mr. Fabian said. "In effect, they're saying that structure only matters when you don't need it" — when everything is normal and the debt is being repaid.

"And when you need to rely on those legal differences, then they don't matter," he added. "It's distressing."

Municipal market participants are also rattled by a big, sudden increase in Mr. Orr's measurement of Detroit's pension shortfall, which he is also classifying as unsecured, leaving workers and bondholders to compete for whatever pool of money is left over. As of June 30, 2011, the city's most recent actuarial snapshot showed that its two big pension funds were in pretty good shape — short by just \$644 million, because the city had issued securities called "certificates of participation" in 2005 and 2006, and put the proceeds into the pension funds.

But Mr. Orr's report said that estimated shortfall had been "substantially understated" through aggressive assumptions and other distortions. After correcting those, the two funds' shortfall was closer to \$3.5 billion.

And as for those certificates of participation, issued to produce money for pensions, they turn out to be among Detroit's shakiest debts. The city already skipped a payment due last Friday, and Mr. Orr said the city had found "certain issues related to the validity and/or enforceability" of the debt. His report did not specify what the issues were, but said further investigation might be warranted.

The report said that to some extent, the trustees who sit on Detroit's pension boards had worsened the pension trouble by promising workers "ad hoc sweeteners" and diverting investment income to other uses. As state-appointed emergency manager, Mr. Orr has authority to remove pension trustees.

But Mr. VanOverbeke said the trustees were not going anywhere. In fact, they have already set aside \$5 million for a legal challenge in case Mr. Orr puts them "in a position that they would not have the resources necessary" to protect the pensioners, Mr. VanOverbeke said.

"It wasn't put aside to do battle," he said. "They were set aside so that as fiduciaries they can make the appropriate decisions and take the necessary actions as it is deemed appropriate."

Study Claims Billions of Dollars of Excessive Muni Markups.

Broker-dealers charged billions of dollars in excessive markups and markdowns on municipal bond trades from 2005 to 2013, according to a study by the Fairfax, Va.-based Securities Litigation and Consulting Group, Inc.

The SLCG, which provides consulting services and expert witnesses to law firms, companies, banks, brokerage firms, and individuals involved in class-action suits and other litigation, used the Municipal Securities Rulemaking Board definitions of markups and markdowns for its study. The MSRB defines markups as the difference between the prices charged to the customer and the prevailing market price. Markdowns are the difference between prices paid the customer and the prevailing market price.

Using the MSRB's EMMA website, SLCG researchers Geng Deng and Craig McCann sampled 13.7 million dealer trades with customers with a par amount of \$3.9 trillion — about 30% of the fixed coupon muni bond trades during more than six-years — and found that 21% of those trades included markups that either were more than twice the median markup for similar trades or were more than 0.5% larger than the markup charged on recent trades of the same bond.

"We estimate that investors were charged \$10.65 billion in municipal bond markups between 2005 and 2013 in our sample — \$6.45 billion in trades on which excessive markups appear to have been charged," the study states. "We have determined that between \$1.84 billion and \$6.45 billion of excessive markups and markdowns have been charged since 2005 on our subset of publicly municipal bond trades."

Extrapolating the data in their sample to cover the entire \$3.7 trillion municipal securities market, the authors estimate that dealers charged \$20 billion of markups from 2005-2013, about \$10 billion of which were excessive.

The study provides some examples, including a recent deal involving debt issued by the City of Commerce, Calif. On Jan. 17, 2013 a customer bought \$1.45 million of bonds for \$101.36 that had just been sold four minutes earlier for \$99.00," the study states. Compared to the average inter-dealer trade price that day of \$99.22, the investor paid a \$30,909 markup — almost 30 times the median.

Broker-dealers have wide discretion to charge the markups when they sell the bonds to investors. But the study argues this results in a transfer of taxpayer wealth to the brokerage community that could be eliminated by routinely disclosing markups.

The MSRB and the Financial Industry Regulatory Authority have written rules designed to prevent excessive markups and FINRA has levied fines when firms have flagrantly broken the regulations.

MSRB Rule G-17 on fair-dealing states brokerage firms must deal fairly with all parties in a transaction. Rule G-30 on prices and commissions prohibits either selling or purchasing securities at rates that are not "fair and reasonable."

FINRA also has very similar rules.

In April 2012, FINRA found that David Lerner Associates, Inc. charged excessive markups on sales of municipal bond sales and mortgage obligations. In 2011, FINRA and Morgan Stanley entered into a settlement under which the firm paid a \$1.0 million fine and \$371,000 in restitution for excessive

markups and markdowns on both corporate and municipal bonds after violating FINRA rules 2110 and 2440, as well as G-17 and G-30.

McCann said he and Deng had been considering a study of municipal bond markups over the past two or three years and that there was plenty of academic literature out there but none that put their findings into really concrete terms.

“Something that was missing was an estimation of how big the markups were,” he said.

The study concludes that if dealers’ markups were accessible to the market, the markups would soon drop to much lower rates.

“Sunshine would eliminate much of the municipal bond markup abuses we have identified,” the report states. “Dealers are already required to determine that the prices and markups charged are fair. This can only be done by reference to prevailing market values, typically grounded in the dealer’s contemporaneous cost. Prevailing market values and markups are already estimated by dealers every time they execute a trade. If dealers disclosed to investors what markup was being charged, the markups charged on municipal bonds would quickly drop to markups found on other securities. This sunshine would benefit both taxpayers and investors.”

Commenting on the report, Bond Dealers of America said: “The BDA is supportive of increased transparency in the market, especially through enhancements being considered by the MSRB to their EMMA system, which will only serve to better educate the investing public. However, it is necessary to point out that without taking a closer look at individual transactions, general statements in the aggregate indicating that investors are being taken advantage of can be misleading and damaging to the market as a whole and furthermore, there is no clear consensus that the retail investor is getting anything but fair and reasonable prices in the fixed income market.”

The BDA added that spreads exist in distressed bonds and that supply and demand move bond prices. The study examples include some distressed bonds.

Michael Decker, co-head of municipal securities at the Securities Industry and Financial Markets Association, also critiqued the study.

“I think it’s flawed in several ways,” Decker said.

The methodology the authors used to cull markup figures from EMMA is unclear, said Decker. Additionally the study appears to make no distinction between trades of bonds in traditional brokerage accounts vs. those in fee-based accounts, where markups will naturally be higher. Decker added that in the muni market, where securities are infrequently traded, the price a dealer sells a security at may have no bearing on the cost the firm paid for it weeks or more earlier. Lastly, he said, markups are one aspect of pricing regulated by the MSRB rules, but the MSRB does not regulate markups alone.

by: KYLE GLAZIER

[Detroit Restructuring Plan Includes Bond Default.](#)

CHICAGO – Detroit’s announcement Friday that it will default on some of its bonds, including a \$39.7 million pension certificate payment due Friday, could have major repercussions for the

municipal market, analysts and bond attorneys said.

The moratorium means the city, at least in the early stages of negotiations with its debtors, intends to put some of its so-called unsecured general obligation bonds on par with its lowest-secured debt, a treatment that one market participant called “an amazing step.” Unsecured GOs, in the city’s view, are those with only a full faith and credit general fund pledge and not a specific lien on a revenue source such as state aid.

News of the pending default triggered a fresh round of downgrades from Standard & Poor’s and Fitch Ratings.

Detroit emergency manager Kevyn Orr unveiled a 134-page restructuring proposal Friday as part of a first round of negotiations with creditors that will start Monday and last through July 12. The negotiations follow a warning from Orr that the fiscally distressed city faces a 50-50 chance of pursuing bankruptcy.

The report says the city will stop making payments on what it calls its unsecured debt, which includes \$530 million of GOs. That includes default on a \$39.7 million June 15 payment to holders of the city’s \$1.4 billion of pension certificates, widely considered among the city’s least-secured obligations.

It’s not clear yet whether the city will default on its next GO payment.

“If we are able to restructure and get a deal in place, then we start paying on the new regime,” Orr told local reporters after the creditor meeting. “We can’t continue paying with the debt service we have going forward.”

Orr is proposing issuing \$2 billion of notes to pay off holders of \$11.4 billion of unsecured debt on a pro-rata basis — a move that would generate less than a dime on the dollar for investors.

Nearly all of Detroit’s bonds are insured, so bondholders will likely continue to get paid regardless of the city’s defaults. “In the event that debt service payments by the city of Detroit are interrupted, National will ensure that its policyholders receive all of their principal and interest payments on time and in full,” said Kevin Brown, spokesman for National Public Finance Guarantee Corp., which wraps nearly \$2.5 billion of Detroit bonds.

The city’s secured bonds, which total about \$7.1 billion, would likely fare better under the plan. Treatment of that debt is “subject to negotiation with holders,” the report said. The city is considering floating new bonds to pay off current investors with changed payment terms aimed at generating debt service relief for the city, according to the report.

The report also featured a dramatic increase in the city’s estimated unfunded liability in the city’s two pension funds, which had been considered one of Detroit’s healthiest assets. The new figure puts the unfunded liability at \$3.5 billion, up from \$600 million. The increased liability could allow Orr to remove current fund trustees.

The city’s unsecured bonds total about \$2.5 billion, including \$1.4 billion of pension certificates, \$161 million of limited-tax GOs and \$369.1 million of unlimited-tax GOs backed only by a full faith and credit pledge.

Unsecured debt in general totals \$11.4 billion. That includes \$5.7 billion of other post-employment benefit liabilities, and \$3.5 billion of unfunded pension liabilities.

The notion that Detroit may treat holders of some of its GO bonds the same as its OPEB liability could rattle the muni market, some said.

"It's a very different way to think about debt," said Matt Fabian, managing director of Municipal Market Advisors.

"Detroit is attempting to dissolve its capital structure and put its GO bonds on par with its pension certificates and the OPEBs," he said. "It's an amazing step.

"It implies that the state sees no distinction in parity between GOs for any city or their OPEBs or their lowest parity pledge," he said, noting that Orr is a representative of the state. "From this perspective, buying a GO bond from an issuer is similar to having a simple contractual obligation, and losing all sense of incremental security from the GO."

The proposed treatment will only emphasize a growing realization in the muni market that not all GO bonds are created equal. "It seems safe to say that municipal investors will buy bonds with their eyes wide open and know what the security features are," Michael Ross, managing director at Raymond James, said in an email.

Bankruptcy attorney James Spiotto at Chapman and Cutler LLP said it's too early to predict the ultimate treatment of the city's various obligations. A Chapter 9 bankruptcy court could view the obligations the same way Orr has, putting the general fund GOs backed only by Detroit's full faith and credit pledge on par with its OPEBs, Spiotto said.

"There's a possibility of that, and that's the concern you're hearing," Spiotto said. "The market anticipates that your full faith and credit pledge means more.

"The question is how will the market digest that and what will be the adjustment," he said. "Will it be viewed as an aberration, or will the market need more assurances for payments on GOs such that they have additional backup?"

The city's secured bonds include \$379 million of GOs, both unlimited and limited-tax, and \$878 million of payments due through 2035 on the city's interest-rate swaps hedging the unsecured pension COPs.

Another \$5.9 billion of water and sewer revenue bonds are also treated as secured debt. Orr said Friday he would likely lease the departments to a new regional authority that would then sell new bonds to pay off current investors.

Orr also wants to lease the city's the parking system, the popular Belle Isle park, and possibly the Joe Louis Arena. The lighting department was recently transferred to a new bond-issuing authority.

In a statement, Gov. Rick Snyder, who appointed Orr, a former Jones Day bankruptcy attorney, to the post in late March, said there are "no easy answers."

"The plan Kevyn discussed with creditors today requires shared sacrifice among all involved, but most importantly focuses on a restructuring designed to return Detroit to solid financial footing," he added.

by: CAITLIN DEVITT

Detroit Default Shines a Light on Bond Insurers.

CHICAGO – Detroit's threat to default on up to \$2 billion of bond debt will shine a light on a beleaguered sector of the municipal market — monoline bond insurers that wrap nearly all the city's bonds.

"This is an important opportunity for bond insurance companies to prove their worth and validate the importance of their industry," Richard Ciccarone, chief research officer at McDonnell Investment Management LLC. "It's a real opportunity for the stronger insurance companies."

Three of the six insurers who wrap the city's debt pledged to cover missed payments after Detroit emergency manager Kevyn Orr announced Friday a moratorium on some debt payments.

The fiscal condition of the insurers could play a role as negotiations play out over the next month, market participants said.

Financial Guaranty Insurance Corp., for instance, recently worked out a plan with all its clients that has it covering only 30% of its claims up front, with the balance paid off after the claim matures, according to Matt Fabian, managing director, Municipal Market Advisors.

The remaining insurers, however, are expected to make 100% payments on the possible losses.

The collapse in the monoline bond insurance business since the 2008 financial crisis left Assured Guaranty Ltd. as the only active insurer until the recent launch of Build America Mutual. Moody's Investors Service in January downgraded Assured to A2 from Aa3, but noted that its capital adequacy remained strong.

National Public Finance Guarantee, after winning key ratings upgrades in May, has also signaled an intention to return to writing new business.

"Many of the bonds are insured, and that makes it easier for the bondholders," Ciccarone said. "It also makes a case for a comeback for those insurance companies that can stick around in distressed situations that they can cover it on your behalf."

Orr announced Friday that the city will stop making payments on debt that does not have a lien on a specific revenue pledge, a total of \$11.4 billion. That includes more than \$9 billion of employee retirement obligations, as well as general obligation bonds not secured by a specific revenue source.

The defaults began Friday when the city withheld a \$39.7 million debt service payment due on \$1.4 billion of pension certificates.

The certificates, like nearly all of Detroit's bonds issued before 2010, carry insurance by one of the six insurers. FGIC and Syncora Guaranty Inc. insure the pension COPs.

Syncora said Monday it had received claims notices on the pension certificates that it insures, which include Series 2005A and 2006B.

"The company will pay such claims as, when, and in the amounts due, under and in accordance with the terms of its insurance policies," the firm said in the release. "The company continues to assess the situation in Detroit, Michigan."

A spokesman for Syncora declined to provide more details, saying the firm does not comment on

individual credits.

FGIC did not return phone calls by press time.

The pension COPs have generally been considered among the city's least-secured debt, backed only by a contractual pledge to pay. In the event of a default, the insurers or bondholders have the same recourse as pensioners, which is to sue the city, and if they win, to get a judgment lien against the city that forces it to raise taxes to pay off the obligation.

Fabian said the expectation that insurers will cover losses does increase their value, though the amount of distressed credits on their books could pose a problem.

"They're paying on Jefferson County, Detroit, Stockton," Fabian said. "These are all very manageable claims, but when you're talking about influencing investor behavior you have to look at both sides.

"This [Detroit default] proves their value," Fabian said. "But the issue for the insurers has always been in pricing the value. How do you price it?"

He added that with Detroit's debt, there is lots of reinsurance, and so it's difficult to pin down exactly how much each firm insures. "The numbers are blurry," he said.

A spokesman from National Public Finance Guarantee, a subsidiary of MBIA Inc., reiterated the company's pledge to cover bond payments after Orr's announcement.

"In the event that debt service payments by the City of Detroit are interrupted, National will ensure that its policyholders receive all of their principal and interest payments on time and in full," spokesman Kevin Brown said in an email Friday.

National wraps nearly \$2.5 billion of Detroit debt, including \$2.4 billion of revenue bonds — most of them water and sewer — and \$101 million of unlimited-tax GO bonds.

Like National, Assured Guaranty has repeatedly assured bondholders of its pledge to cover payments after the city was taken over by the state in mid-March.

After Friday's announcement, Assured issued a statement to reassure bondholders, while noting that the bulk of the Detroit bonds it covers are secured by special revenues.

"As always, Assured Guaranty is committed to honoring its unconditional and irrevocable guaranty to holders of its insured obligations, a commitment backed by Assured Guaranty's substantial claims-paying resources of \$12 billion," a spokesman said in an email.

Assured insures \$2.2 billion of the city's debt, the bulk of which is water and sewer bonds, and \$355 million of GO bonds. The firm said in an email that the \$1.8 billion of revenue bonds are "secured by a pledge of 'special revenues' and therefore timely payment of debt service should be insulated from any financial difficulties of the city."

Assured also wraps another \$320 million of GO general fund bonds that are not considered secured.

The city has \$963 million of unlimited-tax and limited-tax general obligation bonds. Of that, roughly \$205 million of bonds issued in 2008 are uninsured.

There is additional debt issued in 2010 and 2012 that is also uninsured — the junk-rated city could not buy insurance by that point — though those are backed by a pledge of state aid payments and

are considered secured debt.

The city also has \$5.9 billion of water and sewer bonds, all of which is insured except for \$476 million with a 2041 maturity.

Another roughly \$200 million of revenue bonds, including parking and convention center debt, carries insurance.

Detroit has not yet decided whether it will make its next general obligation bond payment, said Orr spokesman Bill Nowling.

“We have a moratorium on our debt payments,” Nowling said. “We’re going to evaluate those on a payment to payment basis. We let our creditors know [Friday] on the payment that was due that we would not be making it.”

Nowling added the city doesn’t think it’s technically in default because it has a 30-day grace period on all debt service payments.

by: CAITLIN DEVITT

NYT: Portent of Peril for Muni Bondholders.

The bankruptcy of the most populous county in Alabama moved closer to resolution this week with an agreement providing that investors will lose 20 percent of the money they invested in bonds that were rated AAA. The big loser financially is JPMorgan Chase, which underwrote many of the securities — and paid bribes to get the business.

Large municipal bond disasters have been rare, but I suspect there will be more. The Jefferson County bankruptcy may serve as a precedent for forcing bondholders to take losses in bankruptcy. Despite lots of legal protections, loans to municipal governments can be just like loans to people and companies: if the borrower truly can’t afford to pay what was promised, it won’t be paid.

Jefferson County’s problems involve corrupt politicians and bad luck, but they also include a longstanding reluctance to face facts about the county’s sewer system — and a bond market that failed to face the facts about the county and kept lending money long after it was prudent to do so.

The corruption involved was breathtaking. More than 20 people, including politicians, contractors and influence peddlers, have been convicted. JPMorgan escaped criminal charges, but the Securities and Exchange Commission penalized it for paying bribes through local middlemen.

That corruption was important and no doubt raised the financing costs for the county. But the basic financial decisions about the structure of the county’s debt were different only in scale from what many other municipalities did.

The disaster provides an example of how derivative securities can be oversold. Not all risks can be hedged, and certainly not at acceptable costs, but that is something Wall Street salesmen tend to overlook when they make their pitches. When such contracts are written, you can be sure that the Wall Street firm will make sure it will come out O.K., even if that increases the risk that the customer will not.

The county's sewer debt used to be long-term, fixed-rate debt. The county would have been better off if that had not changed. But Wall Street persuaded it, and a lot of other municipalities, that such debt was too costly. The county could save some money by issuing what the salesmen called synthetic fixed-rate debt.

And what is that? The county issued long-term variable-rate debt, where the interest payments would fluctuate based on short-term market rates. Just doing that would have left the county at risk if interest rates surged, so JPMorgan also entered into an interest rate swap. That provided that the county would pay a long-term rate to JPMorgan, which would pay a short-term rate to the county.

The net cost of that was a little lower than the cost of fixed-rate debt would have been.

There was an important catch: the swap payments were not based on what the county actually had to pay. They were based instead on indexes that might, or might not, move in the same way that rates moved on the county's actual debt. It was not really "fixed rate," the title notwithstanding.

Another risk, probably never considered, was that the monoline insurance companies, which routinely guaranteed munis for a fee, would collapse.

Those risks were not necessarily large, and if Jefferson County had not structured 90 percent of its debt that way — rather than the 10 or 20 percent some advisers recommend — they might not have become crucial. But in the credit crisis, a lot happened that had not been expected.

Jefferson County issued two types of variable-rate debt, both of which blew up.

The largest was auction-rate debt. That debt paid rates that were set every week at auctions. The risk to investors was that an auction could fail and they would be stuck with the bonds. If that happened, the county would pay a penalty rate, often twice the London Interbank Offered Rate, known as Libor.

When auctions began to fail, that penalty rate was not enough to attract investors, but it was high enough to raise the financing costs for the county significantly. The interest rate swap did not protect it because it was based on an index, not on the actual cost the county was paying. Suddenly the "fixed rate" went up.

The second type was known as variable rate demand bonds, or V.R.D.O.'s to the cognoscenti. Their rates fluctuated based on an index rate, but the holder had the right to sell them every week. If no one else would buy, there were banks that had promised to buy them.

The catch was that the banks were not in it for the long haul. The V.R.D.O.'s might have 30-year maturities. But if the banks were forced to bail them out and could not find other buyers, the interest rates rose and the debt turned into three-year debt. The banks were protected, but the county was not.

Turning for a moment from finance to the real world, these bonds were financing a sewer system that was managed badly for decades. Wealthier areas found ways to stay out of it. In the late 1990s, the county was forced to take over what a court-appointed receiver later called "municipal systems that had never been properly operated and maintained." But it still could not force some people within its service area to hook up to its system.

Some people used the sewers without paying, and when they were caught, they were not forced to pay what they owed. When a consultant told the county commissioners a decade ago that the county would have to raise rates rapidly, the commissioners simply ignored the report and did not mention

it when they borrowed more money.

And the investors were not paying much attention. They were told they did not need to because the bonds were insured by one of three monoline insurance firms, FGIC, XL Capital Associates and FSA, and therefore had AAA ratings.

The records do not show whether those monoline insurers did any real research before they issued the guarantees. If they did, they did not seem to have noticed how poorly the system was run.

The bonds were backed only by sewer system revenue, but there was a covenant in them in which the Jefferson County commissioners promised to keep rates adequate to meet the system's obligations. For many years, they ignored that promise. In 2009, after the bonds defaulted and it was obvious that rates had to be raised substantially if the county was going to meet its obligations, the commissioners did the opposite. They voted to reduce rates. In 2011, the county went into bankruptcy.

Four people who served on the five-member county commission have since been convicted of taking bribes and sentenced to prison, and a fifth was convicted of obstructing justice by lying about gifts she received from investment bankers. She received probation and testified against her former colleagues.

Under the deal disclosed this week, JPMorgan agrees not to be paid for many of the bonds it holds. Including fines, forgone fees the county owed it and forfeited bonds, this has cost the bank more than \$1.5 billion before taxes. The bank has already taken losses, and a JPMorgan spokesman said the settlement would have no significant financial effect on the bank.

Under the deal, normal investors are to be offered a choice of receiving 80 cents for every dollar of bonds they own, and forfeiting the right to get any more, or 65 cents while retaining the right to receive additional payments from the monoline insurers. Two of them are paying claims now, but the other is not. The investors would probably be better off to take the 80 cents.

There is optimism that those payments can be financed by selling new bonds. Those bonds would almost certainly be rated as junk, but the presumed yields, ranging up to 6.75 percent on some bonds where the interest will not be paid until maturity decades from now, are thought attractive enough to draw in investors. Sewage rates will rise and might have to rise further if market interest rates go up before this can be completed, some months from now. But they will not rise as much as would have been necessary without forcing bondholders to take losses.

There are other municipalities where crises are looming, even without rampant corruption.

Cities and states are legally required to pay pensions to retired workers and to pay bondholders, along with paying for continuing government functions. But if there is not enough money for all of that — and in some cases, where population is shrinking, there almost certainly will not be — don't bet that the judges and politicians will conclude that the retirees and bondholders should face no losses while basic government operations are devastated.

WSJ: Intelligent Investor: What's Eating Munis?

Municipal bonds are beginning to look tempting — but investors who buy munis in haste can unwittingly hand over their first year's worth of income to their broker.

Fortunately, with a few simple steps, you can control that risk and maximize your net return.

Intriguingly, the health of many municipalities is improving even as tax-free bonds offer relatively attractive returns. Yields on the highest-quality, widely traded munis, triple-A-rated, 10-year “general obligation” bonds, have risen by 0.45 percentage point since May 1, according to Daniel Berger, senior market strategist at Municipal Market Data.

While U.S. Treasury yields have risen recently, “muni yields have truly skyrocketed,” says George Friedlander, chief municipal strategist at Citigroup. “We’re approaching the levels where retail investors will start to raise their hands again. The pent-up retail demand is very strong.”

But you must proceed with caution, or you will get fleeced. Unlike on stocks, you don’t pay a commission when you buy a municipal bond. Instead, you pay a “markup”—the difference between your broker’s cost and the price you pay.

Unfortunately, most brokers don’t disclose their markup. According to regulators and industry experts, you are likely to hear something like this instead: “I can get you this bond for a yield of 2.989%. You’d have to earn 4.83% on a taxable bond to equal that.”

Because they focus too much on yield and not enough on price, “most retail investors have no idea how much they’re getting charged on these trades,” says Edward Reinoso, chief executive of Castleton Partners, an asset manager in New York specializing in municipal bonds.

Markups can be monstrous. Securities Litigation and Consulting Group, a research firm in Fairfax, Va., recently analyzed nearly 14 million trades of long-term, fixed-rate munis over a period between 2005 and April of this year.

The SLCG study shows that on one out of 20 trades, people who bought \$250,000 or less in municipal bonds paid a markup of at least 3.04%—or approximately a full year’s worth of interest income at today’s rates. By comparison, you will pay less than \$10 in commission to buy a stock at most online brokers, or 0.004% on a \$250,000 purchase; a typical mutual fund charges management fees of about 1% a year.

Craig McCann, founder of SLCG, estimates that investors paid at least \$10 billion in what he considers excessive markups—at least twice the normal cost to trade a given bond—since 2005. “That’s more than a billion dollars a year needlessly transferred from investors to dealers’ pockets,” he says.

To be sure, of the approximately 1.2 million issues outstanding, only about 14,000 trade at all on any given day, according to the Municipal Securities Rulemaking Board, a regulatory body that oversees the muni market.

Brokers rightly point out that it can be difficult and costly to find any particular bond on a given day. Federal rules require that markups be “fair and reasonable” but don’t define those terms exactly.

