# WASTEWATER INTERIM REPORT NO. 1

# CITY OF SAN DIEGO OFFICIALS' FAILURE TO DISCLOSE MATERIAL FACTS IN CONNECTION WITH THE OFFER AND SALE OF WASTEWATER BONDS AND RELATED IMPROPER ACTIVITY

## REPORT OF THE

## SAN DIEGO CITY ATTORNEY

## MICHAEL J. AGUIRRE


**OFFICE OF**
**THE CITY ATTORNEY**
**CITY OF SAN DIEGO**

**1200 THIRD AVENUE, SUITE 1620**
**SAN DIEGO, CALIFORNIA 92101-4178**
**TELEPHONE: (619) 236-6220**


**15 SEPTEMBER 2005**

# EXHIBIT NO. 1

NO EXHIBIT WITH THIS FOOTNOTE

# EXHIBIT NO. 2

# Notice to City of San Diego Property Owners Regarding Water and Sewer Fees and Charges

## If you are the Owner of This Property But Have a Tenant Who Is Responsible for the Water or Sewer Bill, Please Forward This Notice to the Tenant.

This is to inform you, as a property owner of record, that the City Council of the City of San Diego will hold a public hearing on June 8, 2004 to consider and adopt revisions to presently existing water and sewer fees and charges which will enhance ratepayer equity and bring the City into full compliance with the ratesetting requirements of the State Water Resources Control Board. When adopted, the revisions would become effective on October 1, 2004, and are set forth on the tables shown on the attached pages. In addition, the Council will consider and reaffirm water rate increases previously adopted at its April 30, 2002 meeting.

Revenues derived from sewer fees and charges are used solely for the purpose of defraying costs incurred by the sewer system, which include sewage transportation, treatment, and disposal, facilities and equipment maintenance, capital projects and related financing.

Revenues derived from water fees and charges are used solely for the purpose of defraying costs incurred by the water system, which include raw and treated water purchases, treatment and distribution, facility and equipment maintenance, capital projects and financing, metering, billing and account management.

The date, time and place of the public hearing are as follows:

**Date:** Tuesday, June 8, 2004

**Time:** 10:00 a.m.

**Place:** City Administration Building
202 "C" Street
12th Floor Council Chambers
San Diego, CA 92101



PENGAD 800-631-6989
DEPOSITION EXHIBIT
2-D Kahlie
3-21-05

# Notice to Property Owners
# Regarding Sewer Fees and Charges

**The following tables show the impact of the revisions to Sewer Fee and Charges for Single-Family Residences, Multi-Family Residences, and Commercial/Industrial classes:**

- **Monthly Sewer Fee and Charges For The Single-Family Residential Class:**
  For single-family residences the monthly sewer fee and charges equals the sum of the sewer base fee plus a sewer service charge. The service charge is the sewer rate multiplied by a residence's winter water use, measured in units of hundred cubic feet of water (HCF).

TABLE 1-1: SINGLE-FAMILY RESIDENTIAL MONTHLY SEWER FEE AND CHARGES

| Item | Current | Revised |
|---|---|---|
| Sewer Base Fee | $10.90 | $10.53 |
| Sewer Rate (rate per HCF)* | $3.625 | $2.563 |
| New Customer/No Winter Use History | $37.03 | $32.72 |
| Winter Water Use Cap (HCF) | 10 | 14 |
| Maximum Charge: Base Fee + Sewer Rate at Winter Water Use Cap | $47.15 | $46.41 |

**1 HCF (Hundred Cubic Feet) = 748 Gallons. These rates may change due to the Winter Months Water Usage Adjustment effective July 1, 2004.*

Comparison of current and revised bills at various levels of usage for Single-Family Residential Class, effective March 2004:

TABLE 1-2: SINGLE-FAMILY RESIDENTIAL MONTHLY SEWER BILL COMPARISONS

| | | Monthly Charges | | Difference | | |
|---|---|---|---|---|---|---|
| Usage Level | Winter Water Used (HCF) | Revised Method 2004 | Current Method 2004 | Revised $ | Vs. | Current % |
| Lo. Monthly Water Usage | 4 | $20.78 | $25.40 | -$4.62 | | -18.2% |
| Med. Monthly Water Usage | 10 | $36.16 | $47.15 | -$10.99 | | -23.3% |
| Hi. Monthly Water Usage | 14 | $46.41 | $47.15 | -$0.74 | | -1.6% |

NOTES: (1) The revised water usage cap is 14HCF and the current usage cap is 10HCF
(2) Both the Revised Method and the Current Method amounts show the sum total of the Sewer Base Fee plus the Sewer Service Charge line items from the Water and Wastewater Services bill.

The Sewer Base Fee will **decrease** from $10.90 to $10.53. To estimate your monthly sewer service charge under the revised rate structure, obtain the "Sewer Srvc Chrg" amount from your last Water and Wastewater Services bill and divide it by $3.625, then multiply by $2.563 and round the answer to the nearest penny. This will be your estimated new "Sewer Srvc Chrg" amount. This amount should be **lower** than your current "Sewer Srvc Chrg" on your most recent bill. However, if your "Sewer Srvc Chrg" amount on your bill is $36.25, you are at the existing sewer usage cap of 10 HCF. Your "Sewer Srvc Chrg" amount under the revised rates will be no higher than $35.88.