Still, there is no reason why you should pay a much higher markup than someone else recently did for a similar-size trade in the same security.

The MSRB maintains a website, Electronic Municipal Market Access, or Emma, that shines some much-needed sunlight into this shadowy world.

Around 11:17 a.m. this past Tuesday, emma.msrb.org shows, a customer sold \$100,000 in bonds issued by New York’s Triborough Bridge and Tunnel Authority; the customer received a price of

\$105.26. Around 3:15 p.m., the dealer that bought those bonds resold them for \$108.26 — a spread of \$3, or 2.8%, over the previous price. On Feb. 27, a customer sold \$25,000 worth of the same bonds at \$109.769 to a dealer who flipped them the next day for \$113.213 — a fat markup of 3.1%. (Emma doesn't identify any trader by name.)

"[Brokers] respond if they know you're looking over their shoulder," says Ernesto Lanza, the deputy executive director of the MSRB. "If you're buying a bond, look at all the 'customer bought' trades to see what other customers paid. Then say to your dealer, 'Try to match this.'"

That is what Phil Potter, an electrical engineer who lives in the Los Angeles area, does. "Just because the yield sounds good doesn't mean you aren't overpaying," he says.

Using the Cusip, a nine-character mix of numbers and letters unique to each bond, Mr. Potter searches on Emma for the last few trades. If Charles Schwab, the broker where he buys munis, quotes a markup of more than 1.5% over those levels, Mr. Potter calls Schwab's bond desk and tries to negotiate.

If the firm won't budge, Mr. Potter walks away. But, he says, about 20% of the time he does get a better price.

"We always endeavor to show the best price to our clients," responds Patrick Luby, a managing director in Schwab's fixed-income department, "and in some cases, when clients ask, we're able to improve the price even further."

Then, and only then, will Mr. Potter buy. You should do the same.

WSJ: How to Buy Muni Bonds.

Last weekend's Intelligent Investor column, on the often prohibitive costs of buying municipal bonds, set off a thundershower of comments and emails. We can reduce them to a few key questions:

1. Can I avoid the potentially high cost of trading individual munis by buying a mutual fund?
2. Why buy individual munis at all if you can buy a fund instead?
3. Is it more expensive to sell than to buy an individual muni?
4. Why not buy closed-end muni funds (which often trade at discounted prices) instead of individual munis?

Let's answer each of these in turn.

1. Yes, to a point. A large, well-run mutual fund will generally incur lower trading costs than an individual buying some of the same bonds. The fund can buy wholesale while individuals have to buy retail, which typically is more expensive.

Recent research by Securities Litigation & Consulting Group, a financial-research firm in Fairfax, Va., shows that small lots of munis (batches of \$250,000 or less) can be 18 times more expensive to trade than large lots of \$1 million. But even the biggest funds with the most astute managers still have to pay trading costs.

While you can minimize your trading costs by buying a no-load mutual fund or commission-free exchange-traded fund, you can't eliminate them. They will come out of the fund's return in small increments whenever it buys or sells a bond.

2. The question of whether you should buy a fund or individual munis is complex. You can make a plausible argument either way.

"Bonds better than funds": If you hold an individual muni to maturity, you needn't have any fears of losing any principal if interest rates rise. (We're assuming the issuer doesn't default, and we're leaving inflation aside.) In a fund, however, rising rates will take an immediate bite out of your net asset value. While it can be expensive to buy or sell municipal bonds one by one, they don't charge annual management fees; mutual funds do. The average muni-bond mutual fund, according to Morningstar, charges 0.96% in annual expenses. Even if you pay a fat 3% "markup" or trading cost to buy an individual muni, you'll break even relative to a mutual fund if you hold the bond for at least three years. Hold the bond for 10 years or more, and it will be much cheaper than the average bond fund. Buy a new-issue bond in its initial offering and you shouldn't pay any trading costs at all, say market participants.

"Funds better than bonds": If you assume that you need a minimum of 10 bonds for basic diversification and at least \$100,000 per bond to get trading costs down, it can take \$1 million to build a feasible portfolio of individual munis – although many investors, including Phil Potter, whom I profiled in the column, have done it for less. For people who aren't comfortable plunking several hundred thousand dollars at once into a few bonds, a fund might be preferable – even if it ends up costing more. A fund also offers wider diversification than you will likely get in a roll-your-own portfolio. Another factor: Even though rising rates will take a chunk out of your principal at a mutual fund, the fund can reinvest the incoming interest payments at higher yields as rates go up – reducing what bond managers call "reinvestment risk." Small investors can't always reinvest their interest coupons at the latest, best rate.

3. Overall, trading costs tend to be somewhat lower for sellers than for buyers of munis, according to the SLCG report and other analysis. For small trades, however, is much more expensive than buying. That's why you shouldn't buy individual munis at all if you don't plan to hold until maturity (or an early redemption or "call").

Richard Green, a finance professor at Carnegie Mellon University, recommends asking your broker to tell you the "interdealer price," or the latest level at which the bond traded in the wholesale market among brokerage firms. Then ask what markup you will have to pay above that. As your broker tells you, check what he says against the latest price reported on Emma, the pricing website maintained by the Municipal Securities Rulemaking Board. If the price is more than 1% to 1.5% above the latest Emma price, don't buy.

"It's like walking into the car dealership with the invoice price in your hand," says Green.

4. The many people who suggested buying closed-end funds instead of individual munis were, in my opinion, too blasé about the risks of closed-ends. (One reader commented, "The ONLY way to buy Munis is thru Muni Open or Closed End Funds...")

Closed-ends are the Pushmi-Pullyus of the fund world. Their shares trade throughout the day like a stock, while the funds generally publish the value of their portfolios only once a week. Because their share price is set by supply and demand, closed-ends can often trade for more than the net asset value, or NAV, of their portfolios (a "premium" price); the shares can also trade for less than the NAV (a "discount").

Many investors are attracted to closed-end funds by the discount – after all, it isn't every day you can get something for provably less than it is worth. According to Morningstar, the 203 municipal closed-ends that it tracks trade at an average discount of 4% – meaning you have to pay only \$96 for every \$100 worth of munis that you buy.

But closed-ends have liabilities, too – literally.

All but 15 of the muni closed-ends on the market are “leveraged,” meaning they engage in the risky strategy of borrowing money to juice returns. That has paid off over the past decades of declining interest rates but could – make that will – backfire once rates rise. And the average muni closed-end charges a bloated 1.16% in annual expenses, with fully two dozen of them charging an extravagant 1.5% or more. Finally, more than 20 of these funds trade at premiums, not discounts – meaning that you pay more than \$100 to buy \$100 worth of bonds.

Bear in mind, then, that if you buy a closed-end muni-bond fund and interest rates spike upward, you are likely to be hit by a double whammy: The value of the underlying portfolio will fall, and the share price is likely to plunge (meaning that the discount will get deeper, and you might have to sell for much less than the assets are worth).

Until discounts get a lot wider, closed-end funds aren't exactly a cheap back door into the muni market.

WSJ: Illinois Dinged by Downgrade.

Illinois paid a premium to sell \$600 million of sales-tax backed municipal bonds Tuesday, days after the state's general credit rating was downgraded by two rating companies.

Illinois sold a 10-year bond at a yield of 2.94%, 0.75 percentage point more than triple-A-rated debt on a benchmark scale kept by Thomson Reuters Municipal Market Data, as of Monday's close.

The so-called Build Illinois bond sale received a top triple-A rating from Standard & Poor's, and the second highest investment-grade rating of double-A-plus from Fitch Ratings. Market participants said the state paid a premium on the sales-tax bonds because of its fiscal troubles.

Legislators in Illinois again failed to pass pension overhaul recently. Last week, both Fitch Ratings and Moody's Investors Service cut the state's rating on its general-obligation bonds down a notch because of the state's inaction.

“The Illinois label is radioactive for some investors,” said Brian Battle, director of trading at Performance Trust Capital Partners in Chicago.

But Mr. Battle said the protections on Tuesday's sales-tax bond are fairly strong.

The sales-tax revenue that repays the debt is kept in an account separate from the state's treasury. The amount of sales taxes available to repay the bonds exceeds debt payments by around 20 times.

Illinois' sales-tax bond sale comes against a tough bond-market backdrop. Muni prices slid again Tuesday, mirroring selling in Treasuries.

Meanwhile, investors yanked \$1.5 billion out of muni mutual funds and exchange-traded funds last

week, the largest outflow since mid-December 2012, according to Lipper FMI. Flows in and out of muni mutual funds are viewed as a proxy of demand.

Over the past two weeks, the yield on a benchmark 10-year muni has increased from 1.99% to 2.26%, as of Tuesday's close, according to MMD. Prices and yields move inversely.

Justin Land, senior vice president and portfolio manager at Wasmer, Schroeder & Co. in Naples, Fla., said the state will face a bigger test in about two weeks, when it sells a \$1.25 billion general obligation deal.

The success of that sale may hinge on whether or not legislators are able to get anything accomplished on the pension in a special session Gov. Pat Quinn has called for next week.

"People are not very optimistic," Mr. Land said of the special session. "I will be very curious to see how it goes," he said of the state's next bond sale.

Mr. Land said Wasmer Schroeder, which oversees about \$4.7 billion in fixed-income assets, didn't buy Illinois sales-tax bonds Tuesday.

Proceeds of the sales-tax bond deal will refinance older debt with higher interest rates.

John Sinsheimer, director of capital markets for Illinois, wasn't available for comment.

By KELLY NOLAN

[WSJ: The Fed's Eminent Mistake - A Plan to Seize Private Mortgages, Courtesy of the Private Beneficiaries.](#)

The Federal Reserve has spent trillions of dollars trying to revive U.S. housing prices, and at long last a recovery is underway. So it's more than a little surprising that amid this progress the New York Fed would suddenly lend its intellectual imprimatur to a dubious proposal for government to use eminent domain to seize underwater mortgages.

Yet there it was Monday on the New York Fed website: "Paying Paul and Robbing No One: An Eminent Domain Solution for Underwater Mortgage Debt," a research paper by Cornell law professor Robert Hockett. The title is certainly arresting since it promises an economics free lunch.

Mr. Hockett notes with alarm in the paper that home prices "still linger close to 30 percent below peak levels," and he avers that government must act to keep pushing prices back up. His solution?

He wants politicians to identify mortgages worth more than the homes, seize them via the power of eminent domain out of private trusts, refinance them with government help, repackage them into new securities, and sell those securities to new investors. He muses that the money to buy the mortgages could come from the feds (read: taxpayers) or "private investors" or both.

This might please underwater borrowers who would immediately pay less for their loan, and the politicians would take credit for the windfall. But the not-so-free lunch would be financed by the original mortgage investors, who would suffer losses without recourse. There's also the little issue of higher interest rates for future borrowers as lenders price in this new political uncertainty into mortgage contracts.

Eminent domain is supposed to be used for public purposes, with adequate compensation to the private parties whose assets are seized. But in this case government would seize private assets—with uncertain compensation—for someone else's private gain.

We couldn't help but notice that Mr. Hockett's idea closely resembles the eminent-domain pitch made by Mortgage Resolution Partners, a private investment firm out of San Francisco. MRP could be a big winner in such a scheme as the repackager of the seized mortgages into new securities in return for a fee. The firm has pitched the idea to the likes of Chicago and San Bernardino County, without success.

And wouldn't you know, Mr. Hockett turns out to have been on the payroll of none other than Mortgage Resolution Partners. After we made a query, MRP Chairman Steven Gluckstern explained in an email Tuesday that MRP paid Mr. Hockett "a nominal, one-time honorarium" to help the company "with some legal analysis based on his previous published work in related areas."

One problem: The Fed didn't disclose Mr. Hockett's ties to MRP when it posted his research paper. We called the New York Fed on Monday asking about Mr. Hockett and MRP, and only several hours later did the bank get around to disclosing the connection on its website.

New York Fed spokeswoman Andrea Priest emailed us that Mr. Hockett had been an "unpaid visiting scholar" at the bank from 2011 to 2012, adding that the bank has also published work critical of his ideas. She declined to explain on the record who brought Mr. Hockett to the Fed or the reason for the initial failure to disclose his ties to MRP.

For his part, Mr. Hockett explained the oversight to us Tuesday by noting that "I guess because I told everybody about that this past summer, that I had been paid in early 2012." He added that "I've been unassociated with MRP particularly in a pecuniary way ever since then, and of course that's all over the press and television and radio interviews last summer. I suppose it just doesn't occur to me anymore."

Perhaps the Fed was out of this media loop, and in any case our point isn't to play conflict-of-interest gotcha. The real problem is that the Fed would lend its credibility to a scheme for governments to seize private mortgages for someone else's private gain. The central bank used to be known for sensible regulators, not as the venue for every crackpot notion to favor some investors over others.

The Fed has already bent too far to boost housing more than other parts of the economy with its trillion-dollar purchases of mortgage securities. This is credit allocation, but at least those purchases are plausibly related to the central bank's monetary policy mandate.

The Fed goes well beyond that mandate when it starts advertising proposals to urge politicians to seize private mortgage assets. Mr. Hockett's research paper follows New York Fed President William Dudley's 2012 decision to join the lobbying of Fannie Mae regulator Edward DeMarco to allow principal writedowns on Fannie loans. Mr. Dudley was echoing pleas by the Obama Treasury—a highly inappropriate foray into politicized housing regulation by a supposedly independent central banker.

Housing prices are recovering—in some places at a rate that suggests speculation more than economic fundamentals. Mr. Dudley and his fellow Fed Governors ought to be focusing now on how to exit from their extraordinary interventions without further distorting the market or undermining the larger economy. They've already meddled far too much in the housing market.

Goldman Sachs to Test "Social Impact Bonds" with United Way.

Goldman Sachs is making its second foray into an experimental method of financing social services, lending up to \$4.6 million for a childhood education program in Salt Lake City.

This "social impact bond," in which Goldman stands to make money if the program is successful but will lose its investment if it fails, will support a preschool program intended to reduce the need for special education and remedial services. The upshot, in theory, is that taxpayers will not have to bear the upfront cost of the program.

Goldman is being joined in this effort by the Chicago investor J.B. Pritzker, who is providing a subordinate loan of up to \$2.4 million, bringing the total financing to \$7 million. The loans will be announced at an event in Chicago on Thursday.

"Social impact bonds are an entirely new way of financing things that have traditionally been paid for either through philanthropy or by taxpayer dollars," said Alicia Glen, head of Goldman's urban investment group.

Though the effectiveness of this type of financing remains unproved, it has gained a prominent adherent in New York City, which allowed Goldman to invest nearly \$10 million in a jail program last year. The city was the first in the United States to test social impact bonds.

For Goldman, which could gain a public-relations benefit from the investment, Salt Lake City has become an important business center. The city is home to Goldman's second-largest office in the United States, and the Wall Street firm held its annual meeting there in May.

The loans are going to the United Way of Salt Lake, which oversees the Utah High Quality Preschool Program. The investment's success will be measured by the level of cost savings when children do not need to use special education services, which are financed by the state.

The loans carry an interest rate of 5 percent, which is paid along with the principal if the program is successful. In the best case, Goldman and Mr. Pritzker would make additional "success fees."

"We're creating something sustainable that has a focus on returns," Mr. Pritzker said. "This titillates my interest in business and engages me."

This type of financing, which was first used in Britain in 2010, has raised eyebrows. Data on the New York investment, focused on men incarcerated at Rikers Island, is not yet available.

"I think it's distressing the degree to which a new industry has been built around social impact bonds before it's ever been proven viable," said Mark Rosenman, a professor emeritus at Union Institute and University in Cincinnati. "We ought to work it to fruition in a couple places before we start promoting it."

Still, governments around the country are beginning to embrace social impact bonds. Six state and local governments were chosen this week by the Rockefeller Foundation and the Harvard Kennedy School's social impact bond technical assistance lab to receive help in developing such programs after 28 governments applied.

Janis Dubno, a senior policy analyst at the nonprofit Voices for Utah Children, who came up with the idea for the Salt Lake City transaction, said the intention was to shift "resources from remediation to

prevention.”

The deal is “a proof-of-concept transaction,” Ms. Dubno, a former investment banker, said. “What we would like to do is demonstrate that this kind of structure can be put into place.”

BY WILLIAM ALDEN

Reuters: S&P Revises U.S. Credit Outlook to 'Stable' from Negative.

(Reuters) – Standard & Poor’s on Monday removed the near-term threat of another credit rating downgrade for the United States by revising its outlook to stable from negative, citing an improved economic and fiscal outlook.

The change effectively means there is less than a one-third chance of a downgrade in the next two years.

S&P said a key factor to its revision in the U.S. rating outlook was the agreement reached by the U.S. Congress to avoid the ‘fiscal cliff’, which had threatened some \$600 billion in automatic tax increases and spending cuts.

S&P cut the U.S. sovereign credit rating in August 2011 to AA-plus from the highly coveted top grade of AAA, citing political brinkmanship and gridlock in Washington that delayed an otherwise routine raising of the nation’s debt ceiling.

“We did get some movement from both sides and we think that is encouraging, at least to the point of convincing us that the dynamics in Washington are not likely to get substantially worse in the medium term,” Nikola Swann, S&P’s lead sovereign analyst for the United States, said in a webcast with reporters.

Moody’s Investors Service and Fitch Ratings give the U.S. credit their highest rating but both have negative outlooks.

The U.S. Treasury Department, which had argued that S&P’s initial downgrade was misguided, welcomed the latest action. “We’re pleased that they are recognizing the progress in the U.S. economy and fiscal results,” Treasury Under Secretary Mary Miller told reporters.

S&P said it does not expect the debate later in 2013 regarding a raising of the debt ceiling to result in “a sudden unplanned contraction in current spending – which could be disruptive – let alone debt service.”

The current rating already factors in a “lesser” ability of U.S. elected officials to move quickly and effectively to deal with public finance pressures.

S&P estimates the government will need to authorize a further increase in the amount of debt it can issue near the end of the fiscal year in September.

“We think that this (debate) is likely to not be any more dramatic than was the equivalent vote in August of 2011,” said Swann.

The non-partisan Congressional Budget Office announced on May 14 that the U.S. federal budget deficit is shrinking faster than previously thought.

The CBO cut the deficit forecast for the current fiscal year by \$203 billion from estimates made in February of \$642 billion, making it the smallest budget shortfall since 2008.

The deal struck by Congress on New Year's Day 2013 meant much of the threatened tax hikes did not come to fruition.

"The news is better on the tax side," John Chambers, chairman of S&P's sovereign ratings committee, said on the webcast.

Chambers said the boost in tax revenues was due to investors taking profits on investments sooner than they might otherwise have done because of uncertainty over whether tax rates on capital gains might rise if no agreement were to be reached. The tax rates by and large did not rise in the end.

Another factor helping the U.S. fiscal position were the automatic spending cuts, known as sequestration. They were meant to be so severe that Republicans and Democrats would be forced to reach an agreement on a budget to avoid them. They failed, resulting in cuts going into effect on March 1.

"In the meantime we think that policymakers and elected official have a bit more time to get the fiscal house in order," said Chambers.

S&P said it expects the U.S. debt-to-GDP ratio to stabilize around 84 percent over the next three to five years. Economic growth is expected in the 2 to 3 percent range, on average, over the same period.

Financial market reaction to S&P's decision was muted.

Initially, the news led to gains in U.S. stock prices, although they proved short-lived. The U.S. dollar added value against the euro and yen, extending gains already in place from European and Asian trading hours. Prices for U.S. Treasuries fell and in the case of the 30-year bond, the yield hit a 14-month high before receding.

"The strong stock market has created tax revenues, which is certainly positive, and the economy continues a slow but steady growth path, so while we continue to print money, the overall debt numbers have stabilized and I think that's what the S&P is reflecting," said Tim Ghriskey, chief investment officer at Solaris Group in Bedford Hills, New York.

Fitch affirmed its AAA rating in January, effectively stepping back from its threat to downgrade the U.S. credit after a deal was reached to avoid the fiscal cliff.

Moody's has maintained that it is looking for improvement in the ratio of the United States' debt to gross domestic product and setting a downward trajectory on the overall level of debt.

"Few people actually take notice of the rating on the government's debt. The change makes sense, though, since the trajectory of the deficit has improved," said Brian Jacobsen, chief portfolio strategist at Wells Fargo Funds Management in Menomonee Falls, Wisconsin.

"Of course, S&P should not have downgraded the debt to begin with. If the credit rating is supposed to assess the probability of default, it's silly to give the U.S. government anything but a AAA," said Jacobsen.

NYT: A County in Alabama Strikes a Bankruptcy Deal.

Jefferson County, Ala., contains the city of Birmingham, above. The county's \$4.2 billion municipal bankruptcy case is the largest such filing in the country's history.

Jefferson County, Ala., took a big step toward resolving its historic bankruptcy case on Tuesday, saying it had reached an agreement to refinance most of the debt at the heart of its financial breakdown.

The refinancing would save the county hundreds of millions of dollars and position it to emerge from bankruptcy in a matter of months, according to people briefed on the negotiations. But the terms must still be approved by a federal bankruptcy judge, and the county must clear several other hurdles before it can emerge from bankruptcy. Lawyers for the county are scheduled to present details of the agreement in federal bankruptcy court in Birmingham on Wednesday.

The deal, according to the people briefed on the negotiations, covers about \$2.4 billion of Jefferson County's total \$3.078 billion in sewer debt, which was issued to pay for significant repairs needed to bring the county into compliance with federal clean water laws.

The interest due on the sewer debt shot up during the financial turmoil of 2008, and the repayment schedules accelerated sharply, leaving the county unable to pay. The repairs went unfinished as well.

The county also had other debt outstanding when it declared bankruptcy, for a total of \$4.2 billion, making it the biggest municipal bankruptcy in United States history.

Governmental bankruptcies are rare and usually involve small single-purpose authorities and districts, not large, complicated counties with a lot of debt. Experts in public finance have been watching Jefferson County closely to see what kind of legal precedent it will set. Some were concerned that the successful application of Chapter 9 bankruptcy rules to municipal debt could cast a pall over the municipal bond market.

Residents of the county, for their part, have worried that they would bear the brunt of the bankruptcy, through lower property values or higher taxes or rates paid for county services.

The refinancing agreement covers debt held by creditors that include JPMorgan Chase, which holds about \$1.22 billion of the sewer debt, the biggest block; three bond insurers; and seven hedge funds, according to a term sheet circulated in a meeting of the county commission on Tuesday.

The terms call for these creditors to receive about \$1.84 billion for the \$2.4 billion of debt they now hold. The concessions were weighted most heavily toward JPMorgan, the term sheet said, "to increase the recovery of other sewer creditors."

The bank is giving up \$842 million, or about 70 percent, of the face value of its debt, according to people briefed on the negotiations. Just before declaring bankruptcy in 2011, the county abruptly rejected a previous package of concessions that called for JPMorgan to give up about \$750 million.

JPMorgan was widely expected to make big concessions as part of any bankruptcy settlement, because some former officials of the bank were found to have been involved in improprieties in connection with a county debt refinancing in 2002 and 2003. That refinancing involved a complex package of variable-rate bonds and derivatives called interest-rate swaps.

A lawsuit by the county against JPMorgan over the improprieties, still active in state court, would be resolved as part of the proposed agreement. In 2009, JPMorgan agreed to forgive all the termination fees the county owed on the swaps, or about \$647 million, to settle a complaint from the Securities and Exchange Commission. The bank also paid the county \$75 million under the same settlement.

Despite those concessions, residents of Jefferson County have still often complained that they were treated inequitably because several of their elected officials went to prison as a result of the refinancing, while no one from the bank was convicted of a crime. They have railed in particular against the possibility that their sewer rates would go up to allow the county to pay sewer debt that many now see as illegitimate.

On Wednesday, the federal bankruptcy judge, Thomas B. Bennett, is also scheduled to hear arguments in a lawsuit arguing that much of the debt was issued in violation of the state Constitution and should be voided, not restructured or repaid.

In addition, the Bank of New York Mellon, as trustee for small creditors, has asked Judge Bennett for a full independent review of the sewer system's finances, as well as what it has called "poor planning, gross incompetence, waste, graft, corruption or fraud in connection with the construction, repair or rehabilitation" of the sewer system since 1997.

The term sheet indicated that the sewer fees for county residents would indeed rise, by 7.41 percent a year for the first four years of the refinancing deal. After that, they could rise by as much as 3.49 percent a year, depending on variables like inflation and new federal clean-water regulations.

Still, members of the county commission said the new agreement was significantly better than what they could have won without the bankruptcy filing. The five-member commission approved the terms in a 4-to-1 vote.

If the refinancing goes forward, the county's public creditors on the sewer debt will be offered a choice: either 80 cents for every dollar of sewer debt they now hold, if they relinquish all other claims, or 65 cents on the dollar with the right to pursue their own claims, either against the county or its bond insurers.

[NYT: Bankruptcy in Alabama County Offers Warning for Other Municipalities.](#)

The bankruptcy of the most populous county in Alabama moved closer to resolution this week with an agreement providing that investors will lose 20 percent of the money they invested in bonds that were rated AAA. The big loser financially is JPMorgan Chase, which underwrote many of the securities — and paid bribes to get the business.

Large municipal bond disasters have been rare, but I suspect there will be more. The Jefferson County bankruptcy may serve as a precedent for forcing bondholders to take losses in bankruptcy. Despite lots of legal protections, loans to municipal governments can be just like loans to people and companies: if the borrower truly can't afford to pay what was promised, it won't be paid.

Jefferson County's problems involve corrupt politicians and bad luck, but they also include a longstanding unwillingness to face facts about the county's sewer system — and a bond market that failed to face the facts about the county and kept lending money long after it was prudent to do so.

The corruption involved was breathtaking. More than 20 people, including politicians, contractors

and influence peddlers, have been convicted. JPMorgan escaped criminal charges, but the Securities and Exchange Commission penalized it for paying bribes through local middlemen.