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# EXHIBIT NO. 3

# United States District Court

SOUTHERN DISTRICT OF CALIFORNIA

TO:

Custodian of Records
City of San Diego

**SUBPOENA TO TESTIFY BEFORE GRAND JURY**

05-116-SDP-JAF-JBO

SUBPOENA FOR:

☐ PERSON ☒ DOCUMENTS OR OBJECT(S)

YOU ARE HEREBY COMMANDED to appear and testify before the Grand Jury of the United States District Court at the place, date, and time specified below.

| PLACE | ROOM |
|---|---|
| Federal Office Building<br>880 Front Street<br>San Diego, California 92101-8893 | Grand Jury Room<br>Room 5251/5254 |
| | DATE AND TIME<br>August 25, 2005<br>9:00 a.m. |

YOU ARE ALSO COMMANDED to bring with you the following document(s) or object(s):* (04-2 Thur)

**PLEASE SEE ATTACHMENT A AND ALL OTHER NOTICES**

This subpoena may be complied with by mailing the above-mentioned documents to the address below. Please return a copy of the subpoena with the documents.

Should you have any questions regarding this subpoena, please contact FBI Special Agent John Hause at 858-499-7857.

☐ *Please see additional information on reverse*

This subpoena shall remain in effect until you are granted leave to depart by the court or by an officer acting on behalf of the court.

| CLERK | Date |
|---|---|
| W. SAMUEL HAMRICK, JR. | August 8, 2005 |
| (BY) DEPUTY CLERK | |

This subpoena is issued upon application of the United States of America

NAME, ADDRESS AND PHONE NUMBER OF ASSISTANT U.S. ATTORNEY
JOHN B. OWENS, AUSA JBO
U. S. Attorney's Office
880 Front Street, Room 6293
San Diego, CA 92101-8893
Telephone: (619) 557-5629
JBO:amt

*If not applicable, enter "none."

To be used in lieu of AO110

FORM OBD-227
Revised April 2000

**Attachment A**

## I. Instructions and Definitions

This request seeks the production of certain documents, as specified in Paragraph II of this attachment. The documents should be produced in accordance with the following requirements:

A. Submit all documents that are in your possession, custody, or subject to your control, regardless of whether the documents are in your possession.

B. As used in this attachment, the term "documents" refers to all written or graphic matter, however produced or reproduced onto any other tangible record, including, but not limited to, all writings or recordings, whether handwritten, typewritten, printed, photostated, photographed, recorded magnetically, mechanically or electronically, and any drafts of all documents, whether or not used or circulated. Specifically, the term "documents" includes, but is not limited to, email transmissions, books, papers, files, notes, account statements, confirmations, reports, correspondence, memoranda, ledger sheets, telegrams, telexes, telephone bills, messages or logs, notes or minutes of conversations or meetings, contracts, agreements, calendars, rolodexes, date books, address books, diaries, schedules, itineraries, travel logs, bank statements, worksheets, summaries, desk files, invoices, bills, records of billings, checks (front and back), wire transfers, drafts for money, records of payment, tape recordings, disks, diskettes, disk packs and other electronic media, microfilm, microfiche and storage devices. The term "documents" includes, but is not limited to, all versions of electronic and hard copy working papers.

C. "Communications" means and includes, without limitation, any correspondence, memoranda, notes, electronic mail, telephone conversations, and other conversations, conferences or meetings.

D. As used in this attachment, the term "City of San Diego" means the City of San Diego and all entities in which the City of San Diego has or had a controlling interest, all subsidiaries, affiliates, predecessors, predecessor subsidiaries and affiliates, successors, elected officials, officers, employees, agents, general partners, limited partners, partnerships and aliases, code names, trade or business names used by any of the foregoing, all business-type activities of the City of San Diego, including, but not limited to, Airports, Store Development Service, Environmental Service, Golf Course, Recycling, Sewer Utility, Water Utility, San Diego Data Processing Corporation, San Diego Convention Center Corporation, San Diego Housing Commission, San Diego Medical Services Enterprise, LLC,

Ballpark and Redevelopment Project, Fire and Safety Improvements, and the Public Facilities Financing Authority.

E. As used in this attachment, the terms "concern" and "concerning," mean relating to, referring to, regarding, describing, evidencing, or constituting. The terms "reflect", "pertain to" and "pertaining to" mean containing, embodying, comprising, reflecting, identifying, stating, referring to, responding to, relating to, commenting on, describing, inquiring about, regarding or analyzing.

F. Produce the entirety of each and every document described below, without alteration, deletion or obliteration of any information contained therein, even though such information is not specifically requested.

G. The following rules of construction apply to this attachment:

1. the connectives "and" and "or" shall be construed either disjunctively or conjunctively as necessary to bring within the scope of the attachment all responses that might otherwise be construed to be outside of its scope; and

2. the use of the singular form of any word includes the plural and vice versa.

## II. Documents Requested

**From January 1, 2000 to the present**

A. All documents and communications concerning the salaries, benefits, allowances, and wages paid to the Labor Relations Manager, including Daniel Kelley and Alejandro Ruiz. These documents and communications should include, but are not limited to, W-2 forms, payroll data, direct deposit documents, pay stubs, data relating to the "DROP" program, memoranda, and explanations of benefits.

## SUBPOENA

# UNITED STATES OF AMERICA

### SECURITIES AND EXCHANGE COMMISSION

**City of San Diego Bond Offerings (LA-2842)**

To: Custodian of Records, City of San Diego
c/o Paul S. Maco, Esq.
Vinson & Elkins LLP
1455 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-1008

☒ **YOU MUST PRODUCE** everything specified in the Attachment to this subpoena to officers of the Securities and Exchange Commission, at the place, date and time specified below.

5670 Wilshire Blvd., 11th Fl., Los Angeles, CA 90036-3648, on July 21, 2005, by 5 p.m.

☐ **YOU MUST TESTIFY** before officers of the Securities and Exchange Commission, at the place, date and time specified below.

**FEDERAL LAW REQUIRES YOU TO COMPLY WITH THIS SUBPOENA.**
Failure to comply may subject you to a fine and/or imprisonment.

By: Catherine A. Wimberly
Catherine A. Wimberly
Attorney, Office of Enforcement

Date: 6/30/05

I am an officer of the Securities and Exchange Commission authorized to issue subpoenas in this matter. The Securities and Exchange Commission has issued a formal order authorizing this investigation under Section 20(a) of the Securities Act of 1933 and Section 21(a) of the Securities Exchange Act of 1934.

NOTICE TO WITNESS: If you claim a witness fee or mileage, submit this subpoena with the claim voucher.

**Attachment**
**In the Matter of San Diego City Bond Offerings, (LA-2842)**
**June 30, 2005**

## I. Instructions and Definitions

This request seeks the production of certain documents, as specified in Paragraph II of this attachment. The documents should be produced in accordance with the following requirements:

A. Submit all documents that are in your possession, custody, or subject to your control, regardless of whether the documents are in your possession.

B. As used in this attachment, the term "documents" refers to all written or graphic matter, however produced or reproduced onto any other tangible record, including, but not limited to, all writings or recordings, whether handwritten, typewritten, printed, photostated, photographed, recorded magnetically, mechanically or electronically, and any drafts of all documents, whether or not used or circulated. Specifically, the term "documents" includes, but is not limited to, e-mail transmissions, books, papers, files, notes, account statements, confirmations, reports, correspondence, memoranda, ledger sheets, telegrams, telexes, telephone bills, messages or logs, notes or minutes of conversations or meetings, contracts, agreements, calendars, rolodexes, date books, address books, diaries, schedules, itineraries, travel logs, bank statements, worksheets, summaries, desk files, invoices, bills, records of billings, checks (front and back), wire transfers, drafts for money, records of payment, tape recordings, disks, diskettes, disk packs and other electronic media, microfilm, microfiche and storage devices. The term "documents" includes, but is not limited to, all versions of electronic and hard copy working papers.

C. "Communications" means and includes, without limitation, any correspondence, memoranda, notes, electronic mail, telephone conversations, and other conversations, conferences or meetings.

D. As used in this attachment, the term "City of San Diego" means the City of San Diego and all entities in which the City of San Diego has or had a controlling interest, all subsidiaries, affiliates, predecessors, predecessor subsidiaries and affiliates, successors, elected officials, officers, employees, agents, general partners, limited partners, partnerships and aliases, code names, trade or business names used by any of the foregoing, all business-type activities of the City of San Diego, including, but not limited to, Airports, Store Development Service, Environmental Service, Golf Course, Recycling, Wastewater Utility, Water Utility, San Diego Data Processing Corporation, San Diego Convention Center Corporation, San Diego Housing Commission, San Diego Medical Services Enterprise, LLC, Ballpark and Redevelopment Project, Fire and Safety Improvements, and the Public Facilities Financing Authority.

E. As used in this attachment, the term "Metropolitan Wastewater System" means the City of San Diego's Metropolitan Wastewater System and all entities in which the City of San Diego's Metropolitan Wastewater System has had a controlling interest, all subsidiaries, affiliates, predecessors, predecessor subsidiaries and affiliates, successors, elected officials, officers, employees, agents, general partners, limited partners, partnerships and aliases, code names, trade or business names used by any of the foregoing, and all business-type activities of the City of San Diego's Metropolitan Wastewater System.

F. As used in this attachment, the terms "concern" and "concerning," mean relating to, referring to, regarding, describing, evidencing, or constituting. The terms "reflect", "pertain to" and "pertaining to" mean containing, embodying, comprising, reflecting, identifying, stating, referring to, responding to, relating to, commenting on, describing, inquiring about, regarding or analyzing.

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I. The following rules of construction apply to this attachment:

1. the connectives "and" and "or" shall be construed either disjunctively or conjunctively as necessary to bring within the scope of the attachment all responses that might otherwise be construed to be outside of its scope; and

2. the use of the singular form of any word includes the plural and vice versa.

## II. Documents Requested

**From January 1, 1996 to the present**

A. All documents, including, but not limited to, emails, memoranda, drafts, draft disclosures, and minutes concerning San Diego City Council action, discussion and review of proposed changes to the sewer user charge rate system.

B. All documents, including, but not limited to, emails, memoranda, drafts, draft disclosures, and minutes concerning Public Facilities Financing Authority action, discussion, and review of proposed changes to the sewer user charge rate system.

C. All documents, including, but not limited to, best practices reports, e-mails, handwritten notes, memoranda, drafts, and draft disclosures concerning the City of San Diego's sewer user charge rate system, including, but not limited to, all such documents from the State Water Resources Control Board.

D. All documents relating to the noncompliance of the City of San Diego's sewer user charge rate system with federal, state, and local laws and regulations, including, but not limited to, the Clean Water Act [33 U.S.C. § 1251, *et seq.*], Proposition 218 [the "Right to Vote on Taxes Act,"], Article XIIIB of the California Constitution, Article XIIID 6(b)(3) of the California Constitution, and Proposition 218.

E. All documents that analyze and report on City of San Diego's compliance with sewer user charge rate requirements under federal, state, and local law, including, but not limited to, the Clean Water Act [33 U.S.C. § 1251, *et seq.*], Proposition 218 [the "Right to Vote on Taxes Act,"], Article XIIIB of the California Constitution, Article XIIID 6(b)(3) of the California Constitution, and Proposition 218.

F. All internal documents, including, but not limited to, internal notes, internal correspondence, and internal memos to and from City of San Diego employees, including, but not limited to, Rick Duvernay, Dennis Kahlie, Harold Bromfield, Kelly Salt, and Mary Vattimo, relating to the City of San Diego's noncompliance with sewer user charge rate requirements under federal, state, and local laws and regulations, including, but not limited to, the Clean Water Act [33 U.S.C. § 1251, *et seq.*], Proposition 218 [the "Right to Vote on Taxes Act,"], Article XIIIB of the California Constitution, Article XIIID 6(b)(3) of the California Constitution, and Proposition 218.