That corruption was important and no doubt raised the financing costs for the county. But the basic financial decisions about the structure of the county's debt were different only in scale from what many other municipalities did.

The disaster provides an example of how derivative securities can be oversold. Not all risks can be hedged, and certainly not at acceptable costs, but that is something Wall Street salesmen tend to overlook when they make their pitches. When such contracts are written, you can be sure that the Wall Street firm will make sure it will come out O.K., even if that increases the risk that the customer will not.

The county's sewer debt used to be long-term, fixed-rate debt. The county would have been better off if that had not changed. But Wall Street persuaded it, and a lot of other municipalities, that such debt was too costly. The county could save some money by issuing what the salesmen called synthetic fixed-rate debt.

And what is that? The county issued long-term variable-rate debt, where the interest payments would fluctuate based on short-term market rates. Just doing that would have left the county at risk if interest rates surged, so JPMorgan also entered into an interest rate swap. That provided that the county would pay a long-term rate to JPMorgan, which would pay a short-term rate to the county.

The net cost of that was a little lower than the cost of fixed-rate debt would have been.

There was an important catch: the swap payments were not based on what the county actually had to pay. They were based instead on indexes that might, or might not, move in the same way that rates moved on the county's actual debt. It was not really "fixed rate," the title notwithstanding.

Another risk, probably never considered, was that the monoline insurance companies, which routinely guaranteed munis for a fee, would collapse.

Those risks were not necessarily large, and if Jefferson County had not structured 90 percent of its debt that way — rather than the 10 or 20 percent some advisers recommend — they might not have become crucial. But in the credit crisis, a lot happened that had not been expected.

Jefferson County issued two types of variable-rate debt, both of which blew up.

The largest was auction-rate debt. That debt paid rates that were set every week at auctions. The risk to investors was that an auction could fail and they would be stuck with the bonds. If that happened, the county would pay a penalty rate, often twice the London Interbank Offered Rate, known as Libor.

When auctions began to fail, that penalty rate was not enough to attract investors, but it was high enough to raise the financing costs for the county significantly. The interest rate swap did not protect it because it was based on an index, not on the actual cost the county was paying. Suddenly the "fixed rate" went up.

The second type was known as variable rate demand bonds, or V.R.D.O.'s to the cognoscenti. Their rates fluctuated based on an index rate, but the holder had the right to sell them every week. If no one else would buy, there were banks that had promised to buy them.

The catch was that the banks were not in it for the long haul. The V.R.D.O.'s might have 30-year

maturities. But if the banks were forced to bail them out and could not find other buyers, the interest rates rose and the debt turned into three-year debt. The banks were protected, but the county was not.

Turning for a moment from finance to the real world, these bonds were financing a sewer system that was managed badly for decades. Wealthier areas found ways to stay out of it. In the late 1990s, the county was forced to take over what a court-appointed receiver later called “municipal systems that had never been properly operated and maintained.” But it still could not force some people within its service area to hook up to its system.

Some people used the sewers without paying, and when they were caught, they were not forced to pay what they owed. When a consultant told the county commissioners a decade ago that the county would have to raise rates rapidly, the commissioners simply ignored the report and did not mention it when they borrowed more money.

And the investors were not paying much attention. They were told they did not need to because the bonds were insured by one of three monoline insurance firms, FGIC, XL Capital Associates and FSA, and therefore had AAA ratings.

The records do not show whether those monoline insurers did any real research before they issued the guarantees. If they did, they did not seem to have noticed how poorly the system was run.

The bonds were backed only by sewer system revenue, but there was a covenant in them in which the Jefferson County commissioners promised to keep rates adequate to meet the system’s obligations. For many years, they ignored that promise. In 2009, after the bonds defaulted and it was obvious that rates had to be raised substantially if the county was going to meet its obligations, the commissioners did the opposite. They voted to reduce rates. In 2011, the county went into bankruptcy.

Four people who served on the five-member county commission have since been convicted of taking bribes and sentenced to prison, and a fifth was convicted of obstructing justice by lying about gifts she received from investment bankers. She received probation and testified against her former colleagues.

Under the deal disclosed this week, JPMorgan agrees not to be paid for many of the bonds it holds. Including fines, forgone fees the county owed it and forfeited bonds, this has cost the bank more than \$1.5 billion before taxes. A JPMorgan spokesman said that losses had already been accounted for and that the settlement would have no significant financial effect on the bank.

Under the deal, normal investors are to be offered a choice of receiving 80 cents for every dollar of bonds they own, and forfeiting the right to get any more, or 65 cents while retaining the right to sue the monoline insurers, all of which are in financial difficulty. They would probably be better off to take the 80 cents.

There is optimism that those payments can be financed by selling new bonds. Those bonds would almost certainly be rated as junk, but the presumed yields, ranging up to 6.75 percent on some bonds where the interest will not be paid until maturity decades from now, are thought attractive enough to draw in investors. Sewage rates will rise and might have to rise further if market interest rates go up before this can be completed, some months from now. But they will not rise as much as would have been necessary without forcing bondholders to take losses.

There are other municipalities where crises are looming, even without rampant corruption.

Cities and states are legally required to pay pensions to retired workers and to pay bondholders, along with paying for continuing government functions. But if there is not enough money for all of that — and in some cases, where population is shrinking, there almost certainly will not be — don't bet that the judges and politicians will conclude that the retirees and bondholders should face no losses while basic government operations are devastated.

WSJ: Record Muni Bankruptcy Nears End; Jefferson County's Creditors Agree to Forgive \$1.2 Billion of Debt; Hedge Funds Stand to Profit in Deal.

A big bet by hedge funds and private-equity groups on the largest municipal failure in U.S. history is close to paying off after a deal on Tuesday that should enable Jefferson County, Ala., to exit bankruptcy.

The county's biggest creditor, J.P. Morgan Chase & Co., will shoulder a loss of about \$840 million as part of the agreement between Jefferson County officials and holders of \$3.1 billion of debt linked to a troubled sewage system.

Under the deal, \$1.2 billion of the county's debt would be forgiven and a group of investors will help with refinancing some of the remaining debt. The desire by the hedge funds and other distressed-debt investors to earn a return on their money was crucial in reaching an agreement that had eluded other creditors, people close to the matter say.

Jefferson County residents will see their sewer rate increase by about 7% for each of the next four years to help pay for the sewer system's debt going forward, according to the agreement. "We've got to get out of bankruptcy," Commission President David Carrington said.

A bankruptcy-court judge is expected to review the proposed deal at a hearing in Alabama on Wednesday, but he won't need to approve it until the county proposes a formal bankruptcy-exit plan. County officials said they hope the county can emerge from Chapter 9 protection by the end of the year.

A group of seven investment firms, including Claren Road Asset Management LLC and Stone Lion Capital Partners LP, bought around \$900 million of sewer debt. Some firms purchased the debt at a discount to its original price after the county filed for bankruptcy in November 2011, according to people familiar with the situation.

Tuesday's deal could enable some of the firms to make money in two ways, these people said: When the county refinances its current debt, it will use the cash to pay off the old debt held by the investment firms. In some cases, the firms would be paid more than they bought the old debt for. Some of the firms also have agreed to backstop a portion of the refinancing, and can earn fees for that support.

"We are pleased that our clients played an important and constructive role in driving a consensus among the parties," said Soren Reynertson, a managing general partner at GLC Advisors & Co., which advised a group of hedge funds during the bankruptcy.

The county's lawyer, Kenneth Klee, said that the deal will save the county \$200 million more than the last serious debt-restructuring proposal that circulated—but ultimately failed—in September 2011.

The agreement is the result of months of negotiations between county officials, banks, bond insurers and the investment firms.

If approved, the deal would close a painful chapter in the history of Alabama's most populous county, which includes Birmingham. It also could embolden other municipalities to seek to slash their debt through the bankruptcy process.

Jefferson County's financial woes were partly the result of questionable debt deals to finance repairs to an aging sewer system.

Some former county officials and others involved in some of those transactions were sentenced to prison.

J.P. Morgan paid fees and penalties to settle federal securities charges related to its role in the deals.

As part of the deal struck Tuesday, the New York bank has agreed to take the largest haircut—roughly \$842 million on the \$1.2 billion of sewer debt the bank owns, Mr. Carrington said.

A settlement eluded county officials and creditors through months of negotiations leading up to the county's bankruptcy filing in November 2011.

But people involved in the most recent talks said a few things had changed since then. One of the biggest factors was the involvement of the investment firms. Hedge funds sometimes buy up debt on the cheap in corporate restructurings, but their involvement in the Jefferson County case is likely the biggest bet hedge funds have ever made on municipal debt.

WSJ: Massachusetts Selling 'Green' Bonds to Fund Environmental Projects.

Massachusetts is tapping into the popularity of environmental improvement to sell \$100 million of bonds it has labeled "green bonds." The sale is expected to wrap up Tuesday, and the state plans to use proceeds to pay for environmental endeavors, such as improving water quality, increasing energy efficiency and cleaning up pollution.

State officials say they hope to attract new investors for the Massachusetts bonds, which could mean lower rates for taxpayers. The state was inspired by a similar program from the World Bank, which has issued \$3.5 billion in green bonds since 2008. The Massachusetts bonds were being offered late Tuesday morning to yield between 3.20% and 3.85% for 20-year bonds.

Using municipal bonds to finance environmental projects is not unusual, but calling them "green bonds" plays into investors' desire to have more specifics about where their money goes. According to Thomson Reuters, more than \$1.7 billion worth of municipal bonds have been sold this year with explanations that their proceeds would be used to fund environmental facilities. These bonds have been sold by states, or issued by various authorities and linked to specific projects.

Massachusetts is first to call the new debt "green bonds," according to information provider Ipreo, whose database goes back to 2000.

The proceeds will be kept in an account separate from other state bond proceeds and Massachusetts said it plans to post quarterly updates on the use of green bond proceeds to its investor website. It

also plans to post a final list of projects funded from the sale when all the proceeds have been spent. Massachusetts told investors in its bond offering documents that it plans to use the proceeds for environmental projects, but it has no legal requirement to do so, said a spokesman for the state.

"There has been a ton of interest in the product," said Colin MacNaught, assistant state treasurer for debt management. "We think we're offering something that fills a void in the market."

Julie Egan, portfolio manager at Community Capital Management, which plans to participate in the sale, said she would be surprised if proceeds were used for other purposes given how they are being described.

Otherwise, the Massachusetts green bonds are no different from other debt sold by the state. The bonds carry the state's general-obligation pledge, meaning they are backed by its full faith and credit and not tied to any one specific project. The green bonds share the state's overall credit rating of double-A-plus.

That's similar in structure to the World Bank green bonds: they carry triple-A ratings like any other World Bank bond and the bank itself bears responsibility for paying back investors, not any particular project, said Peter Coffin, president of Boston-based Breckinridge Capital Advisors. The World bank "green bonds" have been used to fund projects devoted to climate change.

Coffin says interest in environmentally friendly investing is on the rise. His firm began focusing on what it calls its "sustainable strategy" three years ago, and now oversees more than \$150 million in that area. Overall, the firm manages more than \$18 billion.

For those clients, Coffin said his firm will buy corporate bonds from companies deemed socially and environmentally responsible, the World Bank bonds and other municipal bonds similar to the Commonwealth of Massachusetts sale.

"We think it's good that the commonwealth is highlighting the fact that these are sustainable investments that the state is making," Coffin said. "We think more municipalities should do the same."

Another option for green investors: mortgage-backed securities issued by Ginnie Mae Fannie Mae and Freddie Mac, according to the Weston, Fla.-based Community Capital, which oversees about \$2 billion and focuses on sustainable investing. Some state housing authorities offer mortgage programs that reward more energy efficient homes, and investors can also screen securities for mortgages from areas recognized for developing walkable neighborhoods.

Securities tied to federal agencies like the Small Business Administration also might fit into a green bond portfolio.

Barbara VanScoy, co-founder and chief impact investment officer at Community Capital, called the Massachusetts sale a "sign of progress" for bond buyers interested in sustainable investments.

"Most of the time, there's not a lot of transparency or disclosure in these types of issues," Ms. VanScoy said. "So even though we know that they're financing projects that are environmentally sustainable, a lot of times it's not disclosed."

If the green bonds grow on investors, MacNaught said the state could sell more in the future.

"This isn't sort of a hit and run, where it's one bond sale," he said. "We're trying to determine if there's enough capital, enough investors, where green bonds can be a small part of the state's

capital program going forward.”

Massachusetts is also wrapping up a sale of about \$575 million of additional general-obligation bonds on Tuesday.

WSJ: Should You Buy Taxable Muni Bonds?

What do you get when you throw out the chief reason investors buy municipal bonds—their tax-free status?

Apparently, a truckload of buyers.

This year through Monday, issuers have originated \$19.6 billion in taxable municipal bonds, nearly double the amount of the same period a year ago, according to investment researcher Municipal Market Advisors.

Taxable munis, unlike their tax-exempt cousins, aren’t shielded from federal, state or local taxes.

Some investors still might find the bonds worth a look. But most small investors should be wary.

Despite the lack of tax benefits, issuers have found no shortage of buyers. The bonds are popular among institutional investors and mutual funds that can’t take advantage of tax breaks. One example: The Build America Bonds program, through which state and local governments issued \$181 billion worth of bonds before its expiration in December 2010.

Nowadays, the chief issuers are organizations that want to use the money for purposes that aren’t permitted with tax-exempt bonds, such as to bolster an underfunded pension plan.

Some organizations also have issued the bonds to refinance their debt. Harvard University, for example, issued about \$402 million in taxable muni bonds in May.

But in their persistent search for income, some small investors are grabbing the bonds, too, says Jim Colby, senior municipal strategist at Van Eck Global, which manages five tax-exempt municipal-bond exchange-traded funds.

“I don’t doubt for a moment that some of these bonds are finding their way into individual accounts,” Mr. Colby says.

In the past 12 months, for example, about \$107 million has poured into the \$1.1 billion PowerShares Build America Bond BAB -0.33% ETF, one of the biggest taxable-muni-bond ETFs, according to investment researcher IndexUniverse.

So what is the problem, you ask?

For starters, though the bonds typically have a higher yield than their tax-exempt peers, this year that premium has fallen sharply.

Just a year ago, the spread between the yield of a typical tax-exempt municipal bond and that of a taxable one was about one percentage point, says Matt Fabian, managing director of Municipal Market Advisors. Now, that premium can be as small as half a percentage point.

That means, at least for taxable accounts, small investors will be hard-pressed to find a taxable muni that leaves them with more money than a tax-exempt alternative.

For example, someone in the 39.6% federal tax bracket who could earn 3% with a tax-exempt bond would need to find a taxable bond yielding nearly 5% to make the switch worth it, before factoring in state or local taxes or the 3.8% investment surtax.

Second, funds—the easiest avenue for investors to get exposure to the taxable-muni market—have very long average maturities, which makes them vulnerable to interest-rate changes.

The PowerShares ETF, for example, has a yield of 4% and costs 0.28% annually, or \$28 per \$10,000 invested. The SPDR Nuveen Barclays Build America Bond ETF BABS -0.15% yields 4% with a 0.35% expense ratio, or \$35 per \$10,000 invested.

To estimate how a one-percentage-point rise in rates would hurt bond prices, investors calculate a measure called “duration.” A fund with a duration of two years, for example, would lose 2% if interest rates rose by one percentage point immediately.

Both Build America Bond ETFs have a duration of more than 10 years, meaning that their values will drop by more than 10% if interest rates rise one percentage point.

“It’s too risky. You only get a 4% yield for a lot of interest-rate risk,” says Timothy Strauts, an ETF analyst at investment researcher Morningstar.

To be sure, in some specific cases, taxable munis could still make sense.

For one thing, tax-exempt munis don’t have an edge in tax-advantaged vehicles, like individual retirement accounts. Inside an IRA, income is already tax-deferred.

And next to high-grade, long-term corporate bonds, taxable-munis—which many regard as safer investments—look like a deal.

For example, the yield of the PowerShares ETF is only slightly below that of the Vanguard Long-Term Corporate Bond ETF, which yields 4.5% and has a longer duration.

Finally, President Barack Obama’s latest budget proposal calls for a cap on the amount of muni income exempt from federal taxes for some high earners, which if passed would lessen the advantage of tax-exempt munis.

Taxable munis can sometimes look like a relative value compared with other bonds. But that just reflects the fact that all bonds, no matter what slice you take, are high priced, Mr. Strauts says. If and when rates rise, long-term bonds of all stripes will suffer, he says.

As with all parables, the Great Bond Bubble eventually will end with a memorable lesson. Here’s hoping you will read about it in the papers rather than in a portfolio statement.

[FINRA Foundation Releases Nation's State-by-State Financial Capability Survey.](#)

California, Massachusetts and New Jersey Most Financially Capable; Mississippi, Arkansas and

Kentucky Near Bottom.

The FINRA Investor Education Foundation (FINRA Foundation) today released the results of America's State-by-State Financial Capability Survey. The survey findings are available at www.usfinancialcapability.org, which features a clickable map of the United States and allows the public, policymakers and researchers to delve into and compare the financial capabilities of Americans across all 50 states and the nation as a whole. The survey results were released today at an event featuring FINRA Foundation Chairman Richard Ketchum; U.S. Securities and Exchange Commission Chair Mary Jo White; Consumer Financial Protection Bureau Director Richard Cordray; Cyrus Amir-Mokri, Assistant Secretary for Financial Institutions, U.S. Department of the Treasury; and Stacey Stewart, U.S. President of United Way Worldwide.

The State-by-State Financial Capability Survey, which surveyed more than 25,000 respondents, was developed in consultation with the U.S. Department of the Treasury, other federal agencies and the President's Advisory Council on Financial Capability.

The State-by-State Survey found a significant disparity in financial capability across state lines and demographic groups:

Citizens of California, Massachusetts and New Jersey who were surveyed are the most financially capable. Those states ranked in the top five among all states in at least three of five measures of financial capability.

Mississippi stood out as the least financially capable state, placing in the bottom five in four out of five measures. Arkansas ranked in the bottom five in three out of five measures, and Kentucky ranked in the bottom five in two out of five measures.

Younger Americans, especially those who are 34 and under, are more likely to show signs of financial stress, including taking a loan or hardship withdrawal from their retirement account or making late mortgage payments.

Younger Americans are more likely than older Americans to have unpaid medical bills. Of those surveyed, 31 percent of Americans aged 18-34 reported having unpaid medical bills compared to 17 percent for Americans aged 55 or older.

"This survey reveals that many Americans continue to struggle to make ends meet, plan ahead and make sound financial decisions—and that financial literacy levels remain low, especially among our youngest workers. No matter how you slice and dice it, this rich, new dataset underscores the need for us to continue to explore innovative ways to build financial capability among consumers," said FINRA Foundation Chairman Richard Ketchum.

The five measures of financial capability used to rank the states measure how well Americans are managing their day-to-day finances and saving for the future. The national averages among survey respondents for these key measures are below.

Fewer than half (41 percent) of Americans surveyed reported spending less than their income.

Over a quarter (26 percent) of Americans reported having unpaid medical bills.

More than half of Americans (56 percent) do not have rainy-day savings to cover three months of unanticipated financial emergencies.

Over a third of Americans (34 percent) reported paying only the minimum credit card payment

during the past year.

On a test of five basic financial literacy questions, the national average was 2.88 correct answers.

The state-by-state results break down financial decisions and literacy by gender, age bracket and region, and highlight how a lack of financial capability has disadvantaged many Americans. The State-by-State Financial Capability Survey includes a wealth of data revealing how Americans make ends meet, plan ahead and manage financial products.

The State-by-State Financial Capability Survey collected data on financial behaviors across all 50 states and the District of Columbia. The FINRA Foundation will make the extensive and multi-dimensional information in this study available to policymakers and researchers, allowing them to look at individual financial behavior from various angles and utilize the state-specific data to tailor new programs and policies to promote greater financial capability.

The data were collected through an online survey of 25,509 American adults (approximately 500 per state, plus D.C.), over a four-month period, July – October 2012. The sample used in this study was weighted by age, gender, ethnicity and education. The full data set, questionnaire and methodology are available at www.usfinancialcapability.org.

Muni Underwriting Fees Continue to Decline.

The fees that bankers are paid to underwrite municipal bonds have been declining since financial markets started their recovery in 2009, prompting some dealers to focus on lower quality or more complex deals to boost profitability.

Through May 23, state and local governments have paid underwriters on average \$5.16 per \$1,000 of bonds sold this year, according to Thomson Reuters data.

That number has come down almost 17% since it peaked at \$6.21 in 2009, when deals were riskier to underwrite and fewer banks were competing for business following the financial downturn.

The spread has steadily declined in the years that followed, dropping to \$5.94 in 2010, \$5.62 in 2011, and \$5.52 last year.

Underwriters and other market participants attribute the squeeze in spreads mostly to low issuance of new bonds, which has heightened competition.

“We saw a noticeable difference in takedowns beginning in the middle of 2011,” said Todd Frazier a managing director and head of the pricing group at Public Financial Management Inc., referring to underwriting fees. “It’s no coincidence that in 2011 the market was down about 40%. I think underwriters felt the need to bring in business and to maintain market share.”

David Manges, a managing director and municipal trading manager for BNY Mellon Capital Markets, said dealers will continue to drive for market share as long as they’re making money.

“They’re going to drive to find deals on the competitive side, and on the negotiated side, bankers will push to get market share by reducing spread,” he said.

While underwriters compete on rate as well as spread, he said, it's often easier to cut the spread before they cut the rate, since the rate has to be attractive enough to sell to investors.

"As underwriters compete for the issuers' attention, one of the things they'll talk about is their willingness to reduce spread to produce the lowest rate," Manges said. "The lower the spread, the better the deal for the issuer."

Matt Fabian, a managing director at Municipal Market Advisors, said the declining spreads may also reflect a more aggressive stance by financial advisors and issuers in general.

"This is a seller's market, after all," he said.

On the underwriting side, Fabian said that dealers are feeling competition because there is less issuance, with most of that issuance coming from larger issuers doing refunding deals.

Out of the \$377 billion of municipal bonds sold last year, only \$145 billion was new money.

In 2011, new money also totaled close to \$145 billion, out of the total \$286 billion of issuance. Before that, new money issuance surpassed \$200 billion every year since 2002, according to Thomson Reuters.

Refunding bonds tend to be relatively short-termed, with maturities around 10 to 15 years.

This means the underwriting spread on these deals tends to be lower.

"As you shorten the maturity of these bond issues and the duration of total cash flows, the takedowns will also be compressed for that reason," said Herman Charbonneau, executive vice president and manager of public finance at Roosevelt & Cross.

The "takedown" is one component of the underwriter's discount, and is the compensation to the underwriter for distributing the bonds.

Charbonneau said that on deals today, he rarely sees a takedown over \$5.00.

Other components of the underwriting spread include the structuring or management fee, compensation for risk, and any related expenses.

"So you're looking at a relatively complex situation, where some of the decline is a decline in takedowns, generated by competitive considerations, and some of it is generated by the relatively short maturity of many refunding issues," Charbonneau said.

In addition to the decline in the takedown component, the risk component of the underwriter's fee has also contributed to the overall decline in underwriting spreads.

Underwriters take on some amount of risk related to interest rate fluctuation during the short period it takes them to underwrite the securities.

"With yields as low as they are and having dropped consistently now for the past three or four years, that risk component has dropped to a pretty slight margin," Manges said.

In order to make up for lower spreads on some deals, underwriters may try to focus on other deals consisting of lower quality bonds where they can get slightly higher fees.

On the higher quality bond issues, underwriters will be more aggressive and tend to squeeze down

on their takedown fee as they seek business and make proposals or bids to issuers, Charbonneau said.

"Elsewhere in the market where you're trying to deal with the issuance of low quality bonds that are, say, at the bottom of the investment grade category, the work that you do as an investment banker has higher value," he said. "There's more of a skilled component that goes into the structuring of those issues and into the marketing process so you can charge a little bit more there."

Focusing on issues where the skill component of the work makes a greater contribution to its profitability can help keep up their takedown and structuring fees, Charbonneau said.

"The lower the credit rating, the more speculative the credit, the higher the takedowns are, and that hasn't changed," said Frazier.

"I don't think you can create those deals," he said, "but certainly as they come up there is more competition among underwriters for those deals, but no more so than on any other deal." MMA's Fabian calls it a balance.

"A dealer needs enough lower risk bonds that, even with less compensation, will trade easier and pose less risk to their balance sheet," he said. "But dabbling in riskier stuff isn't a bad idea if done in moderation."

Although underwriters have been receiving less compensation for their work, it doesn't mean their work is any less valuable.

"At PFM, we maintain a database of takedowns and make sure the quality of the underwriting isn't affected by lower takedowns," Frazier said. "We haven't seen that yet."

He added that for the industry, the concern is that the broker dealer community will be pared down because underwriting becomes a less profitable business.

"A smaller universe of broker dealers over time may not be healthy," Frazier said. "Long term, we want to maintain healthy competition."

Though spreads have been declining, they have yet to come to close to the all-time low of \$4.89 in 2008, according to available data going back to 1986.

In fact, prior to the sudden drop in spreads before the financial downturn, followed by a spike after, spreads had been steadily decreasing since 1986, when the average spread was \$12.92.

Spreads came down between \$7.00 to \$10.00 averages in the 1990s, \$4.00 to \$6.00 averages after 2000, to the \$5.20 average today.

"It's low," Charbonneau said. "It's not a small decline — and every decline has some impact on profitability, but it's not catastrophic."

Breaking down the average spread among deal types, competitive issues offer greater fees than negotiated issues.

In 2012, the average underwriting spread among competitive deals was \$6.17 and among negotiated deals it was \$5.40.

Through May 23, the average competitive spread has come down to \$5.29, but it's still higher than

the average negotiated spread of \$5.12.

"This is because there's more risk involved on a competitive deal than a negotiated deal," said Peter Stare, a senior vice president at First Southwest.