G. All complaints received from residents, taxpayers' associations, and citizens' groups relating to the City of San Diego's noncompliance with sewer user charge rate requirements under federal, state, and local laws and regulations, including, but not limited to, the Clean Water Act [33 U.S.C. § 1251, *et seq.*], Proposition 218 [the "Right to Vote on Taxes Act,"], Article XIIIB of the California Constitution, Article XIIID 6(b)(3) of the California Constitution, and Proposition 218.

H. All correspondence with the City of San Diego's auditors, including, but not limited to, KPMG, relating to the City of San Diego's noncompliance with sewer user charge rate requirements with federal, state, and local laws and regulations, including, but not limited to the Clean Water Act [33 U.S.C. § 1251, *et seq.*], Proposition 218 [the "Right to Vote on Taxes Act,"], Article XIIIB of the California Constitution, Article XIIID 6(b)(3) of the California Constitution, and Proposition 218.

I. All documents concerning City of San Diego bond ratings and changes in bond rating as a result of noncompliance with sewer user charge rate requirements under federal, state, and local laws, including, but not limited to, the Clean Water Act [33 U.S.C. § 1251, *et seq.*], Proposition 218 [the "Right to Vote on Taxes

Act,"], Article XIIIB of the California Constitution, Article XIIID 6(b)(3) of the California Constitution, and Proposition 218.

J. All documents concerning the City of San Diego's sewer user charge rates for Kelco.

K. All documents concerning advice from the City Attorney's office concerning the City of San Diego's potential liability as a result of noncompliance with sewer user charge rate requirements under federal, state, and local laws, including, but not limited to, the Clean Water Act [33 U.S.C. § 1251, *et seq.*], Proposition 218 [the "Right to Vote on Taxes Act,"], Article XIIIB of the California Constitution, Article XIIID 6(b)(3) of the California Constitution, and Proposition 218.

L. All documents, including, but not limited to, City Council minutes, agendas, and handouts concerning the City of San Diego's resolution, if any, of its noncompliance with sewer user charge rate requirements under federal, state, and local laws, including, but not limited to the Clean Water Act [33 U.S.C. § 1251, *et seq.*], Proposition 218 [the "Right to Vote on Taxes Act,"], Article XIIIB of the California Constitution, Article XIIID 6(b)(3) of the California Constitution, and Proposition 218.

M. All correspondence between the City of San Diego and all federal and state agencies, including, but not limited to, the State Water Resources Control Board, concerning the City of San Diego's grants under the Federal Clean Water Grant program and the State of California State Revolving Fund low-interest loan program ("SRF").

N. All electronic data, including archived information, concerning the above documents.

# EXHIBIT NO. 4

1 7 1 1

NEW ISSUE - BOOK ENTRY ONLY

*In the opinion of Orrick, Herrington & Sutcliffe LLP, Los Angeles, California and Webster & Anderson, Oakland, California, Co-Bond Counsel, based upon an analysis of existing laws, regulations, rulings and court decisions, and assuming, among other matters, compliance with certain covenants, interest on the Series 1999 Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 and is exempt from State of California personal income taxes. In the further opinion of Co-Bond Counsel, interest on the Series 1999 Bonds is not a specific preference item for purposes of the federal individual or corporate alternative minimum taxes, although Co-Bond Counsel observe that such interest is included in adjusted current earnings when calculating corporate alternative minimum taxable income. Co-Bond Counsel express no opinion regarding any other tax consequences related to the ownership or disposition of, or the accrual or receipt of interest on, the Series 1999 Bonds. See "TAX MATTERS."*

# $315,410,000
# PUBLIC FACILITIES FINANCING AUTHORITY OF THE CITY OF SAN DIEGO
## Sewer Revenue Bonds, Series 1999A and Series 1999B
(Payable Solely From Installment Payments Secured By Wastewater System Net Revenues)

Dated: March 1, 1999

Due: May 15, as shown on the inside cover page

The Series 1999A Bonds and the Series 1999B Bonds (collectively, the "Series 1999 Bonds") are issuable as fully registered bonds and when initially issued will be registered in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York ("DTC"). Purchases of the Series 1999 Bonds will be made in book-entry form only, in denominations of $5,000 or any integral multiple thereof, through brokers and dealers who are, or who act through, DTC Participants. Beneficial Owners of the Series 1999 Bonds will not be entitled to receive physical delivery of bond certificates so long as DTC or a successor securities depository acts as the securities depository with respect to the Series 1999 Bonds. So long as DTC or its nominee is the registered owner of the Series 1999 Bonds, reference herein to Bondholders or registered owners shall mean Cede & Co., as aforesaid, and payments of principal of and interest on the Series 1999 Bonds will be made directly to DTC by State Street Bank and Trust Company of California, N.A., as Trustee. Disbursement of such payments to DTC Participants is the responsibility of DTC and disbursement of such payments to the Beneficial Owners is the responsibility of DTC Participants. See "DESCRIPTION OF THE SERIES 1999 BONDS — Book-Entry-Only System." Interest on the Series 1999 Bonds is payable on May 15 and November 15 of each year, commencing November 15, 1999.

The Series 1999 Bonds are subject to optional and mandatory redemption prior to maturity as described herein.

Proceeds of the Series 1999A Bonds are to be applied to (i) pay for certain capital improvements to the Metropolitan System of the City of San Diego (the "City"), (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds (defined below) and (iii) to pay certain costs of issuance. Proceeds of the Series 1999B Bonds are to be applied to (i) pay for certain capital improvements to the Municipal System of the City, (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds and (iii) to pay certain costs of issuance.

The payment of principal of and interest on the Series 1999 Bonds, excluding the Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 (collectively, the "Insured Series 1999 Bonds"), when due will be guaranteed by a municipal bond insurance policy issued simultaneously with the delivery of the Insured Series 1999 Bonds. The Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 are not insured.

FGIC. Financial Guaranty Insurance Company

FGIC is a registered service mark used by Financial Guaranty Insurance Company, a private company not affiliated with any U.S. Government agency.

The Series 1999 Bonds are limited obligations of the Public Facilities Financing Authority of the City of San Diego (the "Authority") payable solely from Revenues, which Revenues include Installment Payments to be made by the City to the Authority from Net System Revenues pursuant to an Installment Purchase Agreement, as amended and supplemented, including as supplemented by the 1999-1 Supplement to the Master Installment Purchase Agreement, each between the Authority and the City, and amounts on deposit in the funds and accounts established under the Indenture (other than amounts on deposit in the Rebate Fund). The City has pledged Net System Revenues pursuant to the Installment Purchase Agreement to the payment of the Installment Payments. The Series 1999 Bonds are issued on a parity with the Authority's Sewer Revenue Bonds, Series 1993, Series 1995 and Series 1997 (collectively, the "Outstanding Parity Bonds").

The obligation of the City to make Installment Payments does not constitute an obligation of the City for which the City is obligated to levy or pledge any form of taxation or for which the City has levied or pledged any form of taxation. Neither the pledge made by the Authority, nor the obligation of the City to make Installment Payments, creates a legal or equitable pledge, charge, lien or encumbrance upon any of the City's property, or upon its income, receipts or revenues other than Net System Revenues. The Authority has no taxing power.

This cover page contains certain information for general reference only. It is not a summary of the issue. Investors are advised to read the entire Official Statement to obtain information essential to the making of an informed decision.

SEE MATURITY SCHEDULES ON INSIDE FRONT COVER

*The Series 1999 Bonds will be offered when, as and if issued and received by the Underwriters, subject to the approval of validity by Orrick, Herrington & Sutcliffe LLP, Los Angeles, California and Webster & Anderson, Oakland, California, Co-Bond Counsel, and to certain other conditions. Certain legal matters in connection with the Series 1999 Bonds will be passed upon by Casey Gwinn, Esq., City Attorney of the City of San Diego and General Counsel to the Authority and Orrick, Herrington & Sutcliffe LLP, Los Angeles, California, Disclosure Counsel. O'Melveny & Myers LLP has acted as counsel to the Underwriters for specified purposes. See "CERTAIN LEGAL MATTERS." It is expected that the Series 1999 Bonds will be available for delivery through DTC in New York, New York, on or about March 17, 1999.*

Bear, Stearns & Co. Inc. NationsBanc Montgomery Securities LLC

The Chapman Company First Albany Corporation Prudential Securities

March 2, 1999

byproducts, including reclaimed water, are Metropolitan System revenues and are used to offset operation and maintenance costs.

For the fiscal year ended June 30, 1998, out of a total average daily sewage flow of 196.52 million gallons, the total City flow through the Metropolitan System was 138.68 million gallons, or 70.57% of the total flow. This overall proportion of the flow from the City and from the Participating Agencies is expected to continue.

The Participating Agencies in the Metropolitan System are listed in the following table, together with the estimated population, present capacity rights (in mgd), and the percentage of total capacity represented by the capacity rights. The communities and agencies served by the Wastewater System form the second largest integrated metropolitan area in the State of California surpassed only by the Los Angeles metropolitan area.

**Table 3**
**METROPOLITAN SYSTEM**
**CITY AND PARTICIPATING AGENCIES FLOW AND CAPACITY RIGHTS**
**Fiscal Year Ended June 30, 1998**

| Participating Agencies | Estimated Population[1] | Capacity Rights (in mgd) | % of Total Capacity | Flow (mgd)[4] | % of Total Flow |
|---|---|---|---|---|---|
| City of Chula Vista[2] | 153,400 | 19.843 | 8.268% | 9.74 | 4.96% |
| City of Coronado | 29,300 | 3.078 | 1.283 | 2.56 | 1.30 |
| City of Del Mar | 5,200 | 0.821 | 0.342 | 0.68 | 0.35 |
| City of El Cajon | 93,400 | 10.260 | 4.275 | 8.47 | 4.31 |
| City of Imperial Beach | 28,350 | 3.591 | 1.496 | 2.12 | 1.08 |
| City of La Mesa | 57,500 | 6.464 | 2.693 | 5.31 | 2.70 |
| City of Lemon Grove | 25,200 | 2.873 | 1.197 | 1.79 | 0.91 |
| City of National City | 54,900 | 7.141 | 2.975 | 3.62 | 1.84 |
| City of Poway | 46,150 | 5.130 | 2.138 | 4.18 | 2.13 |
| Lakeside Alpine Sanitation District[3] | 31,994 | 4.586 | 1.911 | 3.50 | 1.78 |
| Otay Water District | 28,000 | 1.231 | 0.513 | 0.37 | 0.19 |
| Padre Dam Municipal Water District | 127,903 | 6.382 | 2.659 | 4.10 | 2.09 |
| Spring Valley Sanitation District | 74,514 | 10.978 | 4.574 | 10.38 | 5.28 |
| Winter Gardens Sewer Maintenance District | 9,246 | 1.241 | 0.517 | 1.01 | 0.51 |
| SUBTOTAL | 765,057 | 83.619 | 34.841 | 57.83 | 29.43 |
| City of San Diego | 1,202,500 | 156.381 | 65.159 | 138.69 | 70.57 |
| TOTAL: | 1,967,557 | 240.000 | 100.000% | 196.52[5] | 100.00% |

(1) Source: Participating Agencies and California Department of Finance.
(2) Includes Montgomery Sanitation District.
(3) A single meter serves the sanitation districts of Lakeside and Alpine.
(4) Average for fiscal year. Not adjusted for flows between individual Participating Agencies.
(5) Total flow in Table 3 (196.52 mgd) differs from Table 2 (201 mgd) because Table 2 includes 4 mgd of City flow through the Escondido Wastewater Treatment Plant.