In a negotiated deal, Stare said, the underwriter is not committing to underwrite the bonds until they have gone through the order period and have a balance of, for example, around 10%.

For a competitive deal, however, apart from any bonds sold in a presale, the underwriter is basically committing to underwrite the entire amount, taking on more risk.

He added that this recent decline in spreads is somewhat cyclical.

"I think we see this happen when spreads get tight and we experience a difficult market," Stare said.

"It's been pretty easy to be tight on spreads in the past couple years because we've basically been in a bull market," Stare said. "but if the market starts to back up dramatically and people are still bidding the spreads that they're currently bidding and start taking losses, then I think we'll start to see spreads widen out."

If interest rates start to go back up substantially, Stare said there's a possibility that some underwriters may reevaluate whether it's worth it to continue underwriting deals at such low spreads.

"It's strictly a numbers game. If we get a protracted bear market in municipals, then I think you'll have some people rethink whether they want to be in the market or you'll see spreads widen out."

However, he doesn't think that rates will go up any time soon.

In addition to a rise in interest rates, Roosevelt's Charbonneau said other reasons why spreads would stay down is if the average quality of bonds being sold in the marketplace rises, or if lower quality bond issuance is limited.

Manges said that spreads will stay low or go lower until one of two things happens: either interest rates start to rise or there is a credit problem with some issuer or sector of issuers that makes it more difficult to place their bonds.

"Spreads can stay here or they can go lower. It's a matter of competition," Manges said.

"Underwriters will continue to push to buy deals by reducing their spreads and they will do that until it proves to be unprofitable."

by: TONYA CHIN

[Lawmakers Circulate Bipartisan Letter to Preserve Tax-Exempt Bonds.](#)

A Maryland Democrat and an Illinois Republican are circulating a letter to colleagues asking for their support in preserving the tax-exempt status of municipal bonds.

Rep. Dutch Ruppersberger, D-Md., and Rep. Randy Hultgren, R-Ill., sent their fellow lawmakers an email and a hard copy draft letter addressed to House Speaker John Boehner, R-Ohio., and House Minority Leader Nancy Pelosi, D-Calif., expressing concerns about proposals to eliminate or cap tax

exemption.

“Eliminating or capping the current deduction on municipal bonds would severely curtail state and local governments’ ability to invest in themselves,” they wrote. “It would increase borrowing costs to public entities and shift costs to local residents through tax or rate increases.”

The Maryland Association of Counties voiced concern to Ruppertsberger, a former county executive, that the idea to cap or eliminate tax exemption was gaining traction on Capitol Hill and at the White House, a congressional aide said. They asked Ruppertsberger to investigate ways to preserve municipal bonds.

The one- page Dear Colleague letter notes that proposals to cap or eliminate tax exemption appeared in President Obama’s fiscal year 2014 budget, the Simpson-Bowles report and a recent Government Accountability Office report. Obama suggested capping tax exemption at 28% rate, while the Simpson-Bowles and GAO report suggested eliminating tax exemption altogether.

“Neither capping nor eliminating the deduction on municipal bonds is a smart solution to our country’s economic and fiscal challenges,” the letter said. “It is our hope that you will reject proposals to alter the tax-exempt status of municipal bonds. While we agree that we must reduce government spending and our country’s unsustainable debt, we should not be eliminating a vital tool for job growth and economic development.”

The letter also highlighted that municipal bonds have funded more than \$1.9 trillion in infrastructure construction including for schools, airports, roads and public transit in the past decade and more than \$179 billion in infrastructure spending in 2012. The lawmakers called it “irresponsible to jeopardize” funding for teachers, firefighters, hospital workers and police officers who work in infrastructure-related industries.

The letter comes one week after the collapse of a bridge along Interstate 5 in Washington state, spurring debate about whether Congress should be spending more money on infrastructure.

Ruppertsberger and Hultgren sent an email version of the letter to all 435 members of the House and 625 hard copies to House committees and leadership offices.

The final letter will be sent to Boehner and Pelosi once a sufficient number of signatures have been collected, aides said.

Cuomo Long Island Power Solution Penalizes Bonds: Muni Credit.

New York Governor Andrew Cuomo’s plan to fix the Long Island Power Authority, which left thousands of customers in the dark for weeks after Hurricane Sandy, isn’t winning over municipal-bond investors.

On May 21, eight days after Cuomo announced the plan, tax-exempt LIPA bonds callable in nine years traded at an average yield 2.2 percentage points above top-rated bonds, data compiled by Bloomberg show. That was the most in at least three months.

Enlarge image

Sandy struck the region Oct. 29, knocking out power to 1 million LIPA customers, or 90 percent, as

falling trees downed transmission lines and substations flooded. Photographer: Victor J. Blue/Bloomberg

Under the Democratic governor's proposal, which requires legislative approval, Newark, New Jersey-based Public Service Enterprise Group Inc. (PEG) will take over LIPA operations on Jan. 1, and as much as half of the authority's \$7 billion of municipal debt will be refinanced. LIPA's electric rates, which are among the nation's highest, will be frozen through 2015 and state regulators will review any increases.

"To start off with saying we're not going to have any rate increases for three years when there's a lot of capital needs — the math doesn't work for me," said Howard Cure, director of muni research at New York-based Evercore Wealth Management LLC (EVR), which oversees \$4.7 billion.

Knockout Blow

Sandy struck the region Oct. 29, knocking out power to 1 million LIPA customers, or 90 percent, as falling trees downed transmission lines and substations flooded. A week later, 200,000 customers still were without power.

Last week, Moody's Investors Service lowered the ratings on LIPA bonds backed by customer revenue one step to Baa1, three levels above junk, and gave the debt a negative outlook. The political and media scrutiny following Sandy will make it difficult for the utility to improve its finances and operations, particularly if those actions would require rate increases, Moody's said in a statement.

LIPA has "little if any cushion for the unforeseen events that seem to occur every year," Moody's said.

"We are disappointed by Moody's actions considering the aggressive steps LIPA" has taken to raise liquidity, Mark Gross, a spokesman for the Uniondale, New York-based nonprofit municipal electric provider, said in an e-mailed statement.

"We continue to work with federal and state government towards full and timely" Federal Emergency Management Agency reimbursement for Sandy expenses as well as funds for projects protecting against future storms, he said.

Reimbursement Request

LIPA has received \$257 million of the \$800 million it expects from FEMA reimbursement, Gross said.

Any delay in FEMA funds is "problematic," said Laura Schumacher, a Moody's analyst in New York.

LIPA has about \$335 million of cash on hand, representing about 37 days of liquidity as of Dec. 31, the rating company said. Taking into account \$100 million of commercial paper, the number of days of cash on hand rises to 48.

According to a commission convened by Cuomo to investigate LIPA's handling of the storm aftermath, the key to the utility's failings was a "dysfunctional" management structure.

The authority, which was set up in 1985, owns Long Island's electrical lines and contracted with London-based National Grid Plc (NG/) to operate them. Under such divided management, LIPA let consultants guide spending and failed to replace aging poles or trim trees as recommended in state studies.

'Better Way'

"LIPA has been a problem for a very long time, and it was on full display during Hurricane Sandy," Cuomo said when he announced his plan. "We need a new and better way."

Public Service Enterprise Group would take over LIPA's operations, leaving it a holding company with no day-to-day responsibilities. PSEG will control capital and operating budgets, storm preparedness and response, call centers, computer systems and customer service.

To help relieve LIPA's \$7 billion debt burden, the plan calls for a new entity to issue bonds backed by a new customer charge. The securities would be structured to have higher ratings, lowering borrowing costs and generating savings.

"The state is claiming rates will go down," Cure said. "I'm a little dubious in that the users of the utility are still paying the securitized debt."

Cure said some investors have shown interest in LIPA bonds, and speculated that they are looking to buy securities that will be paid off in the restructuring.

Rate Independence

The proposal would remove management dysfunction while providing improved oversight, Rich Azzopardi, a Cuomo spokesman, said in an e-mailed statement.

"Rating agencies are primarily focused on LIPA's board retaining its authority to set rates and comply with bond covenants, which our proposal does," Azzopardi said. "This should provide great comfort to bondholders."

The proposal would also eliminate a franchise tax of about \$26 million annually that LIPA pays the state, and would cap payments LIPA makes in lieu of taxes to municipalities starting in 2015 at 2 percent per year. The Department of Public Service would review rates and capital spending.

"It's hard to imagine politics not getting involved," Cure said. "There's a lot of pressure on both parties to give some rate relief."

Most public power agencies can set rates independently, said Jeff Panger, a Standard & Poor's analyst in New York.

"The current proposal, if it comes about, will constrain the rate-setting autonomy and flexibility that LIPA has beyond what is generally seen by other public-power entities," he said.

LIPA's total average electric rate of 18.2 cents per kilowatt hour is among the nation's highest, according to a 2011 report by the Brattle Group, a consulting firm based in Cambridge, Massachusetts.

Debt Cost

One of the primary drivers is the cost of servicing \$6.7 billion of debt LIPA issued in 1998 to finance the acquisition of the Long Island Lighting Co., an investor-owned utility. Lilco spent \$6 billion to build the Shoreham nuclear power plant in Suffolk County from 1973 to 1984. The site never opened because of community opposition.

State Senator Michael Ranzenhofer, a Republican whose district sits between Buffalo and Rochester

and who heads the chamber's authorities committee, said he's reviewing Cuomo's proposal and shares the same concern as the rating companies.

"There's the concern with LIPA being able to manage its finances and pay off its debt," Ranzenhofer said in a May 22 telephone interview. "We need to move quickly, but also deliberately, to make sure that the proper actions are taken."

Columbus Issue

In the broader market, municipalities led by Columbus, Ohio, are set to offer \$1.9 billion of debt in next week's holiday-shortened calendar, the slowest period since January.

Columbus plans to offer about \$369 million of general obligations to refinance higher-cost debt as municipal yields are the highest in six weeks.

At 1.88 percent, yields on benchmark 10-year munis are still below the 2.02 percent interest rate for similar-maturity Treasuries.

The ratio of the two yields, at 93 percent, has been below 100 percent on all but one day since May 2. The lower the figure, the more costly munis are compared with federal obligations.

NLC: Food Trucks More Than a Passing Fad for Many Cities.

In spring 2013, Masters of Public Policy students at The George Washington University conducted research on local policy options for food truck regulations for the NLC. This blog post is based on their preliminary report, which will be made available to NLC members as a policy toolkit in the coming months.

Food trucks have expanded rapidly in both numbers and popularity over the past few years, and many cities are finding themselves ill-equipped to deal with these vendors from a regulatory perspective. Communities across the country, from Los Angeles to Philadelphia, are part of a burgeoning movement to find ways to better manage and regulate mobile vending.

City ordinances related to mobile vending were largely written decades ago, with vendors such as ice cream trucks, hot dog carts and sidewalk peddlers in mind. Needless to say, food trucks are not your mother's mobile vending experience. Most use large vehicles equipped with high-tech cooking equipment and sanitation devices to provide sophisticated, safe cuisine usually prepared to order (rather than pre-cooked).

So, what policy options do local governments have to regulate food trucks and incorporate food trucks into the fabric of a city?

City-specific solutions are definitely in order, but there are an emerging set of best practices to help tailor regulations so that both the city and the vendors realize the full spectrum of economic and social benefits that food trucks can bring to a community. Our evaluation produced some overall recommendations for NLC members, including:

Conduct town hall forums and private meetings with core stakeholders

Encourage dialogue and the building of relationships among competing stakeholders

Identify private vacant lots to create partnerships for mobile vendors to gather and sell

Designate public spaces specifically for mobile vending

In addition to the above recommendations, pilot programs can be a useful way to determine what regulations to adopt. Las Vegas currently has a pilot program in place that sets aside a certain number of downtown parking spaces as food truck parking only, and has a lottery system in place for those spaces.

Regulations can also incorporate strategies that steer food trucks to underserved areas of a city to address equity concerns, encourage economic development and alleviate food deserts. Cities such as Denver and Cincinnati have recognized the need for a targeted approach that brings food trucks to parts of the city outside of the core business district. Denver has considered several issues that might impact or encourage economic development, including whether food truck clustering combats food deserts, where restaurant options are constrained and the ability of food trucks to activate underutilized space (like surface parking lots). Cincinnati has seven mobile food truck zones in strategic places around the city.

Due to their low start-up and upkeep costs, food trucks are proving to be an innovative way for entrepreneurs to create viable businesses, particularly as recent economic conditions have made it more difficult to start and operate a conventional restaurant.

The National Restaurant Association reports that they generated approximately \$650 million in revenue in 2012- about 1 percent of total U.S. restaurant sales. And a recent research report by the Intuit Network predicts that food trucks will generate between 3 and 4 percent of total restaurant revenue - about \$2.7 billion - by 2017, a fourfold increase from 2012. A 2011 survey by the research firm Technomic showed that 91 percent of respondents believe the food truck industry has staying power and is not a passing trend.

At a recent Food Truck Association event in Washington, D.C., food truck supporters had plenty of praise for the modern mobile vending industry. John Gaber, an urban planning professor at the University of Arkansas, noted that "food trucks are great things for communities; they provide more 'eyes on the street' for public safety and compliment the surrounding brick-and-mortar businesses."

How will your city tap into these potential new sources of economic growth, entrepreneurship, equity, redevelopment, public safety, and community "flavor"?

by Emily Pickren

[WSJ: What the Lawyers Won't Tell You.](#)

"We want to be good leavers," our attorney said.

He was one of the few lawyers who could represent us. Others were conflicted, because our employer paid retainers to so many law firms across New York City. I liked how our guy used the royal "we." It felt like he had joined our wealth management team, and we could prevail against overwhelming odds.

In some ways, he really was one of us. He helped us negotiate signing bonuses at the new shop. He advised us not to tell clients or to warn sales assistants before we left. He did an excellent job

protecting our interests.

Good news: My team left clean in 2006. Nobody got sued.

Bad news: Several clients were furious we did not confide in them beforehand.

"I don't like surprises," said one.

"Who's watching my money now that you're not there?" asked another.

The most painful comment came from one who had become a friend through the years: "Why didn't you trust me enough to say something?"

She didn't follow us to the new shop. So much for clients being friends.

Bottom line: Breakaway advisers are caught between a rock and a hard place. We can play by the rules and avoid litigation. Or we can level with clients and suffer the consequences.

The choices-what it takes to be a good leaver-may be clear before advisers resign. But afterwards, departures devolve into brutal, sloppy affairs, with no holds barred.

The bosses at my old shop called our cell phones every few hours. "It's not too late to work things out. You pick the time and place, and we'll meet you there." Coffee. Dinner. Weekend meetings. They suggested any number of convenient venues.

Cynically speaking, I believe they were distracting us to buy time. Because as they made nice on the phone, they were simultaneously lining up and dispatching the buzzards.

You know what I mean. Buzzard brokers build their businesses on the AUM carcasses of departing colleagues. Sure, managers sprinkle around the accounts. But they assign the biggest, most profitable relationships to advisers who are really, really good at retaining assets.

For years I laughed at a guy who scribbled notes on napkins during top-producer dinners. A slip here or a war story there, he was recording information, circling, waiting for the day when somebody would leave and their revelations would come in handy.

The wake of buzzards, I soon learned, was no laughing matter. They can damage relationships for years. And their claims undermine the trust so critical to our business.

Take municipal bonds. Advisers sometimes work for a piece of the bid-ask spread. The sales credit is hidden and often negotiable between adviser and trader. "He's been ripping you off for years," a buzzard told my clients. "You're losing out on better yields."

"Not true," I said, defending myself. I offered to run data on trading history, yields and commissions to prove my honesty. The clients never pushed, and these claims and counter claims degenerated into classic cases of he said, she said.

The false claims infuriated me, and I came up with an idea how to respond.

I had spotted three union members striking outside a restaurant on 52nd Street, making a fierce racket. I asked them to drive their 12-foot inflatable rat to my old shop and chant the name of one especially heinous buzzard. Before they could do it, my partner's cooler head prevailed. I wound up saving "Operation Union Rat" for one of my novels.

Hindsight is 20-20. I now wonder if advisers should have a frank talk with their clients long before considering a move. Because the relationship status between advisers and their firms, well, "It's complicated," as they say on Facebook.

A disclosure might go something like this: "In my business, people change firms all the time, either for money or a better fit. While I have no intention of leaving now or in the future, departures are a way of life in the wealth management industry. If that happens, I can't tell you in advance."

When I finally decided to leave my firm, it was far too late to have this discussion because of legal constraints. I trusted most clients would follow me, and it turned out most did. But I had no way of knowing as I plowed forward into the unknown.

Norb Vonnegut built his private wealth-management career in New York City and now writes thrillers about financial malfeasance.

NYT: Justices Take Case on Prayer at Town Board Meetings.

The Supreme Court has agreed to decide whether a town board in upstate New York violated the First Amendment by starting its sessions with a prayer.

The case comes from Greece, a town near Rochester. For more than a decade starting in 1999, the town board began its public meetings with a prayer from a "chaplain of the month." Town officials said that members of all faiths and atheists were welcome to give the opening prayer.

In practice, the federal appeals court in New York said, almost all of the chaplains were Christian.

"A substantial majority of the prayers in the record contained uniquely Christian language," Judge Guido Calabresi wrote for a unanimous three-judge panel of the court, the United States Court of Appeals for the Second Circuit. "Roughly two-thirds contained references to 'Jesus Christ,' 'Jesus,' 'Your Son,' or the 'Holy Spirit.'"

Two town residents sued, saying the prayers ran afoul of the First Amendment's prohibition of the government establishment of religion. The appeals court agreed. "The town's prayer practice must be viewed as an endorsement of a particular religious viewpoint," Judge Calabresi wrote.

In 1983, in *Marsh v. Chambers*, the Supreme Court upheld the Nebraska Legislature's practice of opening its legislative sessions with an invocation from a paid Presbyterian minister, saying that such ceremonies were "deeply embedded in the history and tradition of this country."

The new case is *Town of Greece v. Galloway*, No. 12-696.

Schwab Reverses Ban on Client Class-Action Lawsuits.

May 16 (Reuters) - Charles Schwab Corp has temporarily reversed its requirement that clients waive their right to bring class-action lawsuits, adding a new twist in a battle closely watched by the securities industry and plaintiffs' attorneys.

"Effective immediately, Schwab is modifying its account agreements to eliminate the existing class-

action lawsuit waiver for disputes related to events occurring on or after May 15, 2013 and for the foreseeable future,” the San Francisco-based brokerage company said in a statement that was posted on its website on Wednesday.

Schwab still believes that arbitration is the best forum for clients to resolve disputes with the firm, but said it was backing off the litigation ban in deference to clients who are uncertain about their rights as it fights to defend its original ban.

Schwab’s right to stop clients from bringing coordinated court actions was challenged last year by the Financial Industry Regulatory Authority, the securities industry’s principal regulator. A FINRA hearing panel in February ruled that Schwab’s policy does violate FINRA rules but was consistent with federal law and recent Supreme Court interpretations of the Federal Arbitration Act.

FINRA is appealing the decision to the National Adjudicatory Council, its in-house appellate body.

“Given that the process will likely take considerable time to resolve, and may leave clients with a degree of uncertainty about their dispute resolution options in the meantime, we have elected to remove that uncertainty until the legal and regulatory process is completed,” Schwab wrote in its statement.

Consumer advocates, along with class-action lawyers, have blasted Schwab’s efforts to limit the lawsuits, saying many ordinary investors cannot afford to pay on their own for the cost of arbitration hearings.

In its statement, Schwab noted it will continue to pay arbitration fees for any investor who pursues an arbitration claim under \$25,000 against the company.

Public Citizen, a consumer watchdog group that has been circulating a petition asking Schwab to rescind the class-action ban, congratulated the company for its “responsible” decision. It said many of its 19,000 supporters who signed the petition also are Schwab customers who spoke directly to the firm.

Schwab last year asked its almost 9 million clients to sign new account agreements that agreed to waive their class-action rights. The revised policy followed settlements of such suits in which the firm agreed to pay \$235 million for misleading marketing of its YieldPlus money-market fund between May 2006 and March 2008.

Several U.S. legislators led by Senator Al Franken of Minnesota last month urged the Securities and Exchange Commission to prevent all broker-dealers from mandating that clients bring disputes only through arbitration forums.

[Florida Court Rules State Time Limits Apply to Securities Arbitration.](#)

(Reuters) – Florida’s statute of limitations can apply not only to court proceedings, but to securities arbitration cases between investors and their brokers, the Florida Supreme Court ruled Thursday.

The ruling, in favor of Raymond James Financial Services Inc, could, at least in Florida, empower securities arbitrators to cut the time investors have to file a complaint with Financial Industry Regulatory Authority from six years to four years or even two years. And other states could follow.

The decision clarifies a longstanding question about whether FINRA arbitrators can apply a Florida law to determine whether a case is filed in a timely manner. Many securities arbitrations are filed in Florida due to the state's large number of retirees.

A group of investors, who filed an arbitration against Raymond James in 2005, argued the law applies only to court cases, according to an opinion by Florida Supreme Court Justice Barbara Pariente.

"We are very pleased with the result and believe the court made the correct interpretation," said Paul Matecki, general counsel for Raymond James, in a statement.

The Florida Supreme Court decision could spur high courts in other states to question whether their state statutes of limitations should apply to arbitration cases, said Jonathan Uretsky, a New York-based securities lawyer who represents brokerages

That could, in some cases, shrink the amount of time that investors have to file, say lawyers.

Brokerage customers typically agree to resolve their disputes in FINRA's arbitration forum when they sign agreements to open their accounts.

Investor cases are typically eligible for FINRA arbitration if they are filed within six years from the event giving rise to the case, such as the sale of a stock.

Florida law, however, imposes a four-year deadline to file a negligence case, and a two-year deadline to bring a claim under Florida's securities fraud law, according to the opinion.

The Florida case stems from a Raymond James broker's alleged investments in high-risk equities on behalf of the investors between 1999 and 2005, according to the opinion. The broker allegedly did not diversify the risky investments, causing significant losses. The investors also alleged that Raymond James failed to adequately supervise the broker.

Raymond James tried to dismiss the investors' case, arguing that they filed too late.

"We think it's an unfortunate decision for investors in Florida for those who have claims that arise under Florida law," said Scott Ilgenfritz, president of the Public Investors Arbitration Bar Association, a group of lawyers who represent investors in securities arbitration cases. The group filed an amicus brief, or "friend of the court" brief opposing Raymond James' position.

Lawyers who represent brokerages are relieved. "The convoluted argument that has been made by claimants' lawyers to the contrary is nothing other than a transparent attempt to force a respirator on untimely claims that died a long time ago," said Terry Weiss, a securities lawyer for Greenberg Traurig LLP in Atlanta.

Numerous industry groups, including the Securities Industry and Financial Markets Association (SIFMA) and Financial Services Institute, filed amicus briefs, or "friend of the court" briefs, in the case supporting Raymond James.

"Statutes of limitations ensure fairness to defendants confronted with stale claims," said Kevin Carroll, SIFMA associate general counsel, in a statement.

Moody's: Detroit Restructuring Plan Bad for Bondholders.

Detroit emergency manager Kevyn Orr's restructuring plan released this week "puts default squarely on the table" and signals that a Chapter 9 bankruptcy filing is a strong possibility, Moody's Investors Service warned in a comment Thursday.

"The plan is negative for Detroit bondholders because it indicates that the city requires 'significant and fundamental debt relief' to help shore up its finances, a clear indication that a default or bankruptcy is a real option," Moody's analyst Genevieve Nolan said in the comment.

Orr released the 44-page restructuring report Monday, 45 days after taking over the city, as required under state law. As expected, the report paints a grim picture of the city's fiscal position. It also says restructuring long-term obligations is central to the city's survival.

Orr outlines four restructuring options for its bonds: reducing principal, pushing off near-term debt payments, reducing interest rates, and financing "cash recoveries" for bondholders by issuing new debt.

Moody's notes that Orr said the city will use a "fair and equitable" standard to determine repayments. "While not specifically defined in the recovery plan, this language has been used in relation to other bankruptcy proceedings to manage creditors' expectations on recovering their assets in bankruptcy, setting the stage for reductions to all stakeholders, including bondholders," Nolan writes.

All three major ratings agencies maintain junk-level ratings on Detroit. Moody's rates the city's general obligation and pension debt Caa1 and its limited-tax GO debt Caa2. The rating level incorporates the risk of bankruptcy or default.

The GO bonds and pension debt, both of which are paid from the general fund, total just under \$3 billion. The pension bonds total \$1.8 billion, including interest-rate swaps, and make up 20% of the city's bonds, while general obligation bonds total \$1.1 billion and make up 12% of the bond obligations.

Moody's rates the city's \$6 billion of senior-lien water and sewer bonds, which make up 68% of the city's bonds, Baa3 with a negative outlook.

Nearly all of the city's debt carries bond insurance.

Moody's notes that salaries, wages, and overtime account for 33% of the 2012 budget, while debt service makes up 12%, benefits make up 18%, and other expenditures 32%. The city is deferring its pension payment, which otherwise would make up roughly 5% of the budget.

"The relative burden on each of the stakeholders, such as city employees, pension beneficiaries and bondholders, will be determined by the implementation of the EM's recovery plan," Nolan said.

In his report, Orr says that Detroit's very survival relies on being able to bring down its long-term obligations. "Without a significant restructuring of its debt, the city will be unable to break the cycle of damaging cutbacks in essential municipal services and investments," Orr writes.

The report provides the first glimpse of Orr's restructuring plans. He is expected to unveil more details in the next 60 to 90 days.

Congress Eyeing Munis?

Municipal bonds typically can be purchased individually or in mutual funds and other portfolios. Here are the essential tax elements of muni investments.

The interest paid on most muni bonds isn't taxable at the federal level — a benefit that also applies to fund shareholders.

Bond interest frequently also is exempt from state income tax for local residents. This includes thousands of Arizona bonds that are double-exempt.