As the foregoing table illustrates, the Participating Agencies are currently not utilizing all of their capacity rights for sewage treatment and disposal.

# EXHIBIT NO. 5

NEW ISSUE - BOOK ENTRY ONLY

*In the opinion of Orrick, Herrington & Sutcliffe LLP, Los Angeles, California and Webster & Anderson, Oakland, California, Co-Bond Counsel, based upon an analysis of existing laws, regulations, rulings and court decisions, and assuming, among other matters, compliance with certain covenants, interest on the Series 1999 Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 and is exempt from State of California personal income taxes. In the further opinion of Co-Bond Counsel, interest on the Series 1999 Bonds is not a specific preference item for purposes of the federal individual or corporate alternative minimum taxes, although Co-Bond Counsel observe that such interest is included in adjusted current earnings when calculating corporate alternative minimum taxable income. Co-Bond Counsel express no opinion regarding any other tax consequences related to the ownership or disposition of, or the accrual or receipt of interest on, the Series 1999 Bonds. See "TAX MATTERS."*

# $315,410,000
# PUBLIC FACILITIES FINANCING AUTHORITY OF THE CITY OF SAN DIEGO
## Sewer Revenue Bonds, Series 1999A and Series 1999B
(Payable Solely From Installment Payments Secured By Wastewater System Net Revenues)

Dated: March 1, 1999

Due: May 15, as shown on the inside cover page

The Series 1999A Bonds and the Series 1999B Bonds (collectively, the "Series 1999 Bonds") are issuable as fully registered bonds and when initially issued will be registered in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York ("DTC"). Purchases of the Series 1999 Bonds will be made in book-entry form only, in denominations of $5,000 or any integral multiple thereof, through brokers and dealers who are, or who act through, DTC Participants. Beneficial Owners of the Series 1999 Bonds will not be entitled to receive physical delivery of bond certificates so long as DTC or a successor securities depository acts as the securities depository with respect to the Series 1999 Bonds. So long as DTC or its nominee is the registered owner of the Series 1999 Bonds, reference herein to Bondholders or registered owners shall mean Cede & Co., as aforesaid, and payments of principal of and interest on the Series 1999 Bonds will be made directly to DTC by State Street Bank and Trust Company of California, N.A., as Trustee. Disbursement of such payments to DTC Participants is the responsibility of DTC and disbursement of such payments to the Beneficial Owners is the responsibility of DTC Participants. See "DESCRIPTION OF THE SERIES 1999 BONDS — Book-Entry-Only System." Interest on the Series 1999 Bonds is payable on May 15 and November 15 of each year, commencing November 15, 1999.

The Series 1999 Bonds are subject to optional and mandatory redemption prior to maturity as described herein.

Proceeds of the Series 1999A Bonds are to be applied to (i) pay for certain capital improvements to the Metropolitan System of the City of San Diego (the "City"), (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds (defined below) and (iii) to pay certain costs of issuance. Proceeds of the Series 1999B Bonds are to be applied to (i) pay for certain capital improvements to the Municipal System of the City, (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds and (iii) to pay certain costs of issuance.

The payment of principal of and interest on the Series 1999 Bonds, excluding the Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 (collectively, the "Insured Series 1999 Bonds"), when due will be guaranteed by a municipal bond insurance policy issued simultaneously with the delivery of the Insured Series 1999 Bonds. The Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 are <u>not</u> insured.

FGIC. Financial Guaranty Insurance Company

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The Series 1999 Bonds are limited obligations of the Public Facilities Financing Authority of the City of San Diego (the "Authority") payable solely from Revenues, which Revenues include Installment Payments to be made by the City to the Authority from Net System Revenues pursuant to an Installment Purchase Agreement, as amended and supplemented, including as supplemented by the 1999-1 Supplement to the Master Installment Purchase Agreement, each between the Authority and the City, and amounts on deposit in the funds and accounts established under the Indenture (other than amounts on deposit in the Rebate Fund). The City has pledged Net System Revenues pursuant to the Installment Purchase Agreement to the payment of the Installment Payments. The Series 1999 Bonds are issued on a parity with the Authority's Sewer Revenue Bonds, Series 1993, Series 1995 and Series 1997 (collectively, the "Outstanding Parity Bonds").

The obligation of the City to make Installment Payments does not constitute an obligation of the City for which the City is obligated to levy or pledge any form of taxation or for which the City has levied or pledged any form of taxation. Neither the pledge made by the Authority, nor the obligation of the City to make Installment Payments, creates a legal or equitable pledge, charge, lien or encumbrance upon any of the City's property, or upon its income, receipts or revenues other than Net System Revenues. The Authority has no taxing power.

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SEE MATURITY SCHEDULES ON INSIDE FRONT COVER

*The Series 1999 Bonds will be offered when, as and if issued and received by the Underwriters, subject to the approval of validity by Orrick, Herrington & Sutcliffe LLP, Los Angeles, California and Webster & Anderson, Oakland, California, Co-Bond Counsel, and to certain other conditions. Certain legal matters in connection with the Series 1999 Bonds will be passed upon by Casey Gwinn, Esq., City Attorney of the City of San Diego and General Counsel to the Authority and Orrick, Herrington & Sutcliffe LLP, Los Angeles, California, Disclosure Counsel. O'Melveny & Myers LLP has acted as counsel to the Underwriters for specified purposes. See "CERTAIN LEGAL MATTERS." It is expected that the Series 1999 Bonds will be available for delivery through DTC in New York, New York, on or about March 17, 1999.*

Bear, Stearns & Co. Inc. NationsBanc Montgomery Securities LLC

The Chapman Company First Albany Corporation Prudential Securities

March 2, 1999

## THE AUTHORITY

The Authority was established pursuant to a Joint Exercise of Powers Agreement, dated May 14, 1991, as amended to date between the City and the Redevelopment Agency of the City. The Authority is intended as a financing vehicle for City facilities and projects. The Authority has no taxing power.