Any capital gains earned when investors sell a bond for more than they paid are taxable. Tax-deductible losses also are possible. Capital gains or losses typically result from changes in the general level of interest rates, which affect bond prices.

Because they pay tax-free interest, muni bonds and bond funds aren't suitable for Individual Retirement Accounts, 401(k) programs and other tax-sheltered plans.

Municipal bonds pay tax-free interest — that's one of those constants on which conservative investors could always count, regardless of how tumultuous the financial markets became.

Even the latest fiscal-cliff tax deal left muni bonds and bond mutual funds pretty much alone. If anything, the legislation enhanced their appeal by excluding muni-bond interest from the new Medicare investment surtax that now applies to high-income individuals.

But muni-bond proponents — including officials representing various Arizona cities, counties and state agencies that issue debt — are starting to wonder whether Congress is getting ready to take them to the woodshed next. With huge federal deficits continuing, there's a strong sense that some sort of comprehensive tax-reform deal could get hammered out. If so, muni investments could be stripped of at least some of their favorable tax status.

"That risk is about as high as I've seen it in the 20 or so years I've paid attention to these issues," said Michael Decker, a managing director at the Securities Industry and Financial Markets Association, a trade association in Washington, D.C. "It's a political environment where everything is on the table ... there are no sacred cows."

Decker spoke last week in Phoenix at a muni-bond conference hosted by law-firm Ballard Spahr, Fitch Ratings, RBC Capital Markets and the Bond Buyer, an industry publication. The event attracted about 100 municipal officials, attorneys, investment bankers and others. The specter of tax reform was a hot topic.

Both political parties see something desirable in attacking muni bonds, observers say. Many Republicans are skeptical of offering tax-free subsidies to municipal entities, especially as an inducement to borrow more, while Democrats note wealthier Americans are most likely to buy bonds and thus reap the tax benefits. About 4 percent of households report (but generally don't pay tax on) municipal interest, according to Internal Revenue Service statistics.

Because muni bonds pay slightly lower yields than comparable taxable bonds issued by corporations and other entities, they make more sense for people higher up the income ladder.

A tax attack on munis isn't a certainty, nor are the details known at this stage. The Simpson-Bowles

deficit-reduction commission called for no more tax-free bonds to be issued going forward. Other proposals range from capping the tax benefits for people in high-income brackets to disallowing tax-free financing done to help private enterprises.

A recent White House proposal would tax muni interest for people above the 28 percent bracket, meaning someone paying taxes at the top 39.6 percent rate would pay 11.6 percent on muni interest.

Chris Mauro, head of municipal research for RBC Capital Markets and another speaker at the Phoenix conference, said he doesn't expect any legislation in the current year that would impair the favorable status of municipal bonds. But he said that threat now hovers over the market and represents one more risk that investors must factor in.

Tax reform, if it passes, wouldn't apply to tax-free bonds only. Other changes could affect deductions for charitable contributions, mortgage interest, state income taxes and many more provisions.

Infrastructure impact

If Congress did strip away at least some of the tax-free status of munis, some investors would dump their bonds, pushing down prices and pushing up yields. The higher yields then needed to lure investors amid diminished tax appeal would raise borrowing costs for cities, counties and state agencies, with implications for taxpayers in those jurisdictions.

Given budget pressures, many municipal entities already have put capital-infrastructure projects on hold as they have grappled to bring operating costs in line with reduced revenues. Projects that have been tabled include roads, bridges, water-treatment plants, sewer systems, schools and a host of other infrastructure deals that typically have been financed by bond sales.

"Investment in infrastructure has been put on the back burner," said Gary Yaquinto, executive vice president of the Arizona Investment Council. "Arizona is a new state but has aging infrastructure, much of it nearing capacity."

Prior to the recession, many Arizona cities were busy building infrastructure to stay ahead of projected population growth, but more recently the focus has been on rehabilitating and maintaining what already was built, said Jeff DeWitt, chief financial officer for Phoenix.

Eventually, though, officials at many Arizona municipalities still expect to dust off blueprints for bridges, roads, water-treatment plants and other projects and finance them at least partly with money raised in the bond market.

Kristine Ward, assistant director of finance and accounting for the Arizona Department of Transportation, said her agency faces an estimated \$63 billion funding gap through 2035. The financing pressures have been exacerbated by federal-revenue shortfalls and by declining state-tax revenue whenever gasoline prices shoot up and motorists cut back on driving. Pump prices above \$3.50 a gallon seem to be the catalyst for that, she said.

Scope of the market

Phoenix ranked as Arizona's largest municipal-bond issuer with \$7.1 billion of outstanding debt as of a mid-2012 study by the Arizona Department of Revenue, with the Arizona Department of Transportation fifth at \$2.2 billion. The other top-five debt leaders were Salt River Project, the Arizona Health Facilities Authority and the Maricopa County School District.

Cities, counties, state agencies and other issuers look at muni-debt issuance differently today from the way they did in years past, when population and economic growth were more robust. The debt total for all Arizona municipalities roughly doubled from \$20.7 billion in fiscal 2002 to \$41.2 billion in 2009 but has increased only marginally since then. It actually declined a bit last year to \$43.3 billion from \$44 billion one year earlier, according to a mid-2012 report from the Arizona Department of Revenue.

And while Arizona entities did sell \$5.5 billion of new bonds in the latest fiscal year, more than half went to refinance existing debt at lower interest rates, much like homeowners have obtained new mortgages to cut their monthly housing payments.

Nearly all sizable muni-bond issuers in Arizona have maintained top ratings of either double-A or triple-A, despite the challenging economic environment. In general, investors “have a fair degree of confidence in Arizona,” said Jaime Durando, a managing director at RBC Capital Markets.

Favorable factors

While municipal officials wouldn’t welcome tax reform, in some respects it could come at a reasonably good time, all things considered.

Much of the Arizona infrastructure built in anticipation of population growth is still fairly new and in good shape, said Steve Murray, a senior director covering Southwestern states for rating-agency Fitch.

Also, the general level of interest rates is so low that borrowing costs are still historically very cheap. Tax reform would cause prices to drop and yields to rise but it’s uncertain how sharp the reaction might be, and it would be starting from a very low interest-rate level.

Even amid a lengthy and powerful stock-market rally, munis and other types of bonds are holding their own. Bond mutual funds in general have added about \$1 trillion in net new cash flow from investors over roughly the past five years — at the same time that stock funds have lost about \$500 billion in net cash, according to Investment Company Institute data.

Investors continue to favor conservative assets including muni bonds, and an aging population suggests that trend will continue.

Claims under scrutiny

Hundreds of Arizona cities, counties and state agencies issue municipal bonds, and officials must be careful not to make public statements that are misleading or conflict with what they provide to investors in disclosure documents.

In separate cases, the Securities and Exchange Commission recently asserted fraud against officials representing Harrisburg, Pa., and the state of Illinois for making statements about their financial situations that were incomplete, outdated or otherwise didn’t mesh with what they told muni-bond investors. Both Illinois and Harrisburg are having financial difficulties.

In the Harrisburg situation, the SEC for the first time asserted fraud for comments made outside of disclosure documents, said Anastasia Khokhryakova, a partner at law-firm Ballard Spahr, speaking in Phoenix.

Although not citing any Arizona examples, Khokhryakova said any municipalities could face liability over comments made by officials that conflict with what’s provided in their bond-disclosure

documents. As smart practices, she suggests municipalities adopt formal policies to communicate with the public, designate an official spokesperson and provide ongoing training.

— Russ Wiles

SIFMA Municipal Securities Regulation Seminar.

June 5, 2013 University Club of San Francisco

San Francisco, California

The Seminar is Open - Complimentary to all Members of the Municipal Securities Community.

This event is closed to the press.

- SIFMA travels to San Francisco for a presentation by MSRB Regulation staff of their most pressing rulemaking initiatives including:
- duties of underwriters to issuers; retail order periods;
- bond ballot initiatives and
- Rule G-37; and more.

The program will also include FINRA and the IRS on municipal securities compliance and enforcement matters.

The Seminar is Open - Complimentary to all Members of the Municipal Securities Community.

Register at:

<https://mbrservices.net/ConferenceRegistration/MeetingRegistration.aspx?meetingid=1124>

SIFMA: Compliance and Legal Society - Regional St. Louis Seminar.

We cordially invite you to attend the SIFMA Compliance & Legal Society St. Louis Regional Seminar to be held at The Hilton Frontenac on Wednesday, June 5th, 2013. This one day seminar will feature presentations by leading securities regulators and industry professionals.

Topics Include:

- Working with Aging Clients-Competency, Elder Abuse and supervising “complex products”
- Banking business within broker/dealers—dealing with multiple regulators
- Public Finance/Financial Advisors
- Investment Advisors-regulatory, legal and supervisory matters
- Cyber Risk/Data Protection
- NASAA and State regulatory developments

Register at:

<http://www.sifma.org/cl-stlouis2013/home/>

Reps. Stivers, Moore, Lobby SEC Chair White on MA Definition.

Reps. Gwen Moore, D-Wis., and Steve Stivers, R-Ohio, have sent a letter to new Securities and Exchange Commission chairman Mary Jo White urging her to make sure that the SEC's final definition of municipal advisor reflects their bill, which is pending before the House Financial Services Committee.

"We were dismayed in December 2010 when the SEC released the proposed definition of municipal advisor," Stivers and Moore wrote. The pair are sponsors of H.R. 797, which would clarify Section 975 of the Dodd-Frank Act and define MAs as those engaged with issuers to provide financial advice for compensation. The bill contains exceptions for dealers seeking to be underwriters and those providing related advice, as well as bankers, swap dealers and governmental board members.

"The proposed rule went far beyond the scope of Section 975 by encompassing entities and activities that Congress never intended to fall under the definition of municipal advisor," they told White in their letter.

The legislation takes the same tack as a bill sponsored by former Rep. Bob Dold, R-Ill., that passed the House during the last Congress but failed to move forward in the Senate.

The Stivers/Moore bill enjoys the support of dealer groups but has been criticized by non-dealer financial advisors and others who fear it creates a way for banks to circumvent Dodd-Frank.

"We've been actively engaged with Reps. Stivers and Moore since the beginning of this Congress on the issue and we appreciate their writing to the commission," said SIFMA spokesman Andrew DeSouza.

But a market participant who asked not to be named said the letter is dishonest in claiming that Congress never intended for certain participants to fall under the definition. "They're trying to recreate congressional intent after-the-fact," he said. "They're trying to create an after-the-fact record."

The Stivers/Moore letter references the "extensive stakeholder input" that went into the legislation, but the market participant said not a single member of the National Association of Independent Public Finance Advisors was formally included in the process. Nathan Howard, an attorney at Kodner, Watkins & Kloecker LC, who works with non-dealer muni advisors, said there is no record of congressional intent and the bill would create an end-run around the SEC.

"HR 797 prohibits the commission from effectively protecting the interests of state and local government issuers by preventing the commission from regulating entities if they do not receive compensation specifically for their municipal advisory activities, which is contrary to the commission's longstanding philosophy, that can be put simply as, if it looks like a duck, walks like a duck and sounds like a duck, it's a duck," Howard said.

An SEC spokesman declined to comment on the letter, saying the commission will respond to Stivers and Moore. However, John Cross, the SEC's top muni official has said publicly that he would prefer that the SEC be allowed to complete its rulemaking process on MAs before Congress enacts legislation that might possibly force it to go back to the drawing board.

Market participants are clamoring for the SEC to finalize the MA definition. The Municipal Securities Rulemaking Board also has been waiting for the definition, which has held up its efforts to

author new rules and rule changes for MAs.

Originally expected to come out in 2011, then 2012, then the first quarter of 2013, the final definition is still waiting for approval by the SEC commissioners. "Three years after the enactment of Dodd-Frank, it is vitally important that Section 975 be implemented so that state and local governments gain the protections of the regulatory umbrella Congress intended," Moore and Stivers wrote to White.

White is slated to appear before the House Financial Services Committee on Thursday at an oversight hearing on the SEC's budget, operations and agenda.

Kyle Glazer

The Bond Buyer

Muni Bonds Deserve a Tax Break: Obama's proposal to limit the municipal-bond tax exemption would raise the cost of public works.

President Obama's budget, introduced in April, includes proposals to attract private investment in partnership with government for upgrading the nation's infrastructure. As he said in his State of the Union address, "what our businesses need most [are] modern ports to move our goods, modern pipelines to withstand a storm, and modern schools worthy of our children."

State and local governments are crucial for achieving the president's goals. Three-quarters of all U.S. public infrastructure projects are built by state and local governments, and tax-exempt municipal bonds are the primary means to finance them. Unfortunately, the president's budget includes a provision to limit the tax-exempt status of these bonds.

This would make it more costly for governments, and ultimately taxpayers, to improve America's roads, ports, bridges, schools, hospitals, and even its water and wastewater systems.

The municipal bond market has functioned effectively for much of U.S. history, and one important reason was the agreement reached between states and the federal government a century ago that the interest on these bonds would never be subject to the income tax. Tax exemption was an integral part of the debate on the adoption of the 16th Amendment, which authorized the federal government to tax income.

Because municipal bonds have a strong repayment record—much higher than corporate bonds—they provide a safe and reliable investment income for U.S. citizens. More than 60% of municipal bonds are owned by individuals, directly or through mutual funds. The federal tax exemption makes them attractive to all investors, especially those whose income is taxed at high rates.

That would all change if the president's proposal—which would cap the tax exemption at 28% for the top 2% of income earners. Consider someone in the 39.6% bracket earning \$100,000 in municipal-bond interest; he currently pays no federal income taxes on that interest. After a 28% cap, he will pay \$11,600 in federal income taxes—and demand a higher return to offset the tax burden.

Limiting the tax exemption would reduce investor demand for municipal bonds and raise the interest states and localities would have to offer to attract the investments they need. Had the tax-exemption limit been in place from 2003-2012, it would have cost state and local governments an additional

\$173 billion of interest on infrastructure investments, according to an analysis by the Securities Industry and Financial Markets Association. These added costs mean higher taxes.

Worse, the tax cap proposed by the president would apply to interest income on bonds that people have already purchased. That will disrupt the bond market, because the value of bonds held by all investors will decline. The change to 100 years of tax policy also would introduce an unwelcome uncertainty into an efficient public-private system. Investors would demand higher rates simply to protect them from future tax shocks.

One estimate by Citigroup Municipal Strategists puts the tax-risk premium alone at 30-40 basis points, and we've already had a demonstration of what could occur. Further analysis by Citigroup showed that the municipal bond market experienced dramatic rate increases of between 20 and 50 basis points depending on the quality of the bonds in December. The increase was directly related to proposals made during the fiscal-cliff debate to cap the municipal-bond tax exemption.

Washington's renewed focus on rebuilding and improving the nation's infrastructure is welcome, and so is the search for new ways to meet the challenge. However, any new tools must be in addition to—not instead of—the primary financing mechanism that state and local governments have used to meet the needs of their citizens. Let's not dismantle something that works.

Ms. Ganeriwala is treasurer of Virginia and president of the National Association of State Treasurers.

SIFMA: Municipal Bonds - Risky Business?

Why invest in the \$3.7 trillion municipal bond market? Tax exemption, low default risk, and an investment that lends money to state and local governments to build roads, schools, and hospitals, among other essential needs, are among some of the compelling reasons. And the returns: the average weekly value of the Bond Buyer 20-bond GO Index over the last 20 years (1993-2012) is 5.0%. Generally, municipal bond investors' interest income is exempt from taxation, so for an investor in the 35% federal tax bracket and with a 5% state income tax buying in-state bonds, that 5.0% translates into a taxable equivalent yield of 8.3%, a very attractive return for so little credit risk. Now in 2013, with the 39.6% federal bracket back in place and a new tax on investments in effect, the value of tax-exempt interest is even larger.

As with any investment, however, investors need to weigh the risks against the returns and determine if a particular investment meets their specific needs. To be sure, one of the primary concerns of investors in any "fixed-income" instruments like municipal bonds is the effect of rising interest rates on a bond's market value.

Some investors may be concerned that a spike in interest rates could mean losses for municipal bond investors. In the bond markets, prices move inversely to interest rates. If rates spike, investors would see their bonds' market values drop. Bond funds are typically active traders of bonds and their assets are also marked to market daily, so market values in these funds would fluctuate with interest rates. The measurement of the sensitivity of a bond's price to changes in interest rates is known as "duration," and duration generally is higher for longer-term bonds.

For buy and hold investors in individual bonds, this won't matter, as they will continue to receive

principal and interest payments as they come due, and their bonds will generally mature at par. Investors who don't plan to hold a bond until maturity need to weigh the risks and rewards of investing in a particular bond given their investment time horizon. A very low interest rate environment leaves little to no room for interest rates to fall further, but plenty of room for rates to rise. How quickly that may happen and how the market may react are important pieces of the overall investment picture. The Financial Industry Regulatory Authority, or FINRA, recently issued a useful report outlining considerations for bond investors in low interest rate environments like the current one.

Moreover, many investors have been staying out of the fixed income markets because of the currently low market yields or the fear of rising rates. Households hold far more of their assets in bank deposits, money market funds and other "cash-like" investments which currently yield close to 0% than they do in municipal bonds. When interest rates do finally go back up, investors' cash holdings will yield more, and some investors may be incented to return to the bond markets. Still, investors should consider duration risk as an element of examining investment alternatives.

Amid the concerns, this basic fact bears repeating: issuers of municipal bonds have an outstanding record of meeting interest and principal payments in a timely manner. The long-term default rate for rated, investment-grade municipal securities is 0.15%. Unless the credit picture for state and local governments changes in an unexpected and fundamental way, investors who hold their bonds to maturity have a very high likelihood of seeing their investment perform just as expected.

In the interest rate discussion, it should not be lost that this is the best time in generations for state and local governments to borrow money and issue bonds to fund infrastructure and other important projects. Year to date municipal bond issuance through the end of March was 4.8% higher than issuance in the first three months of 2012, and issuance for the full year 2012 was over 28% higher than issuance in 2011. That's good for our municipalities and the people who live - and work - in them.

Michael Decker

Managing Director, Co-Head Municipal Bonds

SIFMA

Moody's: Municipal Defaults Up Since Crisis, But Still Low.

May 7 (Reuters) - Moody's Investors Service said on Tuesday that the number of defaults among the U.S. municipal bonds it rates has risen since the financial crisis but still remains low.

The economy has been recovering but many local governments are buckling under a combination of stresses on their budgets, with places such as Stockton, California, in bankruptcy.

"Revenue and spending pressures from the sluggish economic recovery, including soaring pension costs, have intensified credit stress faced by local governments," Moody's said in its annual report on municipal defaults.

In 2012, there were five Moody's-rated defaults and 23 since the beginning of the recession in 2008, with an average of 4.6 defaults per year, up from 1.3 in the 1970-2007 period.

"We expect states and the vast majority of local governments to continue to do the hard work of rebalancing and adjusting their budgets," it said. "Given long-term demographic trends, cuts in federal spending, and substantial underfunding of pensions and other entitlements, this hard work is by no means over, and will need to continue for some time."

During and after the recession, state and local revenues plunged to record lows. At the same time, the financial crisis ravaged the returns on public pension investments, the primary source of funding for most retirement systems. Revenues are now back at pre-recession levels and many pensions have made reforms, but the federal government is embracing spending cuts that threaten both the grants cities and states receive and their revenue in general.

The five defaults among Moody's rated issuers last year included two towns, Stockton and Wenatchee, Washington. KidsPeace, a non-profit in Pennsylvania, and American Opportunity for Housing in Colinas, Texas, along with California's Oakdale Sewer Enterprise, also defaulted.

Particularly, there has been a rise in speculative-grade rated governments and risks remain in healthcare, Moody's said. Multi-family housing bonds are stressed by historically low interest rates, which can hurt housing projects' cash flow and threaten debt repayment, Moody's said.

Last August the Federal Reserve Bank of New York said defaults are more numerous than rating agencies such as Moody's report. Combining data on unrated and rated bonds, researchers at the bank found that from 1970 to 2011, there were 2,521 defaults, compared with just 71 listed by Moody's.

Usually, bonds sold by smaller municipalities or authorities and carrying higher risk of default do not have ratings from Moody's, Standard & Poor's or Fitch Ratings.

Moody's said defaults in 2012 came close to reasonable expectations, but that "over the longer term - and even since the advent of the financial crisis in 2008 - have been so infrequent as to suggest that our rating distribution on the whole may be too low."

Still, it said it has actively lowered ratings in recognition that credit risk has increased.

Analyst Meredith Whitney predicted a large cascade of defaults two and a half years ago. Even though her forecasts did not come true, they cast a pall over demand for bonds. Last month, a Securities and Exchange Commissioner raised the possibility of a municipal "Armageddon" related to recent bankruptcies and the looming rise of interest rates.

Commissioner Dan Gallagher said the bankruptcies could set legal precedents ending the long-held tradition of fully repaying bondholders when a local government goes under.

"Local government defaults are necessarily high-profile events because of their rarity, of course, but also because of their consequent power to set precedents and expectations ranging from loss recovery rates to bankruptcy case law," Moody's said.

[Newark's Terrible New Foreclosure Fix Idea: Activists in the city think eminent domain can save their neighborhoods.](#)

The foreclosure crisis hit hardest in cities like Newark, New Jersey. Lenders preyed on low-income areas and made loans to people who had little ability to pay them back. Since 2008, 6,810 homes

have been foreclosed in Newark, and citywide, homeowners have lost roughly \$1.8 billion in home values, according to a report from the grassroots advocacy group New Jersey Communities United. This wave of vacant properties increased costs for maintenance and public safety by approximately \$56 million. Blight increases danger in a city; last July, five residents, four of them children, died in a fire that started in one of Newark's vacant properties. Foreclosures also damage the value of neighboring homes. Another 9,000 Newark residents are "underwater" on their homes, meaning they owe more on their mortgage than what their homes are worth.

The situation has made politicians and activists in Newark desperate, enough to explore a controversial idea: using eminent domain to seize mortgages from the lenders and renegotiate them at the market rate. Eminent domain laws enable municipal, state or federal governments to take property for a public purpose; in this case, the public purpose would be foreclosure prevention and the reduction of potential blight.

While the eminent domain option has been discussed in several cities hit hard by the foreclosure crisis—including Chicago and San Bernardino, California—no city has stepped forward to implement such a scheme. And that's because the way eminent domain has been envisioned, especially by the well-connected company trying to sell many cities on the idea, is legally dubious and incredibly risky for the municipality. Properly structured, eminent domain as a foreclosure prevention tool might work. But there are other ways to stop the proliferation of blight in Newark, none of which involve enriching a third party.

The biggest problem with eminent domain is that mortgages are costly, and city budgets, particularly in communities with foreclosure problems, are strapped. So inevitably, they would have to bring in a private partner to acquire the working capital needed to buy the mortgages before resetting them. This ultimately may save the communities money in the long run, from avoided foreclosure costs and more property tax revenue. But in the near term, they're going to need some money.

So far, only one group has stepped forward as a viable partner, an organization called Mortgage Resolution Partners (MRP), run by several Democratic operatives from California. MRP has attempted to activate their eminent domain plan in several cities around the country, but it's not clear whether the deal makes sense for anybody.

First of all, MRP is only interested in dealing with performing mortgages, where the borrower is current on the loan. These are not the people most in need of help from foreclosure. They actually have some options already: The federal HARP program, which extends refinancing options to underwater borrowers, has proven attractive enough to banks (who make money in fees off the new loan and often lock in rates higher than the going average) to become successful, with over 1 million refinances made. While this doesn't give underwater borrowers the cheapest possible interest rate, it does often save them hundreds of dollars a month and makes the loans more affordable. It's borrowers who have missed payments that are most at risk of foreclosure. But MRP doesn't want to help them.

It's also questionable whether performing mortgages are condemnable. If borrowers have been paying for years, why does it serve community needs to take those mortgages over? There's certainly a somewhat higher risk of foreclosure on an underwater mortgage, but the benefit seems to go to the individual borrower rather than the city, which puts the concept in legal jeopardy.

Moreover, under eminent domain, the government entity must offer a "fair value" for the entity it condemns. And there's a big difference between fair value for a house, and fair value for a mortgage. In this case, if a borrower is dutifully paying their mortgage every month, expectations are high that

they will continue paying it. The owner of the mortgage would be unlikely to consider a discounted rate as a fair deal, when the borrower is able to pay full price. Therefore, the only legal way for the government to acquire the mortgage at fair value would be to pay it off in full, a much higher price than the value of the house. MRP, a for-profit company, is obviously more interested in buying the mortgage at a deep discount, taking a cut (reportedly 5.5 percent) when they reset the loan for the borrower and turning a profit. As financial writer Yves Smith, who has criticized this rendering of eminent domain, noted recently, "The mortgages must be stolen." What's more, if the borrower were to default on the new loan, MRP would take none of the risk, which would all be borne on the municipality.

There may be ways to structure eminent domain that make sense for both the municipality and investors. But the most-cited proposal on the table has made communities wary once they dig into the details. And this has given the mortgage lending industry time to counterattack. Not only did it threaten to essentially cut off lending to any community that engages in this kind of scheme, it got some back-up, incredibly, from the Federal Housing Finance Agency, the government overseer of mortgage giants Fannie Mae and Freddie Mac. Last August the FHFA sent a notice to the Federal Register that expressed "significant concerns" with eminent domain plans for mortgages, ominously asserting that "action may be necessary" to avoid any risks associated with the program. Perhaps in part because of these threats, the constitutional challenges sure to arise, and the high-risk, low-reward deal from MRP, San Bernardino, the first city to really explore this idea, gave up on it earlier this year.

Cities like Newark have other options to prevent foreclosures and the troubling rise of vacant properties. One of the biggest issues concerns what is known as a bank walkaway. In this scenario, banks pursue foreclosure (typically to collect foreclosure fees) and evict the homeowner, but instead of completing the process, and therefore taking responsibility for maintenance, property taxes and municipal fees, they walk away. Banks often don't inform the former homeowner or the municipality that they stopped foreclosure, leaving the individual on the hook for any costs, and leaving the municipality confused about whom to hold accountable. This lack of information about abandoned foreclosures violates regulatory guidelines, but banks have accelerated this technique. According to a recent report, over 300,000 vacant homes nationwide are the result of bank walkaways. And one study of Newark showed that almost 43 percent of bank-owned properties in one neighborhood remain vacant.

To combat this, cities could make it cost-prohibitive to foreclose in this fashion. Newark already has a vacant property registration ordinance, which allows for fines of \$1,000 a day for failure to register vacant properties or maintain them. New Jersey Communities United argued that the city should fully enforce that ordinance. A better solution would be to ensure that the ordinance gets assessed on the foreclosing bank, whether they abandon the foreclosure or not. A more punitive fee that would stop bank walkaways and force them to put those homes back into circulation could make banks think twice before foreclosing. In Los Angeles, the city attorney has sued several major banks for failing to maintain foreclosed properties. Only changing the financial incentives surrounding bank foreclosures will lead to a change in behavior.

The lack of support at the state and federal level for communities still suffering from the foreclosure crisis has understandably led municipalities searching for answers. But before jumping into eminent domain, cities can use their existing leverage to encourage better treatment of their citizens.

David Dayen is a freelance writer based in Los Angeles.

NYT: S.E.C. Contends Harrisburg, Pa., Misled Its Bond Investors.

The Securities and Exchange Commission on Monday accused Harrisburg, Pennsylvania's debt-laden capital, of violating federal antifraud rules for securities issuers by repeatedly giving misleading information that created risks for bond investors as the city's finances were rapidly deteriorating.

Harrisburg, pulled to the brink of bankruptcy by a huge debt on its municipal trash incinerator, is also having trouble paying daily bills while it delays payments on general obligation bonds. As a result, it is Pennsylvania's only municipality that is under a state takeover.

The S.E.C. said the charges against Harrisburg, a city of about 50,000, represent the first time a municipality has been accused of misleading statements that were not included in securities disclosures. The S.E.C. is scrutinizing state and municipal governments around the country in connection with offerings in the \$2.7 trillion municipal bond market.

Among the misstatements or omissions by Harrisburg city officials were a 2008 audited financial report that did not mention a downgrade by Moody's Investors Service of Harrisburg's general obligation debt and a midyear financial report in 2009 that did not mention \$2.3 million in debt guarantee payments for the incinerator, the S.E.C. said.

From 2009 to March 2011, the city did not file annual audited financial statements with municipal securities agencies, the S.E.C. said.

On Dec. 31, 2007, the city's bonds and bond guarantees for its agencies totaled about \$500 million, many times its revenue of about \$61 million, the S.E.C. said.

The commission cited cooperation by Harrisburg officials in the investigation and the city's actions to create policies and procedures to ensure that its financial statements are accurate. As a result, the S.E.C. did not impose a financial penalty, and the city did not admit to or deny the commission's accusations in its settlement of the charges. Still, the S.E.C. ordered Harrisburg not to violate disclosure rules again.

"In an information vacuum caused by Harrisburg's failure to provide accurate information about its deteriorating financial condition, municipal investors had to rely on other public statements misrepresenting city finances," George S. Canellos, co-director of the S.E.C.'s enforcement division, said.

Cities to Assist Families in Debt to Public Utilities through NLC's New LIFT-UP Initiative.

In collaboration with municipal leaders in a small group of cities, NLC has launched an innovative, two-year pilot program called Local Interventions for Financial Empowerment through Utility Payments (LIFT-UP) that seeks to help low-income families pay their utility bills and achieve financial stability.

Through LIFT-UP, NLC's Institute for Youth, Education and Families will test a new model in which cities identify families who are in debt to city-owned utilities and offer them a restructured payment plan, payment incentives, and a variety of financial empowerment services. Cities participating in

this pilot project include Houston, Texas; Newark, N.J.; Savannah, Ga.; and St. Petersburg, Fla.

The LIFT-UP initiative is supported by grants from the Center for Financial Services Innovation (CFSI) Financial Capability Innovation Fund II, the Ford Foundation, and the Annie E. Casey Foundation.

“Too many families are struggling to make ends meet and pay for basic necessities like electricity, water, and heat,” said Newark Mayor Cory Booker. “Connecting residents to financial coaching, while allowing for some restructuring of their utility debt, is a smart approach to financial empowerment. This effort has the added benefit of bringing in revenue we might not otherwise see. Privately-funded, publicly-run pilot programs like the LIFT-UP project are essential to innovation in municipalities across the country. I’m thankful to the National League of Cities for orchestrating this initiative and I look forward to working with my team to make it a success.”

“I am excited to see how LIFT-UP will be able to offer a helping hand to residents who are in debt to city-owned utilities, such as our water and sewer system,” said Houston Mayor Annise D. Parker. “At the same time, we will be able to provide counseling and education to help them keep out of financial trouble in the future. As we face a nationwide epidemic of personal debt crises, this program may help some in at least one arena, and hopefully enable them to stay out of debt in the future.”

Municipal Financial Empowerment Initiatives

Even before the recession, millions of Americans faced acute financial hardship, with insufficient income and assets to withstand unexpected crises such as job loss or large medical bills. Recognizing the disastrous consequences for children, families, and neighborhoods when these crises occur, city leaders have developed increasingly sophisticated financial empowerment (FE) strategies in recent years in an effort to help low- and moderate-income families stabilize their finances and begin to accumulate savings.

These strategies include outreach campaigns to connect residents with federal and state tax credits and benefits; efforts to reduce reliance on check cashers and payday lenders; matched savings initiatives; financial education programs; credit repair services; assistance finding employment; and individualized financial coaching.

Reaching Families in Debt

At the same time that cities are developing FE initiatives, however, city-owned utilities may be working at cross-purposes by aggressively seeking repayment of debts owed by low-income residents. This “disconnect” within local government represents a major missed opportunity to identify and assist struggling families.

While utility debt is not a large fraction of overall consumer debt, unpaid utility bills are a reliable indicator that families are in serious financial trouble since they typically must make these ongoing payments to maintain their housing.

Aggressive debt collection efforts not only exacerbate the problems that FE services are designed to address, but may also represent an ineffective approach to maximizing city revenues. Families’ ability to pay their utility bills and meet other financial obligations on an ongoing basis is directly linked to the success of local financial empowerment initiatives. In addition, municipal governments that turn to private debt collection agencies often pay high fees that limit the amount of net revenue collected.

“When families cannot pay their utility bills, it is often a sign that they are in deep financial distress,” said NLC President Marie Lopez Rogers, Mayor of Avondale, Ariz. “By connecting these residents with existing financial empowerment programs, LIFT-UP project cities will help them reduce debt and strengthen their ability to pay bills on time. The project will also provide cities with a sustainable way to increase revenues from utility payments.”

The LIFT-UP Model

Through the LIFT-UP initiative, NLC will test a new framework to align local financial empowerment services with municipal utility debt collection practices, identifying struggling families with the goal of helping them become financially secure.

By working with cities to pilot the LIFT-UP model, NLC will focus on:

1. Forging connections between utilities and FE agencies to identify eligible residents;

City-owned utilities will develop a streamlined identification and referral system to connect indebted residents with a financial counselor. The counselor will work with families to identify their financial needs and connect them to existing services.

2. Designing and testing a new mix of products and services that can financially empower indebted families, help them pay overdue bills, and prevent future accumulation of debt;

Each participating city already has in place a network of FE services that can be targeted toward struggling utility customers participating in the LIFT-UP program. In some cities, these services are offered by city agencies – such as Newark’s Financial Empowerment Centers – and in others they are available through partnering organizations.

3. Restructuring outstanding debt owed to city-owned entities and using behavioral economic approaches to facilitate debt repayment.

Financial counselors will work with participants and utility companies to negotiate a restructured debt repayment plan incorporating behavioral economic principles that incent repayment. For instance, local variations of the LIFT-UP model may provide participants with forgiveness of a portion of debt if regular payments are made, deposit funds into a savings account when customers repay a specified amount of their debt, or convert the customer’s debt into a credit union loan.

Throughout the initiative, NLC will provide each city with in-depth technical assistance and peer networking opportunities through site visits, cross-site convenings, conference calls, and partnerships with other national experts in the financial empowerment field.

Program Evaluation and Broader Project Implications

NLC has partnered with the Center for Financial Security at the University of Wisconsin-Madison, which will evaluate the effectiveness of the LIFT-UP model in improving participants’ ability to repay their debts, increasing on-time payment of their utility bills, reducing their debt levels, and decreasing city spending on utility shut-offs and debt collection.

If the LIFT-UP program is successful in achieving these objectives, it could affect the way other fee-collecting city agencies, such as public hospitals or municipal courts, structure their debt collection practices. This framework, developed in collaboration with cities that are leaders in the FE field, has the potential to create a “win-win” scenario that brings key services to struggling residents while bringing needed revenue to cities.

Details: For more information about the LIFT-UP initiative, contact Denise Belser at (202) 626-3028 or belser@nlc.org.

The Bond Buyer's Financing Municipal Utilities Symposium - May 16-17, 2013 - Houston, TX

Municipal water, wastewater, and power utilities' overstressed infrastructure are in the spotlight, as policy makers look for ways to close yawning gaps between their capital-investment needs and the revenues already identified to fund them.

Hurricane Sandy cast a harsh spotlight on the fragility of the nation's utility grids, even in the nation's most populous areas. But the shortcomings were no surprise to insiders: if current trends persist over the next five years, capital investment in water and wastewater systems will fall short of the needs by \$109 billion, and power-grid spending will fall \$25 billion short, according to the American Society of Civil Engineers.

Meanwhile, state and local policy makers are increasingly looking to their utilities — and their independent revenue streams — to help advance energy-efficiency and renewable energy goals despite the continued stress on local government budgets from the struggling national economy.

TOPICS TO BE COVERED

The Bond Buyer's inaugural Municipal Utilities Conference will address these pressing issues, and bring together the state and local leaders who are at the forefront of designing solutions. Join us in Houston, May 16-17, at the Hilton Americas-Houston, to learn:

- Which utilities have emerged as national leaders in designing and funding capital investment programs to meet their communities' needs, what are they funding, and how did they build the revenue base they need?
- How innovative financing structures, from full public-private partnerships to design-build contracts can help bridge the gap between needs and local utilities' ability to pay for upgrades.
- Whether general government fiscal stress can spill over to the municipal utility sectors, and what happens in bankruptcy court if it does?
- If global climate change will really force a wave of capital spending to harden utilities against damage from future storms and flooding. How soon will the changes emerge, and what will that mean for bond sales and investor protections?

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<http://www.bondbuyer.com/conferences/utilities/>

Forbes: Mortgage-Seizure Plan Resurfaces As Investors Try To Kill It For Good.

Later this week, securities-industry representatives will jet out to Nevada and California to try and tamp out a brushfire they thought they'd extinguished last year. In meetings with officials in North Las Vegas; Richmond, Calif. and possibly other foreclosure-plagued cities they will once again argue against a plan in which cities would use their eminent-domain powers to seize mortgages so they can be refinanced at lower rates.

"I feel like I'm playing a game of Whac-A-Mole," said Vincent Fiorillo, a portfolio manager with DoubleLine Capital, which has more than \$50 billion invested in mortgage-backed securities. "This idea keeps coming back."

Fiorillo belongs to the Association of Mortgage Investors, which, along with the Securities Industry Financial Markets Association, talked San Bernardino, Calif. and several neighboring cities out of adopting the eminent-domain scheme last year, saying it would be "immensely destructive to U.S. mortgage markets" and force lenders to avoid those cities in the future. Despite their efforts, Mortgage Resolution Partners, a firm affiliated with Evercore Partners, has signed up the city of Richmond and several others it won't name to try and pursue the same plan.

John Vlahoplus, MRP's chief strategy officer, said the program is designed to do what banks and loan servicers are unwilling or unable to do: Restructure mortgages with lower principal amounts and payments, taking advantage of state and federal incentives that can mount to as much as \$100,000 per loan. The "public purpose," necessary for any condemnation, would be to prevent further foreclosures and erosion in property values, he says.

"These are toxic loans, and they are toxic for the community," Vlahoplus told me.

Investors like Fiorillo disagree - vehemently. They say the moment for MRP's plan, if it ever made sense, was in early 2009, when the percentage of loans in hard-hit cities like Richmond that were falling into delinquency and default peaked above 60%. Since then even in Richmond, where unemployment still runs above 13%, delinquencies have fallen to a fraction of their peak levels while private lenders - the only ones targeted by MRP's proposal for political and legal reasons - have extended principal forgiveness to 20% of borrowers.

Another big problem with MRP's plan, critics say, is despite protestations to the contrary the only mortgages the firm will be able to restructure are performing loans. That's because the plan relies on pulling loans out of private-label securities trusts at a discount and reselling them to agencies like Fannie Mae, Freddie Mac or the Federal Housing Administration.

"Even FHA has some underwriting standards," said Tim Cameron, head of the asset management group at SIFMA, which represents big banks and asset managers. "If a city seizes a non-performing loan, they own it. The theory only works if they can refinance it."

Vlahoplus says cities could still provide borrower relief by restructuring the loans themselves, possibly with financial assistance from the Treasury's Hardest Hit program.

Unanswered legal questions swirl around the entire proposal. Proponents say cities can seize any kind of property they want under eminent domain, even paper assets like stocks and bonds. Robert Hockett of Cornell Law School, considered the intellectual father of the MRP plan, told me "intangibles are quite commonly taken," although he acknowledged there are no examples of residential mortgages being seized.

Second, the mortgages are claims embedded in trusts, typically governed by Delaware law and traded far from the cities doing the seizing. Investors like DoubleLine don't own the underlying mortgages except through bonds issued by those trusts, and no one has ever used eminent domain to pluck individual mortgages out of a trust. The assumption is that would cause the entire trust structure to collapse, causing mayhem in the mortgage-backed securities market.

Hockett said property law is clear that local courts have jurisdiction over claims against real estate in their area, and investors who bought securities backed by those loans should understand that cities can seize them through eminent domain. The cities are actually trying to do these trusts a favor, he adds: By seizing loans that are in high danger of default because they exceed the value of the underlying home, Hockett says, cities would be improving the overall quality of the pool.

"The thought is the trustees would love to sell these out of the trust, but they can't," he said.

Fiorillo laughed at that suggestion. Hedge funds and managers like DoubleLine have been coining money on subprime loans for several years now specifically because defaults are plunging at the same time as the value of the underlying collateral rises. Since cities will likely only be able to seize performing loans, Fiorillo says, the plan really represents a transfer of wealth from one set of investors to another, with an otherwise current borrower getting lower payments in the deal.

"Just because you're upside-down doesn't mean you're in need of forgiveness," Fiorillo said. "You borrowed your money, you pay it back."

Finally, there's the question of how to value the loans. The Fifth Amendment requires cities to pay fair market value for property they seize, but nobody can explain precisely how a court in, say, Richmond can determine the value of one loan out of 1,000 or more in a given pool, which itself has been sliced and diced into a profusion of different securities. Investment banks assembled many of these pools with different types of loans in different regions as a sort of internal hedging mechanism; if all the performing loans in California are suddenly sucked out of the pool at a price a court there considers "market value," that could have severe repercussions for the remaining value of the pool and all the securities backed by it.

Vlahoplus, a Harvard Law grad and Rhodes Scholar with years in the real estate securities business, said "this is just business. These are just financial assets."

"How does DoubleLine determine the price of that loan? It uses financial models. And so will the city," he told me. As for undermining the internal structure of the pool, he said, investors would be in no different shape than if the cities seized the houses themselves and extinguished the debt that way. In either case, the loans would be sucked from the pool.

(I asked both Vlahoplus and Hockett why cities don't do exactly that. If, as they both maintain, even current borrowers who are underwater on their homes have a 70% chance of defaulting, why not rescue them from that situation by seizing their homes and renting them back to them at a lower monthly rate? They said that would leave on the table thousands of dollars in state and federal aid for mortgage restructuring. Investors, of course, cite current statistics to show that less than 20% of current borrowers in cities like Richmond are likely to default in the future and the number is dropping rapidly, so current borrowers don't need help simply because they bought at the peak of the bubble and owe more on their homes than they are currently worth.)

It's one measure of the success of MRP's plan that it has driven investors like DoubleLine into Defcon 1 mode. Vlahoplus says investors have nothing to fear, because eminent domain will merely break up a financial and legal logjam that prevents private mortgage pools from restructuring loans.

He says when it comes down to it, the cities – with MRP as advisor – will negotiate terms with the pools.

MRP has every incentive to do that: Under the terms of its proposals with Richmond and other cities, it stands to earn \$4,500 for each loan it restructures. The firm is targeting only private mortgage pools, Vlahoplus said, because federal law preempts cities from seizing loans guaranteed by federal agencies like Fannie and Freddie.

Cameron of SIFMA said the reality is private pools are in many cases doing a better job than the agencies of restructuring these loans. Cities may get a rude shock when they try to seize private-label mortgages that are actually held in the trading portfolios of Fannie and Freddie, he said. He also ridiculed the idea of negotiating the sale of these mortgages when cities hold the gun of eminent domain to investors' heads.

"It's a non-starter," he said. "Asset managers, as fiduciaries, have to go to court to make sure somebody doesn't pick their pockets."

"They say we're threatening them," he added. "No, it's the obligation we have."

WSJ: Kerry Mayo, on the Benefits of Individual Bond Portfolios.

The biggest reason to use bond portfolios made up of individual bonds for your clients is that you can create something that is specific to the client. Bonds funds tend to be more generic and don't always work with clients' objectives.

But with individual bonds you can be more flexible, making sure clients' funds are there when they need them.

One thing to realize is that it's important to be working with client portfolios that are large enough to provide a good amount of diversification. For example, a bond portfolio less than \$250,000 can't purchase enough different issues to provide that diversification.

What we've found is that as interest rates have declined, finding attractive yields is getting harder and harder. There's not a lot of yield available from regular corporate bonds, or regular tax-free municipal bonds—the common ones tend to trade more like commodities. So we think that we can create value for our clients by using bonds that are different than regular corporate or municipal bond bullet structures.

One of the things that we found a lot of value in is collateralized mortgage obligations, which are backed by cash flows from mortgages. When borrowers make their mortgage payments, they pay both principal and interest. So instead of getting the entire principal back at the end as with regular bonds, investors receive staggered payments depending on how the underlying loans were prepaid, either through refinancing or someone selling their home to move.

The CMOs are backed by mortgages, which can be insured against losses. Also a process called tranching means that junior, or subordinated class bondholders absorb any losses first. Understanding these factors allows you to choose which CMO is the best value for the client.

We've also found value in a specific kind of structured note called "steepener" notes, which base their coupon on the spread between interest rates of different maturities. There's also value in

municipal bonds as long as you dig deeper to find what we call “story” bonds. These might look like bad investments on the surface, but when you dig into what the bond collateral is, they’re actually a great value.

It’s important that advisers do their homework and understand how to analyze all the factors that go into buying individual bonds. Having a good bond broker can also help. You need to understand the risks, so that if you’re taking higher risk you’re getting properly compensated with higher return.

Yields have been going down, but when they go up, the value of bond funds will fall. Investing in individual bonds can give clients some protection. In many ways it’s a timing issue. The value of the bond portfolio isn’t necessarily as important as the client’s money being there when they need it. Even if a bond falls in value, individual bond portfolios can be structured so the client still gets the cash flows they need.

Kerry Mayo

Voices is an occasional column that allows wealth managers to address issues of interest to the advisory community. Kerry Mayo is a financial planner with Clifton Park, N.Y.-based Capital Financial Advisors of New York.

[National Association of Counties: President’s FY14 Budget Targets Key County Priorities.](#)

Click here to see NACo’s presentation on the president’s FY14 Budget.

http://www.naco.org/legislation/Documents/NACo-Presentation_FY14-Presidents-Budget.pdf

Click here to see a detailed table comparing the proposed FY 14 and actual FY 13 budgets:

<http://www.naco.org/newsroom/countynews/Current%20Issue/4-22-2013/Pages/Crunching-budget-numbers-proposedFY14-vs-actualFY13.aspx>

President Obama’s \$3.6 trillion budget for FY14 includes proposals that would, if adopted by Congress, make big changes to the way counties do business across the country.

It recommends measures to achieve \$25 billion in savings in FY14 through eliminating and consolidating programs, and cutting spending in others. It proposes reducing discretionary spending through the annual appropriations process from 8.3 percent of Gross Domestic Product (GDP) in FY12 to 7.3 percent in FY14 and 4.9 percent by FY23. It lays out a plan to cut the deficit by \$1.8 trillion over the next 10 years, bringing it below 2 percent of GDP by 2023; when combined with the sequester, it would cut the deficit by \$4.5 trillion.

The budget’s highlights – or lowlights – for counties include:

Cap on Municipal Bonds – It’s Back

As in last year’s proposal, the president’s FY14 budget would impose a 28 percent cap on the value of certain tax benefits, including tax-exempt interest. This would have the effect of partially taxing otherwise tax-exempt municipal bond interest and would apply to taxpayers in the 33 to 39.6 percent tax brackets. As proposed, the cap would apply to both newly issued and outstanding bonds beginning in 2014.

NACo will continue to oppose this and any other proposals to change the tax-exempt status of municipal bonds, which would raise borrowing costs and undermine an essential financing tool for county governments.

As an alternative approach to infrastructure investment, the president proposes establishing the America Fast Forward (AFF) Bond program. Similar to the Build America Bonds program that expired at the end of 2010, the AFF program would provide state and local governments that issue conventional taxable bonds with a subsidy payment equivalent to 28 percent of the interest on the bonds. The AFF bonds could be used for purposes currently eligible for tax-exempt bonds starting in 2014.

If AFF bonds are issued in 2014 and 2015 for school construction and new capital projects for 501(c)(3) nonprofit educational entities, issuers would receive a 50 percent subsidy payment. The AFF proposal does not address reduced subsidy payments due to sequestration, which is currently confronting Build America Bond issuers.

Community Development Block Grant – On the Chopping Block

The Department of Housing and Urban Development (HUD) budget proposes cutting Community Development Block Grant (CDBG) formula grants by \$280 million, from \$3.07 billion in FY13 to \$2.79 billion under the president's FY14 proposal. This is 37 percent below FY10, 17 percent below FY11 and 28 percent below FY12. It does, however, propose retaining the 20 percent for administrative costs. Additionally the budget proposes statutory changes to establish a minimum grant threshold for CDBG and eliminates the community-grandfathering provision for entitlement communities.

Who Needs SCAAP?

The Department of Justice budget proposes eliminating funding for the State Criminal Alien Assistance Program (SCAAP). In FY13, SCAAP provided \$220 million (pre-sequestration) to help offset costs incurred by counties for jailing undocumented immigrants.

Public Lands County Payments Targeted for Reauthorization

The president's FY14 budget for the Department of the Interior proposes legislation to extend mandatory funding for the Payment in Lieu of Taxes (PILT) program at \$410 million, an increase of \$8.8 million from the FY13 level. The budget also proposes an independent public evaluation of PILT to review the program, in both concept and practice, with the goal of developing options to put the program on a sustainable long-term funding path.

The U.S. Department of Agriculture (USDA) budget proposes a five-year reauthorization of the Secure Rural Schools and Community Self-Determination Act (SRS), starting in FY13, with mandatory funding. The FY14 payment is proposed at \$278 million, a reduction of \$68 million from FY12 levels. The USDA Forest Service has recently announced that funds already distributed under the most recent SRS extension or payments based on revenue generated in FY12 are subject to the FY13 sequester, and the agency will be requesting repayment of \$17.9 million in SRS and "25 percent fund" payments that have already been disbursed. The National Governors Association, NACo and more than 50 members of Congress are pushing back against the White House Office of Management and Budget (OMB) and USDA over the legal authority of applying the sequestration cuts to FY12 SRS payments.

Water Loans Levels Drop Some More

The Environmental Protection Agency (EPA) receives \$8.15 billion under the president's FY14 budget numbers. This is a decrease of \$348.1 million over FY13.

In what's becoming a bad habit, the Clean Water State Revolving Funds (CWSRF) and Drinking Water State Revolving Funds (DWSRF) continue to decrease under the proposal. For FY14, the budget proposes \$1.1 billion for CWSRF and \$817 million for DWSRF. This is a decrease of \$300 million and \$56 million for each program, respectively. SRF programs provide water grants to eligible communities based on state water priority projects.

In the proposal, EPA stressed its increased focus on funding small, underserved communities for SRF funds.

Medicaid Mostly Spared

As predictable controversies swirl around the president's proposals to slow the growth of Social Security and Medicare, cuts to Medicaid appear to be off the table. The budget documents for the Department of Health and Human Services (HHS) emphasize a commitment to implementing the Affordable Care Act (ACA) fully in 2014, including the expansion of Medicaid to non-elderly, childless adults with incomes below 133 percent of the federal poverty level. Keeping Medicaid stable may reassure skeptical states that the Medicaid expansion is not a "bait and switch."

The budget does propose a few modest legislative proposals to trim the program, which would result in just over \$22 million in savings. These include extending the ACA's cuts to Medicaid disproportionate hospital share (DSH) payments into FY13. This is now a routine adjustment that prevents DSH payments from jumping back to pre-ACA levels at the end of the 10-year budget window, yielding a few billion dollars compared to current law.

The budget also asks Congress to delay the DSH cuts scheduled for 2014 to help states and county hospitals adjust to ACA implementation. The proposal calls for spreading the cuts out over 2016 and 2017 to maintain budget neutrality.

Transportation on Track

The budget proposes a total of \$76.6 billion in discretionary and mandatory funding for U.S. Department of Transportation (DOT), an increase of 5.5 percent or \$4 billion above FY12. Highway funding is consistent with the authorization levels contained in MAP-21 (the federal surface transportation act) with a \$40.1 billion obligation level. Transit funding reflects the \$10.9 billion authorization level contained in MAP-21: \$8.59 billion for formula grants and \$1.98 billion for capital grants.