## WASTEWATER SYSTEM

### The Wastewater System

The Wastewater System consists of the Municipal System, which is a municipal sewage collection system for the City's residents, and the Metropolitan System, which is a regional sewage collection, treatment and disposal system initiated in 1958 (and operational since 1963) to serve the City and various other public agencies including cities situated within common drainage areas. The Metropolitan System was designed to provide sufficient capacity to accommodate a regional population of 2,600,000. The City, as operator of the Metropolitan System, is the holder of the National Pollutant Discharge Elimination System ("NPDES") permit and is responsible for maintaining the discharge requirements required under Federal law. The Metropolitan System, as presently designed, provides advanced primary treatment of sewage at its Point Loma Wastewater Treatment Plant and tertiary treatment of sewage at its North City Water Reclamation Plant. See "ACTIONS UNDER THE CLEAN WATER ACT -- Relief From Secondary Treatment Standards" for information regarding the waiver from secondary treatment standards of the Clean Water Act which the City received in 1995 and which expires in November 2000.

The map which follows the Table of Contents of this Official Statement shows the sewer service area boundaries of the Wastewater System which covers approximately 450 square miles, including most of the City.

### Wastewater System Management

The Metropolitan Wastewater Department of the City of San Diego (the "MWWD") manages the Metropolitan System and on July 1, 1996 also assumed management of the Municipal System. For the fiscal year ending June 30, 1999, the MWWD has a $463 million budget and expects to employ approximately 907 employees.

The MWWD operates the Wastewater System with funds derived primarily from service charges which are deposited in the Sewer Revenue Fund. The Sewer Revenue Fund was established by amendment to the City Charter on November 8, 1960. Funds in the Sewer Revenue Fund are used for the operation, maintenance and capital improvement of the Municipal System and Metropolitan System.

### Municipal System Facilities

The Municipal System is comprised of 2,544 miles of trunk and collector mains, 82 sewer pump stations and 14 storm water interceptor pump stations serving in excess of 250,000 customer accounts. On average, these accounts (of which 82% are single-family dwellings, 12% are multi-family dwellings, and the remaining 6% are commercial and industrial customers) generate 138 million gallons per day ("mgd") of wastewater which is conveyed by the Municipal System to the Metropolitan System for treatment and disposal.

The Municipal System also includes the San Pasqual Water Reclamation Plant which has a production capacity of 1 mgd of reclaimed water and was formerly operated by the City's Water Department. The San Pasqual Water Reclamation Plant was transferred to MWWD on July 1, 1997. The San Pasqual Water Reclamation Plant takes a portion of the influent from the Rancho Bernardo area of San Diego via Pump Station 77 and treats the influent to tertiary standards then further demineralizes the product to meet the total dissolved salts standards for the San Pasqual Valley. Three agricultural type businesses are served by the San Pasqual Water Reclamation Plant. Excess effluent and brine from the demineralization process is pumped back to Pump Station 77 and from there to the City of Escondido's Hale Avenue Wastewater Treatment Plant.

The Wastewater System Capital Improvement Program contemplates appropriations of $409.0 million for Municipal System facilities during the eight fiscal years ending June 30, 2006. The proceeds of the Series 1999B

# EXHIBIT NO. 6

# Metropolitan Wastewater

Public Program • Public Input • Public Good

## Important Phone Numbers

- Report a Sewer Spill: (619) 515-3525
- Report Manhole Vandalism: Dial 9-1-1
- Billing Questions: (619) 515-3500
- Sewer line locations: (619) 236-6080
- New Sewer Connections: (619) 446-5000
- Plant Tours: (858) 292-6484
- FEWD Program: (858) 654-4188
- Industrial Waste: (858) 654-4100
- Storm Water Pollution Hotline: (619) 235-1000

## News & Announcements

- Press Releases
- West Nile Virus Prevention (PDF: 130K)

- **General Information**
  Contact Information, Commissions, History and Background, Service Area/Map, Organization Chart, Glossary, Speakers Bureau/Tours
- **Facilities**
  Pt. Loma Wastewater Treatment Plant, North City Water Reclamation Plant, South Bay Water Reclamation Plant, Biosolids Center, Laboratories, Pump Stations
- **Sewer Spill Reduction Program**
  Sewer Spill Stats, Televising Sewer Lines, Canyon Cleaning, Habitat Restoration, F.O.G. (Fats, Oils, Grease) Reduction
- **Protecting the Environment**
  Ocean Monitoring, Industrial WW Control, Water Reclamation, Storm Drains/Runoff, Bi-national Programs, Plant Monitoring
- **Residential Concerns**
  Sewer Rates, Home Plumbing, Sewer Lateral Policies
- **Business Concerns**
  Advertised Projects, CWP Guidelines
- **Department Initiatives**
  Energy Efficiency Program, ISO 14001, Public Contract Operations

Metropolitan Wastewater Info Line (858) 292-6484

Kids Stuff

BE A CANYON WATCHER

GREASE DISPOSAL PROGRAM

SEWER SPILL STATISTICS

VIDEOS

# EXHIBIT NO. 7

# Metropolitan Wastewater

Public Program • Public Input • Public Good

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- **General Information**
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  Pt. Loma Wastewater Treatment Plant, North City Water Reclamation Plant, South Bay Water Reclamation Plant, Biosolids Center, Laboratories, Pump Stations
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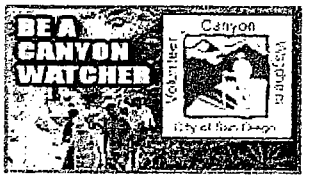
Kid Stuff