The budget also proposes a new \$50 billion "fix-it-first" initiative for immediate transportation investments, including \$40 billion to improve existing infrastructure assets most in need of repair, \$10 billion to help spur states and local innovation in infrastructure development and leveraging state, local, tribal and private funds, and a \$2 billion competitive grant program that targets investment in roads, railways and runways. This is the fourth time the Administration has made a similar proposal.

Rural Business Programs Consolidated; Water-Wastewater Grants Chopped

The president's budget increases overall budget authority for USDA Rural Development by 10 percent to \$2.28 billion above the FY13 level. This increase returns the agency to a funding level slightly higher than the pre-sequester FY12 enacted level. However, most of the increase went to Salaries and Expenses (\$58 million or 10 percent) and Rental Assistance Grants (\$177 million or 21

percent), while Water and Waste Disposal Grants (\$93 million or 23 percent) and Single Family Housing Direct Loans (\$40 million or 80 percent) were targeted for major cuts.

The deep cut in the Water and Waste Disposal Grants will make rural water projects cost-prohibitive for some rural communities, and the shift towards a reliance on direct loans is unsustainable in the long run as interest rates will eventually rise, which will dramatically decrease the water infrastructure loan financing available through USDA.

The most significant rural development policy shift is the proposal to consolidate six of the agency's rural business programs into the Rural Business and Cooperative Grant Program, funded at \$55 million. This shift would eliminate the Rural Business Opportunity Grants, Rural Business Enterprise Grants and Rural Microenterprise Investment Program, which are three programs that counties and their public and nonprofit partners use in their economic development efforts.

The new program will provide the benefit of one streamlined application, a focus on regional priorities and \$20 million in additional overall funding. However, NACo is concerned about public sector grantees being lumped into a program that will now directly serve individual producers, cooperatives, nonprofits and rural businesses as well through the authorities of the Rural Cooperative Development Grants, Grants to Assist Minority Producers and the Rural Community Development Initiative.

The budget no longer includes the Regional Innovation Initiative proposal, which NACo supports, and instead promises to concentrate on regional priorities through the new consolidated business program. NACo opposes the proposal to eliminate the Water-Wastewater and Community Facilities Guaranteed Loan Programs, High Cost Energy Grants and Economic Impact Initiative Grants.

Virginia Circuit Court finds \$2.1 Billion Virginia P3 Unconstitutional.

A Virginia Circuit Court judge has ruled that the financing mechanism of the Elizabeth River Crossings project in the southeastern part of the state is unconstitutional, calling into question the future of the multi-billion dollar public-private partnership and other Virginia P3s.

Judge James A. Cales Jr. ruled from Portsmouth in *Meeks v. Virginia Department of Transportation* that the Virginia General Assembly went beyond its state constitutional authority in granting VDOT a free hand to set toll rates supporting backing the debt of the \$2.1 billion tunnel under construction beneath the Elizabeth River between Norfolk and Portsmouth. The project is supported by \$664 billion of private activity bonds and a \$422 million federal loan under the Transportation Infrastructure Finance Innovation Act.

The tunnel, scheduled for completion in 2017, is intended to help clear congestion in one of the commonwealth's major population centers, but a group of citizens brought the lawsuit last year after the project's agreement with VDOT specified that drivers would begin paying tolls in January to use an existing tunnel. That revenue is being covered by VDOT in the interim. While area residents celebrated the decision, state leaders expressed disappointment. Virginia has become a national leader for P3s under Gov. Bob McDonnell, with the ERC project as the crown jewel.

Last month, the project was honored as the 2012 North America Toll Road Deal of the Year by Project Finance Magazine.

The private company formed for the project, Elizabeth River Crossings, LLC, is to operate and

maintain the tunnel for 58 years under the terms of its agreement with VDOT. The company will also take point on several other major transportation projects in the area. McDonnell vowed to contest the circuit court's decision.

"I am disappointed with the ruling made by Circuit Judge James A. Cales Jr. in Portsmouth today regarding the tolling for the critically needed Elizabeth River Crossings project, including the Midtown Tunnel, the Downtown Tunnels and the Martin Luther King Boulevard among other improvements," McDonnell said following the decision. "The existing tunnels were built with toll revenues and tolls are needed again to build a second Midtown Tunnel and make other essential improvements for the sake of safety and efficient travel. The commonwealth will seek a stay and appeal the judge's ruling to the Virginia Supreme Court because we believe the state's position is legally correct through the Virginia Constitution and state code."

Brian Gottstein, a spokesman for Virginia attorney general Ken Cuccinelli, said the decision could have grave implications for tolled projects all over the commonwealth.

"The revenues raised through the tunnel tolls were user fees to be used solely for a single transportation project," Gottstein said. "As such, we still believe the tolls cannot be considered a tax and that it is completely within VDOT's authority to set reasonable tolls to pay for the construction, operation, and maintenance of the project. Certainly, we are disappointed with the court's decision. We expect to appeal. If this ruling stands and becomes the law of Virginia, it would threaten the commonwealth's ability to use public-private partnerships to construct major transportation projects. Many tolled projects could require legislative approval before proceeding, which would mean significantly increased costs and construction delays."

Scott Zuchorski, who rates the project's debt for Fitch Ratings, said it is not yet clear what the decision will mean for the project and its rating. Fitch and Standard & Poor's have both rated the project's debt BBB-minus, and the PAB deal came to market in April 2012 with yields ranging from 4.45% with a 4.25% coupon in 2022 to 5.5% priced at par in 2042. That was "slightly below expectations," according to a Fitch report.

"At this point we'll obviously continue to monitor it," Zuchorski said, adding that under the concession agreement VDOT would shoulder the burden to pay the bondholders.

"We think VDOT would be on the hook to pay off the ERC debt," Zuchorski said.

A panel of three judges would need to approve the appeal before it could go before the seven justices of the Virginia Supreme Court.

Kyle Glazier

The Bond Buyer

[WSJ: Distressed-Debt Investor Persuades Cities to Play Ball.](#)

When Laurence Gottlieb pitches his private-equity fund to investors, he says they often ask the same question: "What is going to happen if you buy a nursing home and kick granny out on the street?"

His answer: "That's not our business."

Investing in distressed municipal debt is a rough-and-tumble game. Fundamental Advisors LP, where Mr. Gottlieb is chairman and chief executive, is one of the biggest and best-known investors in the business.

Fundamental has bought debt in senior-care facilities, college dorms and the sewer system of bankrupt Jefferson County, Ala. Last month, the firm finished raising a \$450 million investment fund that includes money from pension funds and other big investors.

The 44-year-old Mr. Gottlieb, a former municipal proprietary trader at Citigroup Inc., says Fundamental eschews the “sharklike private-equity model” that buys up targets, siphons off cash and makes few improvements. To succeed, Mr. Gottlieb must often convince political officials that a deal will benefit the greater good, not just Fundamental’s bottom line. “We don’t pave paradise to put up a parking lot,” he says.

The strategy is being put to work in Memphis, Tenn., where Fundamental bought \$58 million in municipal bonds on a downtown baseball stadium for about 42 cents on the dollar in late 2010.

More than a third of pest-management companies in the U.S. were called in by hospitals in 2012 to exterminate bedbugs, according to a new survey by the National Pest Management Association. MarketWatch’s Jim Jelter reports.

Park’s owner defaulted on the bonds when ticket, food and beer sales didn’t live up to expectations. After essentially taking financial control of the ballpark, Fundamental spent \$2 million on an upgraded scoreboard, improved seating and other efforts to make the park more family friendly. Attendance rose.

The private-equity firm now is helping lead talks to sell the park and the team. One proposed deal would involve an investor group led by the St. Louis Cardinals buying the minor-league Memphis Redbirds from their nonprofit owner.

The other piece of the proposed deal could involve the city borrowing money to buy the stadium from the nonprofit group. The proceeds of the deal would be used to pay off Fundamental.

To pay for the new bonds, Memphis would collect sales taxes from the stadium and lease payments from the Cardinals.

Not everyone is sold on the idea. “I can’t support the city getting in further debt or issuing bonds to buy a stadium when we could issue debt to rebuild our roads,” said Harold Collins, a member of the Memphis City Council. Other city and team officials say residents have an interest in preserving the stadium because it is a vital part of downtown Memphis and generates jobs. Fundamental has assured city officials that the deal won’t result in additional costs for taxpayers.

If the deal goes through, the firm is targeting a return on its distressed-debt purchase in Memphis in the 15%-to-20% range that is typical of its private-equity deals.

[In Congress, a Bill Seeks to Tie Municipal Borrowing Power to Public Pension Disclosure.](#)

Representatives from California and two other states introduced a bill in Congress on Thursday that would strip states and cities of their right to issue tax-exempt bonds unless they first disclosed the

true cost of their pension plans and whether they could pay it.

The measure seeks to prevent more municipal bankruptcies like the one in Stockton, Calif., where the city has defaulted on hundreds of millions of dollars' worth of municipal bonds but continues to pay hundreds of millions of dollars more in pension costs.

A debate is now raging in that bankruptcy over which of the two debts has legal priority. The question has far-reaching implications both for labor relations and the building of public works, and many experts expect the Supreme Court to have the final say.

Sponsors of the disclosure bill, all Republicans, said Stockton and other distressed cities would not be in such deep trouble — and their workers, residents and bondholders exposed to such painful losses — if they had been keeping accurate track of what they promised to their retirees all along.

Sponsors said they wanted to send a signal that no matter what else happened, the federal government would not bail out states, cities or other governments that promised more than they could deliver.

"The costs of public pension funds are driving an increasing number of states and municipalities toward insolvency," said a sponsor of the bill, Representative Devin Nunes, a California Republican whose district includes Fresno and other inland cities that are still struggling to recover from the housing bust and the Great Recession.

Another sponsor, Darrell Issa, also a California Republican, said he thought that because pension costs were essentially hidden, state and local officials could "pander to both public employees and taxpayers" by racking up huge promises that local taxpayers would never agree to if they understood the cost.

"The key to addressing this problem is shining a light on the financial health of pension systems and making clear that federal taxpayers will not pick up the bill for reckless mismanagement," said Mr. Issa, whose district includes prosperous communities in San Diego County, which has had pension trouble, and Orange County, which declared bankruptcy in 1994 after its aggressive investments soured.

Other sponsors were Paul Ryan of Wisconsin, chairman of the House Budget Committee, and Senator Richard Burr of North Carolina. He said he would introduce the Senate version of the bill in a few days.

The bill would not require governments to change the type of benefits they offered workers, or to invest their retirement money in any particular way. The federal government has little or no power to direct such decisions by states and cities because of state sovereignty provisions in the Constitution.

A similar bill was introduced in 2011, and while it picked up sponsors from both parties, it drew withering opposition from public employees' unions, who viewed it as an attack on public workers. They argued the bill was a deliberate effort to make pensions look exorbitant, to stoke taxpayer anger and resentment, and heighten the pressure on states and cities to switch to 401(k) plans.

"The federal government does not need to intervene in this issue," said Iris J. Lav of the Center on Budget and Policy Priorities, a policy research group based in Washington, at a hearing on the previous bill before the House Ways and Means Subcommittee on Oversight. "States should be able to gradually solve their underfunding problems with the steps they are already taking," like requiring bigger contributions from both workers and governments.

In the new bill, the method for calculating pension costs has been changed so that it closely resembles the one that actuaries already use under certain circumstances. The big bellwether California state pension system, known as Calpers, already uses such a method to calculate a local government's final bill when it drops out of the system, for example.

This time, the bill may also gain momentum from the changing circumstances — Stockton's pension fight is out in the open, for instance, and certain other cities, like Detroit, are clearly struggling more than ever with retirement benefit costs. Federal regulators recently accused Illinois of securities fraud for issuing what they said was misleading information about its pension system.

Perhaps most important, in Washington the search is on for ways to reduce the federal deficit. The tax exemption for municipal bonds costs the Treasury more than \$30 billion a year in forgone revenue, and fiscal experts say municipalities are at greater risk of losing it now than since the Great Depression. The Obama administration has repeatedly proposed capping it. So did Mitt Romney during the last presidential campaign.

The new bill would not use the tax exemption so much to narrow the federal deficit as to force municipalities into giving the world an unvarnished look at their pension plans. Until now, the accounting rules have permitted governments to factor in actuarial assumptions and smoothing techniques that greatly lowballed the benefits' cost.

In some cases, local governments could even say their workers' benefits were free. The Governmental Accounting Standards Board recently tightened the rules, but many economists say the revisions do not go far enough.

Moody's Investors Service, for one, has said it will not use the numbers that states and cities disclose in rating municipal bond offerings without first adjusting them. On Wednesday, Moody's said it had started making the adjustments, and had put Chicago, Cincinnati, Minneapolis, Portland, Ore., and 25 other local governments and school districts on review for possible downgrades as a result.

"The manner in which these obligations are reported varies widely, and we believe the liabilities are underreported from a balance sheet perspective," said Timothy Blake, a managing director at the ratings firm.

City and state officials generally remain hostile to the idea of so-called fair value pension disclosures. But they also cherish their ability to raise money at low cost with tax-exempt bonds and would probably make the disclosures if that were the only way to keep the tax exemption.

Eminent Domain to Fix Troubled Mortgages Makes a California Comeback.

A controversial proposal to get local government officials to condemn distressed mortgages — in the same way they might condemn a dangerous property — is slowly gaining traction in some California communities, several months after it appeared the idea had been killed.

After months of contentious debate, officials in San Bernardino County, in January killed the idea of seizing troubled home loans in a process known as eminent domain. They rejected the idea after fierce opposition from Wall Street trade associations and investors in mortgage-backed securities.

But since then, San Francisco-based Mortgage Resolution Partners (MRP) has signed advisory

agreements with five California towns that permit the financier-backed group to begin negotiating a sharp reduction in the dollar value of distressed loans that are held in securities administered by banks and mortgage servicing firms.

MRP's strategy is to either achieve a voluntary agreement with servicers and banks to reduce the principal owed on loans that are valued at prices higher than the homes are worth, or use the club of eminent domain to forcibly seize the loans and restructure them at a lower price.

MRP, which earns a \$4,500 fee for every loan that is restructured, argues the threat of eminent domain gives municipalities, hard-hit by the housing crisis, an opportunity to help cash-strapped homeowners struggling to pay their mortgages.

But Wall Street trade groups like the Securities Industry and Financial Markets Association and the Association of Mortgage Investors argue that forcibly condemning home loans and rewriting them is a violation of contractual agreements between a bank and a borrower.

"This type of government intervention is only going to harm the housing market," said Chris Katopis, executive director of the Association of Mortgage Investors, which represents a group of about two dozen, private bond investors. "This is not a fair and equitable solution."

Chris Killian, a SIFMA managing director, said the MRP plan forces "investors to lock in a loss on a loan" by reducing the mortgage value, even if the borrower is still making payments.

MRP's most recent advisory agreement was signed on April 2 with the city of Richmond, Calif., according to public records and MRPs marketing materials reviewed by Reuters. Other California communities that have signed similar agreements with Mortgage Resolution Partners are El Monte, La Puente, San Joaquin and Orange Cove.

The group is also negotiating with officials in North Las Vegas, Nevada a community of 227,000 people that was particularly hard hit by the housing bust. In North Las Vegas, MRP has identified at least 4,700 underwater home loans, mortgages that are for more than the homes are currently worth, that could qualify under its plan.

The revival of eminent domain as a strategy for restructuring distressed mortgages comes as the U.S. housing market is showing signs of revival. But according to CoreLogic there are still an estimated 10.4 million U.S. homeowners who are underwater on their mortgages.

"It's not a panacea to deal with the broad issue of foreclosure, but it is another tool that could be potentially effective," said Bill Lindsay, the manager for Richmond, California, a city of 105,000 people.

The loans MRP seeks to restructure are those packaged into securities sold by Wall Street banks before the financial crisis. These private label mortgage securities do not carry a government guarantee of principal repayment, which distinguishes them from mortgage debt issued by government-sponsored mortgage firms Fannie Mae or Freddie Mac.

Loans in private label bonds are not eligible for most federal government mortgage modification programs.

Last year, private label mortgage bonds returned 21 percent, making it one of the top performing assets for bond investors, according to Amherst Securities Group. The bonds rose in value in response to the Federal Reserve's decision to buy \$40 billion in government-guaranteed mortgage debt each month and an improvement in the performance of some of loans.

Traditionally, local governments have used eminent domain to condemn blighted properties or seize land for public works projects. Wall Street trade groups have warned communities that using eminent domain to seize mortgages could spark litigation and cause lenders to be wary about writing mortgages in certain towns.

MRP, in its marketing documents, has said it has investors willing to finance the cost of condemnation so the municipalities do not have to spend any money seizing mortgages. The group has not publicly identified its financial backers.

By Matthew Goldstein

Piper Jaffray to Acquire Seattle-Northwest Securities.

Minneapolis-based Piper Jaffray announced Wednesday that it is buying Seattle-Northwest Securities Corporation in a deal worth around \$21 million.

The acquisition is subject to approval by Seattle-Northwest's shareholders, as well as regulatory approvals and customary closing conditions. It is expected to close in the second half of 2013.

Upon closing, the tangible book value of Seattle-Northwest is estimated to be \$13 million.

"Joining forces with Piper Jaffray will allow us to build on Seattle-Northwest's strength and reputation in the Pacific Northwest," said Karl Leaverton, chief executive officer and president of Seattle-Northwest. "We believe there is a strong cultural fit between our firms, and our employees and clients will benefit from Piper Jaffray's specialized products, deep inventory and strong capital base."

Founded in 1970, Seattle-Northwest is a public finance firm in the Northwest region that specializes in underwriting municipal securities. Piper Jaffray said the two firms have minimal geographic business overlap, and the combination will strengthen its public finance leadership in serving the middle market.

"We have known and respected Seattle-Northwest for many years," said Andrew Duff, chairman and chief executive officer of Piper Jaffray. "A key part of our firm's strategy is investing in our public finance business, and this represents a significant step forward in developing a national franchise for our business."

Piper Jaffray is an investment bank and asset management firm founded in 1895. The firm was the tenth ranked underwriter of long-term municipal bonds by volume in 2012, according to Thomson Reuters data. Last year, Piper Jaffray worked on 568 issues totaling \$9.3 billion.

NAIPFA: SEC Rulemaking on Muni Advisors Should Be Top Priority.

With the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, individuals providing certain types of advice to muni issuers became regulated as "municipal advisors."

Although all of the rules have yet to be proposed or implemented, there are laws and regulations

currently in existence with which municipal advisors, or MAs, must comply, including those relating to fiduciary duty and fair dealing.

Nevertheless, some market participants have stated on numerous occasions that muni advisors are still totally unregulated, and have urged that the regulation of MAs be implemented as quickly as possible.

While the National Association of Independent Public Finance Advisors disagrees with these participants' statements that municipal advisors are wholly unregulated, NAIPFA does agree that the Securities and Exchange Commission's MA rulemaking should be completed as soon as possible to allow for further development of Municipal Security Rulemaking Board rules.

Therefore, we were surprised to learn that the bill referred to as the Dold Amendment was reintroduced in the current congressional session by Rep. Steve Stivers, R-Ohio.

The bill has the support of a number of those market participants who have and will continue to advocate for the quick implementation of Municipal Advisor rules.

Yet, this position seems contradictory in light of the SEC's statements indicating that if such a bill were to be enacted its rulemaking undertakings could be delayed by as much as two years.

NAIPFA believes that the Dodd-Frank Act got it right by clearly delineating the roles of certain municipal market participants, particularly the roles of municipal advisors and underwriters.

These roles had been blurred for too long as a result of underwriters having provided advice to issuers within the scope of their underwriting engagement that was identical to that which was provided by financial advisors (i.e. municipal advisors), with the only distinction being that underwriters lacked corresponding fiduciary duties for such services.

As a result, muni issuers began to rely on their underwriters to provide advice that was perceived to have been given with the issuer's best interests in mind.

Notably, even previous to the passage of the Dodd-Frank Act, the Government Financial Officers Association officially recognized that financial advisors owed duties to their clients that underwriters did not.

As such, GFOA went so far as to recommend the engagement of financial advisors in its best practices guide for municipal issuers.

But unlike the Dodd-Frank Act, the Stivers bill will allow underwriters to continue their long-standing business practices to the detriment of municipal issuers as well as taxpayers and ratepayers. In this regard, the proposed bill contains two provisions that are of particular concern.

First, the Stivers bill requires an individual to receive compensation for certain types of advice in order to be considered a municipal advisor.

Nevertheless, advice without compensation is still advice. What's more, this measure, if it is enacted, will likely result in the eradication of substantial portions of the issuer protections put in place by the MA provisions of the Dodd-Frank Act.

Individuals who otherwise would have sought to receive compensation for providing advice as an issuer's MA will simply stop seeking compensation for their advisory services in order to avoid regulation, and will instead seek to mask their advisory activities by receiving compensation for non-

advisory related services.

Our concern in this regard is not limited to merely underwriters, but also attorneys, engineers, nonprofit organizations and any other individual who wishes to avoid regulation as a municipal advisor.

Second, the Stivers bill allows broker-dealers to provide advice “in connection with” their role as underwriter. This provision will allow broker-dealers serving as underwriters to provide advice on virtually every aspect of the financing, including with respect to the structure, timing, terms and other similar matters related to municipal securities issuance (municipal advisory services), but without owing a corresponding fiduciary duty to the issuer.

The Stivers bill purports to be a clarification of the regulation of municipal advisors. But in light of the foregoing it seems that this effort by Rep. Stivers with the support of the underwriting community to define MAs – not by the services they provide, but by whether they receive compensation for them – will instead undermine the original intent of Dodd-Frank’s municipal advisor provisions.

We do believe, however, that broker-dealers should be allowed to discuss matters with issuers that are related to the transaction and that are within the scope of their underwriting role as a purchaser and distributor of securities.

Nevertheless, broker-dealers that provide muni advisory services, regardless of the title they utilize, do have a conflict of interest and should not be allowed to provide them without obtaining fiduciary duties and triggering the corresponding prohibition on underwriting the issuer’s securities, by simply not receiving compensation for such services.

While some market participants may reminisce about their pre-Dodd-Frank business practices, unfortunately it is some of those very practices that led to the enactment of Dodd-Frank’s municipal issuer protections. It is time to move forward.

The role of the municipal advisor and underwriter are distinct, and the definition corresponding to each must be clear. Issuers must be able to distinguish between those individuals whose role is to provide advice and those whose role is to purchase and distribute securities.

It is our fear that Dodd-Frank’s accomplishments in this regard will be undone by the enactment of the Stivers bill.

We believe that the SEC understands the concerns of market participants and that it is fully capable of addressing these concerns.

Conversely, the Stivers bill takes the wrong approach to addressing the markets’ concerns and will simply allow certain market participants to return to the business practices that contributed to the worst financial crisis since the Great Depression.

Therefore, the SEC must be allowed the opportunity to develop and release a rule clarifying the definition of muni advisor prior to any legislative action that will only further delay the rulemaking process and undermine Dodd-Frank’s municipal issuer protections.

Jeanine Rodgers Caruso is president of the

National Association of Independent Public Finance Advisors.

NFMA Submits Amicus Brief in Litigation Challenging California Redevelopment Agency Legislation.

The National Federation of Municipal Analysts ("NFMA") announced today that it has submitted an amicus curiae brief (the "Brief") with the Superior Court of California, County of Sacramento (the "Court") in support of the Complaint and Writ of Mandate of Syncora Guarantee Inc. and Syncora Capital Assurance Inc. ("Syncora").

The NFMA rarely files amicus briefs, and almost never at the trial court stage. However, the NFMA Board felt strongly that an exception should be made in this case given that the matter before the Court has such far-reaching ramifications for the municipal bond market generally. The Brief alerts the Court to the significant negative ramifications to the municipal market that can result from the passage of any law authorizing the elimination of existing bondholder protections, as exemplified by sections 34182(d), 34174, 34177(d), 34183(a)(4) and 34188 of the California Health and Safety Code, which were recently added to the California Health and Safety Code by Assembly Bill x1 26 ("AB26") and Assembly Bill 1484 ("AB1484" and together with AB26, the "RDA Legislation").

The dispute before the Court involves a challenge by Syncora to the RDA Legislation. While the NFMA takes no position generally regarding the dissolution of California's redevelopment authorities, the NFMA argues in its Brief that the RDA Legislation has caused significant and unwarranted marketplace uncertainties and complexities which have already rippled through the marketplace, including across the board rating downgrades, rating withdrawals and constrained liquidity and may, if not clarified by the Court, fundamentally change market expectations nationwide with respect to certain previously irrevocable protections, rights and privileges.

The NFMA asserts in its Brief that the RDA Legislation is a textbook example of the type of change in security that undermines credit analysis and weakens the confidence that investors have in their understanding of the marketplace. The RDA Legislation seeks to unwind not only redevelopment agencies, but the layers of protection granted to bondholders, including a pledge of tax revenues, debt service coverage through excess revenues, exercisable remedies, and continuing disclosure.

"The NFMA is deeply concerned by the troubling precedent set when any state retroactively seeks to restructure, redistribute, and recast existing bondholder protections and covenants and the NFMA believes that it is important for the Court to understand the far-reaching significance of such actions which negatively impact the foundation of municipal finance nationwide" said Jeff Burger, NFMA Chairman.

The full brief can be found at:

<http://www.nfma.org/assets/documents/position.stmt/ip.amicus.brief.ca.rda.4.13.pdf>

Orrick Keeps Top Spot, Other Counsel Rankings Shift in 1Q.

While Orrick Herrington & Sutcliffe LLP retained its longstanding number one spot among law firms, little else remained the same among rankings during the first quarter of 2013.

Squire Sanders jumped to the number two spot from fourth place during the first quarter last year, working on 51 issues that totaled \$5 billion, according to Thomson Reuters data. The firm also took

second place behind Orrick in the negotiated-only issue category. Squire Sanders worked on \$4.4 billion of negotiated deals and \$608 million of competitive deals.

Hawkins Delafield & Wood LLP saw a strong first quarter, climbing up in rankings across the board. The firm jumped five spots from the first quarter last year to take third place for all issues, working on 80 deals, totaling \$3.7 billion. Hawkins jumped to fourth place from seventh among negotiated deals, seventh from 28th among competitive deals, and to first from second among underwriter's counsel.

Fulbright & Jaworski LLP jumped one spot to fourth place, with 94 issues totaling \$3.6 billion. The firm came in third among bond counsel for negotiated issues, and sixth among underwriter's counsel.

No firm came close to Orrick Herrington, however, which worked on 79 issues worth \$9.7 billion this year. About \$8.8 billion of that total were negotiated deals, the largest amount in the category. The firm took third place among competitive issues with \$956.6 million, fourth place among underwriter's counsel with \$2.5 billion, and first place among disclosure counsel with \$5.3 billion.

"We're very proud that so many public entities, and so many of them repeatedly, choose us as their bond counsel," said Roger Davis, partner and chair of the public finance department. "We think that reflects the quality and responsiveness of our legal services."

Orrick, which was founded in San Francisco in 1863, had a 12% market share for the quarter – nearly twice the amount of the 6.2% market share of runner-up Squire Sanders.

"We work across every type of bond issue and across a broad geographic span as well, so there's quite a lot of diversity, and that contributes to the consistency of our ranking," Davis said.

The largest jump to a spot among the top 10 came from McCarter & English LLP, which jumped from 47th place last year, to fifth place this year.

"McCarter & English has been active in the public finance space for more than 30 years and we have continued to expand our bond counsel, as well as our other counsel roles in the area of public finance," said Barbara Kroncke, partner and practice group leader for the public finance group.

The Newark, N.J.-based law firm worked on eight issues totaling \$3.1 billion during the first quarter, with a 3.8% market share. Last year, the firm worked on four issues totaling \$372.1 million in the first quarter. McCarter & English also took fifth place among negotiated issues with a 4.1% market share totaling \$2.6 billion.

"We have attracted a growing array of clients over the years," Kroncke said. "We're fortunate that some of those clients were active during the first quarter."

McCarter & English worked on the second largest deal of the first quarter – a \$2.3 billion refunding deal for the New Jersey Economic Development Authority in January.

Among trustees, the Bank of New York Mellon retained its number one spot, participating in 160 issues totaling \$16.6 billion for the first quarter. US Bank worked on 170 issues – slightly more than BNY Mellon – but had a lower par amount at \$12.8 billion.

The bond insurance industry continued its steady decline as the total principal amount of bonds insured dropped to \$2.1 billion during the first quarter from \$3.3 billion during the fourth quarter of 2012, and \$3.7 billion during the first quarter of 2012. Bond insurers were responsible for wrapping

2.6% of the overall municipal market during the quarter, compared to 4.6% during the beginning of last year.

Assured Guaranty Municipal Corp., which has been responsible for almost all of the new issues insured in the past few years, saw its market share decline to 54.9% from 99.4% during the fourth quarter of 2012, and from 100% during the first quarter of 2012.

Assured said that the low interest rate and tight credit spreads are the main factors limiting insured market penetration.

“We have seen some investors willing to give up the additional safety of insurance in an effort to pick up every basis point of yield,” said Robert Tucker, managing director of investor relations and corporate communications at Assured. “As interest rates increase and spreads widen, we expect to see an increase in the demand for insurance.”

Another factor affecting business during the first quarter was the “natural market dislocation that occurs leading up to and just after a rating action,” Tucker said. “We’ve observed that, following a rating action, the market needs time to adjust — it seems like that has now occurred.”

The bond insurer had been on review for downgrade from Moody’s Investors Service for much of 2012, finally receiving a multi-notch drop to A2 from Aa3 in January.

Still, Assured remained the market leader, working on 129 issues totaling \$1.2 billion in principal amount. The company also issued 148 policies totaling \$214 million of par in the secondary market, according to Assured.

Build America Mutual Assurance Company saw a major uptick in business during the first quarter, insuring a total of 131 issues, worth \$856.7 million. That amounted to a 40.1% market share for the quarter.

After it launched in July 2012, BAM insured one deal during the third quarter of 2012. During the fourth quarter, it insured 3 deals, which totaled \$18.7 million for a 0.6% market share.

“We were particularly gratified that our market share of insured new issues grew substantially over the quarter, from 20% in January to 53% in February and March, and we continue to see inquiry from a variety of newly licensed states where BAM is now qualified to do business,” said Seán McCarthy, co-founder of BAM.

In the letter-of-credit business, JP Morgan Chase was the top provider by principal amount, with two issues, totaling \$189.1 million. Wells Fargo Bank and Citibank followed closely behind.

Among guarantors, the Texas Permanent School Fund was again ranked first, with 103 issues totaling \$2.3 billion.

The Bond Buyer.

[WSJ: Regulators Are Concerned About Municipal-Bond Deals.](#)

U.S. regulators are probing whether securities firms are circumventing rules implemented in the wake of the financial crisis to protect municipalities against potentially biased investment advice,

according to people familiar with regulators' efforts.

At issue is whether banks are attempting to skirt postcrisis rules, including those restricting firms that provide financial advice to municipalities from underwriting certain municipal-bond transactions. Lawmakers and regulators implemented the changes to avoid situations similar to those leading up to the crisis in which some municipalities were steered into risky and complex deals municipal officials didn't fully understand.

The 2010 Dodd-Frank law stipulates banks hired as financial advisers act as fiduciaries, or in their clients' best interests. Regulators have also restricted banks from underwriting a municipal-bond transaction if they were initially hired to advise on the deal. Yet the Securities and Exchange Commission is concerned banks may be mischaracterizing their role in order to preserve their ability to underwrite bonds, according to the people familiar with regulators' efforts.

The SEC is investigating several municipal contracts entered into by banks, including Goldman Sachs Group Inc., Piper Jaffray Cos., Robert W. Baird & Co. and Stifel Financial Corp. Spokesmen for Piper and Stifel declined to comment. A spokeswoman for Baird didn't respond to requests for comment.

The SEC is scrutinizing a February contract between Goldman and a St. Louis stadium authority, according to the people familiar with regulators' efforts. Worried about losing the St. Louis Rams, the city's National Football League franchise, local officials hired Goldman to analyze a range of financing options to upgrade the Edward Jones Dome and keep the team in the 18-year-old stadium. The options include a bond deal to finance contractually required upgrades.

Goldman's \$20,000-a-month contract as "financial advisor" to the St. Louis Regional Convention and Sports Complex Authority says the bank isn't providing "advice" - just information to senior officials at the authority. The bank says it may seek to underwrite the authority's bonds should the agency issue debt in the future.

James Shrewsbury, chairman of the stadium authority, said the agency hired Goldman at the request of Missouri Gov. Jay Nixon, who can appoint five of the authority's 11 members, including its chairman. Mr. Shrewsbury said the stadium authority is trying to get the best advice on how to keep the Rams in the dome. The team's contract to play in the stadium expires in 2015. "Right now, they are not underwriting any bonds," he said of Goldman.

A spokesman for Gov. Nixon wasn't immediately available for comment on the contract.

A person familiar with the contract said the firm was hired on a broad assignment that is still in its early stages, and that there is currently no plan to sell municipal bonds for the stadium. Still, regulators are concerned the firm is calling itself an adviser and then disclaiming responsibility to act as a fiduciary, according to the two people familiar with regulators' efforts. Regulators are also concerned, according to these people, that the firm would have a say in how to structure a bond deal while setting itself up to underwrite the bonds, which is the type of role-switching regulators have tried to quash.

Previously, banks serving as financial advisers could switch roles provided they obtained their client's consent and after disclosing that conflicts may exist. Regulators began to crack down on "role switching" in the \$4 trillion municipal-bond market in 2010 at the behest of former SEC Chairman Mary Schapiro, who described the practice as a "classic example of a conflict of interest." Unlike financial advisers, who act in the best interests of their clients, underwriters enter into an "arm's length" relationship when they underwrite municipal debt. Supporters of the ban warn many

municipal borrowers aren't sophisticated enough to understand the distinction. Ms. Schapiro pushed the Municipal Securities Rulemaking Board, which sets the role-switching rule, to tighten the measure.

John Cross, director of the SEC's municipal-securities office, said in a statement that the agency is generally concerned about investment banks' compliance with role-switching restrictions and that municipalities receive conflict-free advice. He declined to comment on a specific company or its services.

Regulators also are scrutinizing "general consulting services" agreements, in which brokerage firms seek to sidestep the role-switching restrictions by providing "general" financial advice that isn't tied to a specific bond transaction. In one such agreement between Monroe County, Wis., and regional bank Robert W. Baird, the firm said it will provide advice based on the county's financing needs but warns it isn't working in the capacity of a financial adviser or underwriter. Still, the firm leaves the door open to being hired in those roles in the future.

[U.S. Conference of Mayors Paves the Way for 457\(B\) Plan Transparency and Market Overhaul, Selected Finalist for Plan Sponsor of the Year.](#)

U.S. Conference of Mayors (USCM) announced last fall its new USCM Retirement Programs (Program) with Great-West Financial®. This new program brings, for the first time, widespread fee savings and transparency to cities and municipal entities of all sizes in the 457(b) deferred compensation market, coupled with a best- in-class plan design.

Because of this overhaul, the Program was nominated for Plan Sponsor Magazine's prestigious Plan Sponsor of the Year Award. The Program came in as a finalist in the Public Defined Contribution category. As Conference CEO and Executive Director Tom Cochran explained, "We knew this Program would cause a ripple effect through the marketplace, and we are honored that Plan Sponsor has recognized this effort just 5 months into the Program."

While other 457(b) programs have begun to follow the Program's example by dropping fees and adding new resources to help municipalities meet their fiduciary duties, the Program acts as a benchmark for current best practices.

These best practices include:

- No Administrative Fees for Plans With \$500,000 or More in Total Assets - An employee paying administrative fees
- of 0.65% to 0.95% pays an extra \$50,000 to \$70,000 over a 30-year savings period¹.
- Fee Transparency - It is critically important for administrators and participants to understand exactly how their fees relate to the service and support they receive. Great-West Financial is ranked 2nd among the industry's top 20 record keepers/administrators on fee transparency, according to DALBAR's November 2012 Perspective on Fee Transparency whitepaper.
- Performance - The Program offers a rich lineup of investment options with the performance potential to improve employees' retirement readiness. The variety of innovative solutions will allow employees to create diversified portfolios for potentially better performance. The Conference monitors the Program to ensure it remains by all accounts "best in class."
- Education - Employee education is a high priority and offers a multi-channel, behavior-based approach to education that fits the needs of a wide range of employees with different learning

styles.

- **Fiduciary Support** – The Program offers plan sponsor training about fiduciary matters and legislative updates both in person and by Web. The Program also includes the offering of plan documents, investment policy statements, outsourcing services, and a new fiduciary warranty provided by Great-West Financial.
- **Service** – The Program is committed to streamlining the workload of the city or municipality, including the sharing of plan administration, retirement plan best practices, and support in addressing fiduciary responsibilities at no cost.

Moody's: CalPERS Haircut in Stockton Case Would Have Big Impact.

A reduction of Stockton's obligations to the California Employees' Retirement System debts in the city's bankruptcy reorganization would have major ramifications for bondholders as well as California municipalities, Moody's Investors Service said in a report Wednesday.

Such an outcome is far from certain, but would set an important precedent, Moody's said.

San Bernardino Outsources Finance Department to Urban Futures.

San Bernardino, Calif., in bankruptcy proceedings, has hired Orange County-based Urban Futures on a contract basis in lieu of hiring a finance director and filling other vacant finance department positions.

NLC: Limit on Tax-Exemption Would Mean Fewer Local Projects.

The number and scope of investment projects will decrease for state and local governments if a federal limit is placed on tax-exemption for municipal bonds, the National League of Cities warned in a survey released Thursday.

Bloomberg: SEC Backs Forcing Bank Disclosures on Muni-Bond Campaigns.

The U.S. Securities and Exchange Commission will force state and local government bond underwriters to disclose more information about donations to election campaigns supporting new debt sales.

Banks will be required to report the timing of their contributions to such campaigns, any work done on behalf of the effort and whether they won underwriting work on resulting bond issues passed by voters. On March 28, the SEC approved the mandates, proposed by the Municipal Securities Rulemaking Board last year.

<http://www.bloomberg.com/news/2013-04-01/sec-backs-rule-to-force-bank-disclosures-on-muni-bond-campaigns.html>

WSJ: Beware the Muni-Bond Illusion.

When reviewing a new client's portfolio, I am often told that my recommendations need to include keeping the client's municipal-bond manager, as they are earning over 4% tax-free. By comparison, the Vanguard Intermediate-Term Tax-Exempt Fund's Admiral shares are earning only 1.64%.

To the client, it appears the manager is earning his fee by tripling the return, but appearances can be deceiving.

The illusion that one is earning this return can be illustrated by taking a look at one particular bond held by one of my clients: a California State Public Lease Revenue bond paying a handsome 4.5% coupon. It matures in just under four years, and the manager recently bought the bond at \$112, or a 12% premium to the par value. The statement showed the bond yielding 4%, which is calculated by taking the \$4.50 annual payment per \$100 par and dividing by the \$112 purchase price.

Still not too shabby.

Unfortunately, for those buying the bond at a premium, bonds mature at par. This means the investor gets back only \$100 for every \$112 invested. Simply put, the investor is losing \$12 over the remaining four-year life of this muni, or roughly \$3.00 per year - 2.7% of the initial investment. So now the 4% yield is reduced to 1.3% after taking into account what is known as the "amortization" of the premium.

We're not done yet. The manager charges this investor 1% annually for holding this and every other bond, reducing the 1.3% to a measly 0.3% annualized return. That's what this investor will net by holding this bond until maturity.

Suddenly, the 1.64% yield of the low-cost diversified muni-bond fund is looking pretty good compared to the 0.3% this investor is netting after buying the bond at a hefty premium and paying a manager 1%.

The numbers in this example are a bit overly simplified to illustrate the point. The more-precise numbers are actually a bit worse for this investor. It's also important to note that this illusion is just as prevalent and valid for taxable bonds as well.

That's why I like low-cost diversified bond funds. Investors end up with a higher actual yield, much more diversification and higher liquidity as well. You just have to give up the illusion.

California Tobacco Bond Sale a Hit With Investors.

California on Tuesday had little trouble selling \$380 million in municipal bonds backed by revenue from tobacco companies, even as litigation deepens over a payment dispute related to the companies' lost market share.

Taking advantage of low interest rates, the Golden State Tobacco Securitization Corp. will use proceeds from the sale to refinance a portion of about \$3.1 billion of tobacco bonds issued in 2005. On Tuesday, a 2030 bond was initially offered with a yield of 3.78%, but California lowered it to 3.70% later in the day, reflecting good demand from investors. Bond prices move inversely to yields.

The bonds will be backed by payments from tobacco companies, including Philip Morris USA Inc., Reynolds American Inc. RAI +1.15% and Lorillard Tobacco Co., LO +0.86% to the Golden State under a 1998 settlement agreement. That agreement resolved health-related claims by 46 states against the tobacco companies, and payments are based on annual cigarette shipments in the U.S. Many other states have also sold bonds backed by the tobacco payments.

Tobacco bonds, however, have run into some trouble in recent years. Cigarette consumption declined faster than expected in the wake of the recession, and last summer, Moody's Investors Service MCO +1.09% said it expected about three-quarters of the tobacco bonds it rates to default should consumption continue to decline 3% to 4% annually. New tobacco bond sales recently have built in a bigger buffer, with larger annual declines needed before the bonds default.

Still, with extra risk comes extra yield, and that has attracted some investors to tobacco bonds at a time of low interest rates. The S&P Municipal Bond Tobacco Index has returned 2.15% so far this year, compared with the broader S&P Municipal Bond Index, which has returned only 0.61%.

California's bond deal Tuesday is considered more secure than other tobacco bonds because it also carries an "appropriation pledge" from the state, meaning California promises to put money in its budget to pay the bonds back if tobacco revenue isn't enough. The tobacco bond deal was rated A2 by Moody's, single-A-minus by Standard & Poor's Ratings Services and triple-B-plus by Fitch Ratings.

As a result, the price of the California tobacco deal is more closely tied to California state bond prices in general. State bonds have generally increased in value relative to the rest of the market after voters approved tax increases in November; though the bonds took a hit last month when the state brought a \$2.5 billion deal to market.

Initial pricing Tuesday had the California tobacco bonds offering about 40 basis points, or hundredths of a percentage point, in extra yield compared with regular California state bonds. Michael Schroeder, chief investment officer at Wasmer Schroeder & Co., said that seemed fair. Typically, he said he would expect California tobacco bonds with the appropriation pledge to trade with between 25 to 50 basis points of extra yield over state bonds.

"We'll probably focus on it for our California portfolios," said Mr. Schroeder, whose firm oversees \$3.5 billion in municipal bonds, adding that it is cheap enough to consider for non-California accounts as well.

Bill Black, who helps manage the \$7.2 billion Invesco High Yield Municipal Fund, said the fund would likely skip the California deal because yields were too low. But he said the fund added some tobacco debt to its portfolio last year, noting that a December agreement between some states and the tobacco companies over a disputed portion of the payments is generally positive for the bonds. The dispute centered on a provision in the original agreement that allowed the tobacco companies to reduce their payments if they lost market share and certain other conditions were met.

Under the accord reached in December, the 17 states and two territories signing on will get 54% of their share of the money in dispute. At least one state, however, has moved to derail the agreement: Colorado filed a motion in state court to vacate the settlement, according to bond documents.

"What's fun about tobacco bonds is it's a never-ending story," said Mr. Black, adding that he expected the settlement will ultimately go into effect. "You're always looking for the next thing to try and figure out what's going on."

California's tobacco deal follows a \$170 million tobacco-refinancing issue from South Dakota's Educational Enhancement Funding Corp. earlier this year. Louisiana is also looking into refinancing more than \$800 million in outstanding tobacco debt.

CBO: A Review of CBO's Activities in 2012 Under the Unfunded Mandates Reform Act.

The federal government, through laws and regulations, sometimes imposes requirements—known as federal mandates—on state, local, and tribal governments and entities in the private sector in order to achieve national goals. In 1995, lawmakers enacted the Unfunded Mandates Reform Act (UMRA) in part to ensure that, during the legislative process, the Congress receives information about the potential effects of mandates as it considers proposed legislation. To that end, UMRA requires CBO, at certain points in the legislative process, to assess the cost of mandates that would apply to state, local, and tribal governments or to the private sector. This report, which is part of an annual series that began in 1997, summarizes CBO's activities in 2012 under UMRA.

How Is a Mandate Defined in UMRA?

UMRA defines a mandate as any provision in legislation that, when enacted, would do one of the following:

- Impose an enforceable duty on state, local, or tribal governments or on private-sector entities;
- Reduce or eliminate funding authorized to cover the costs of complying with existing mandates;
- Increase the stringency of conditions that apply to the provision of funds to state, local, or tribal governments through certain large mandatory programs or make cuts in federal funding for those mandatory programs if the affected governments lack the flexibility to alter the programs.
- Duties that arise from conditions of federal assistance or that are tied to participating in voluntary federal programs generally are not considered mandates as defined in UMRA.

What Does UMRA Require of CBO?

The law requires CBO to prepare mandate statements for bills and joint resolutions that are approved by authorizing committees; when requested, the agency also reviews proposals at other stages in the legislative process for intergovernmental and private-sector mandates. As a part of its review of legislation, CBO must determine whether the aggregate direct costs of the mandates would be greater than the statutory thresholds established in UMRA and identify any funding that the bill would provide to cover those costs. In 2012, the thresholds, which are adjusted annually for inflation, were \$73 million for intergovernmental mandates and \$146 million for private-sector mandates.

How Many Bills Reviewed by CBO in 2012 Contained Mandates?

CBO found that most of the legislation the Congress considered in 2012 contained no mandates as defined in UMRA. Of the 428 bills CBO reviewed in 2012, 68 (16 percent) contained intergovernmental mandates and 80 (19 percent) contained private-sector mandates. Most of the mandates that CBO identified in 2012 would not have imposed costs that exceeded those thresholds. Only two bills (fewer than 1 percent) included intergovernmental mandates with costs above the threshold, and 14 bills (3 percent) contained private-sector mandates that would have imposed costs exceeding the annual threshold.

Occasionally, CBO cannot determine whether the cost of the mandates in a bill would exceed the annual cost thresholds. The reason in most cases is uncertainty about the scope of a mandate—the number of people or entities affected, the extent of the requirements they would face, or both. Such uncertainty generally arises because of insufficient information about the contents of regulations that a bill might require. Legislation might give a federal agency broad discretion in issuing regulations, and without information about the scope of the regulations to be issued, CBO cannot estimate with any confidence the cost of the bill’s requirements at such an early stage. In 2012, CBO could not determine the annual costs of the intergovernmental mandates in six bills (about 1 percent) or the annual costs of the private-sector mandates in 18 bills (4 percent).

How Many Public Laws Enacted in 2012 Contain Mandates?

In addition to examining bills during the legislative process, CBO reviews public laws enacted each year for intergovernmental and private-sector mandates. This report assesses the 202 public laws that were passed by the 112th Congress (which ended on January 3, 2013) and were signed into law by the President in 2012 or early 2013. (For simplicity, the text of this report refers to those public laws as “enacted in 2012.”) Of those 202 public laws, 16 (8 percent) contain intergovernmental mandates and 23 (11 percent) contain private-sector mandates.

Public laws generally contain fewer intergovernmental mandates than private-sector mandates. In the 17 years since the enactment of UMRA, CBO has identified 13 laws with intergovernmental mandates that have costs estimated to exceed the statutory threshold. The last such law was enacted in 2010; none of the public laws enacted in 2012 contain intergovernmental mandates with costs estimated to exceed the statutory threshold. (One law contains an intergovernmental mandate with costs that CBO cannot estimate.) Since 1996, CBO has identified private-sector mandates with costs estimated to exceed the threshold in 89 public laws, including 7 laws enacted in 2012. Those 7 laws contain 12 private-sector mandates that impose government fees or regulate pipeline safety, transportation, pharmaceuticals, or telecommunications.

As indicated in the tables, the number of bills and other legislative proposals that contain mandates and the number of individual mandates that appear in proposed legislation generally differ. Because the House and the Senate may consider the same or similar mandates in more than one piece of legislation, the number of bills that contain mandates can be greater than the number of individual mandates considered by the Congress in any given year. Conversely, because one bill may contain several mandates, the number of mandates identified can be greater than the number bills reviewed.

http://www.cbo.gov/sites/default/files/cbofiles/attachments/44032_UMRA.pdf

Senators Oppose Capping Tax Exemption for Municipal Bonds.

Shifting the burden of national fiscal challenges to states and cities by placing a cap on or eliminating tax exemption of municipal bonds would be “inappropriate and shortsighted” and such a change would negatively affect the federal budget outlook, according to an April 2 letter to President Obama signed by 14 senators.

National League of Cities Examines Effects of Municipal Bond Tax Exemption.

The National League of Cities in an April report announced the results of a survey finding that 61 percent of polled city officials said they would limit the number of projects undertaken if a federal limit is placed on the tax exemption of municipal bonds, while 54 percent said they would reduce the scope of projects.

Obama Proposes AFF Bonds at 28% Rate for PAB Projects, Eases Restrictions on PABS.

The White House on Friday proposed a new “Rebuild America Partnership” program that would allow direct-pay American Fast Forward bonds to be used for any project that can currently be financed with tax-exempt private activity bonds.

NYT: Pension Funds Wary as Bankrupt City Goes to Trial.

Wall Street is taking America’s biggest pension fund to court this week, for a long-awaited battle over who takes the losses when a city goes bust — workers and retirees, municipal bondholders, or both.

Stockton, Calif., declared Chapter 9 bankruptcy last year after suffering one of the country’s sharpest riches-to-rags swings when the mortgage bubble burst. Struggling to stay afloat, Stockton has slashed tens of millions of dollars’ worth of city services — firefighters, senior centers, library programs for at-risk children — and said it would cut its municipal bond repayments to a degree never seen before in a municipal bankruptcy.

But it has drawn the line at slowing down its current workers’ pension accrual, or cutting the benefits its retirees now receive.

Mutual funds that hold the threatened bonds, and the insurers that guarantee them, have cried foul, citing the principle that in bankruptcy, similar classes of creditors must be treated the same way. Their objections have prompted the federal bankruptcy judge handling Stockton’s case, Christopher M. Klein, to schedule a four-day trial this week, starting Monday.

The immediate question before the judge is whether Stockton qualifies for Chapter 9 at all; unlike companies, cities must meet certain criteria before they can get federal court protection from creditors.

But there is a looming, larger question that has pension funds around the country nervous: Will a victory by bondholders in Stockton pave the way for cuts in its workers’ pensions and its payments to Calpers, which, in turn, could lead to the demise of other public pension plans?

Obama Renews Public-Works Push.

President Barack Obama renewed his push for investing in roads, bridges and other infrastructure upgrades Friday, traveling to Florida to make the case for tax incentives and other efforts aimed at attracting private dollars to public works projects.

Calling it the “Rebuild America Partnership,” the president laid out a plan that he said would leverage private and public capital for infrastructure projects and generate jobs.

<http://online.wsj.com/article/SB10001424127887323501004578390851308236448.html>

H.R. 789 Would Permanently Extend Build America Bonds.

H.R. 789, the Build America Bonds Act of 2013, introduced by House Ways and Means Committee member Richard E. Neal, D-Mass., would modify and permanently extend Build America Bonds.

Barclays: Some Issuers Could Wait Years to Call BABs.

Barclays is warning that if a Build America Bond subsidy payment is reduced under sequestration and this triggers an extraordinary redemption provision, the issuer may be able to call those BABs anytime, even years later when market changes make the call affordable.