# EXHIBIT NO. 8

NEW ISSUE - BOOK ENTRY ONLY

*In the opinion of Orrick, Herrington & Sutcliffe LLP, Los Angeles, California and Webster & Anderson, Oakland, California, Co-Bond Counsel, based upon an analysis of existing laws, regulations, rulings and court decisions, and assuming, among other matters, compliance with certain covenants, interest on the Series 1999 Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 and is exempt from State of California personal income taxes. In the further opinion of Co-Bond Counsel, interest on the Series 1999 Bonds is not a specific preference item for purposes of the federal individual or corporate alternative minimum taxes, although Co-Bond Counsel observe that such interest is included in adjusted current earnings when calculating corporate alternative minimum taxable income. Co-Bond Counsel express no opinion regarding any other tax consequences related to the ownership or disposition of, or the accrual or receipt of interest on, the Series 1999 Bonds. See "TAX MATTERS."*

# $315,410,000
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## Sewer Revenue Bonds, Series 1999A and Series 1999B
(Payable Solely From Installment Payments Secured By Wastewater System Net Revenues)

Dated: March 1, 1999

Due: May 15, as shown on the inside cover page

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The Series 1999 Bonds are subject to optional and mandatory redemption prior to maturity as described herein.

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Bear, Stearns & Co. Inc. NationsBanc Montgomery Securities LLC

The Chapman Company First Albany Corporation Prudential Securities

March 2, 1999

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## WASTEWATER SYSTEM

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The Wastewater System Capital Improvement Program contemplates appropriations of $409.0 million for Municipal System facilities during the eight fiscal years ending June 30, 2006. The proceeds of the Series 1999B

# EXHIBIT NO. 9

NEW ISSUE - BOOK ENTRY ONLY

*In the opinion of Orrick, Herrington & Sutcliffe LLP, Los Angeles, California and Webster & Anderson, Oakland, California, Co-Bond Counsel, based upon an analysis of existing laws, regulations, rulings and court decisions, and assuming, among other matters, compliance with certain covenants, interest on the Series 1999 Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 and is exempt from State of California personal income taxes. In the further opinion of Co-Bond Counsel, interest on the Series 1999 Bonds is not a specific preference item for purposes of the federal individual or corporate alternative minimum taxes, although Co-Bond Counsel observe that such interest is included in adjusted current earnings when calculating corporate alternative minimum taxable income. Co-Bond Counsel express no opinion regarding any other tax consequences related to the ownership or disposition of, or the accrual or receipt of interest on, the Series 1999 Bonds. See "TAX MATTERS."*

# $315,410,000
# PUBLIC FACILITIES FINANCING AUTHORITY OF THE CITY OF SAN DIEGO
## Sewer Revenue Bonds, Series 1999A and Series 1999B
(Payable Solely From Installment Payments Secured By Wastewater System Net Revenues)

Dated: March 1, 1999

Due: May 15, as shown on the inside cover page

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The Series 1999 Bonds are subject to optional and mandatory redemption prior to maturity as described herein.

Proceeds of the Series 1999A Bonds are to be applied to (i) pay for certain capital improvements to the Metropolitan System of the City of San Diego (the "City"), (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds (defined below) and (iii) to pay certain costs of issuance. Proceeds of the Series 1999B Bonds are to be applied to (i) pay for certain capital improvements to the Municipal System of the City, (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds and (iii) to pay certain costs of issuance.

The payment of principal of and interest on the Series 1999 Bonds, excluding the Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 (collectively, the "Insured Series 1999 Bonds"), when due will be guaranteed by a municipal bond insurance policy issued simultaneously with the delivery of the Insured Series 1999 Bonds. The Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 are <u>not</u> insured.

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This cover page contains certain information for general reference only. It is not a summary of the issue. Investors are advised to read the entire Official Statement to obtain information essential to the making of an informed decision.

SEE MATURITY SCHEDULES ON INSIDE FRONT COVER

*The Series 1999 Bonds will be offered when, as and if issued and received by the Underwriters, subject to the approval of validity by Orrick, Herrington & Sutcliffe LLP, Los Angeles, California and Webster & Anderson, Oakland, California, Co-Bond Counsel, and to certain other conditions. Certain legal matters in connection with the Series 1999 Bonds will be passed upon by Casey Gwinn, Esq., City Attorney of the City of San Diego and General Counsel to the Authority and Orrick, Herrington & Sutcliffe LLP, Los Angeles, California, Disclosure Counsel. O'Melveny & Myers LLP has acted as counsel to the Underwriters for specified purposes. See "CERTAIN LEGAL MATTERS." It is expected that the Series 1999 Bonds will be available for delivery through DTC in New York, New York, on or about March 17, 1999.*

Bear, Stearns & Co. Inc. NationsBanc Montgomery Securities LLC

The Chapman Company First Albany Corporation Prudential Securities

March 2, 1999

may be met through a combination of operational efficiencies, greater utilization of projected cash balances and commitment of rate stabilization reserves, it is possible that certain capital improvements contained in the Wastewater System Capital Improvement Program will be deferred until later years to accomplish that goal.

**Table 4**
**EXPECTED WASTEWATER SYSTEM CAPITAL IMPROVEMENT PROGRAM APPROPRIATIONS**
**(July 1, 1998 through June 30, 2006)**

| Expected Projects | Estimated Amounts[1] (In Millions) |
|---|---|
| **Metropolitan System Projects** | |
| Point Loma Plant Upgrade | $110.6 |
| South Bay Sewer Conveyance System | 113.3 |
| South Bay Water Reclamation Plant | 89.2 |
| South Bay Wastewater Treatment Plant | 26.3 |
| Major Interceptors (North & South) | 29.1 |
| Mission Valley Water Reclamation Plant | 16.2 |
| Centrate Treatment Facility | 12.1 |
| Environmental Monitoring & Technical Services Lab | 9.4 |
| Other Metropolitan System Projects | 104.6 |
| Subtotal Metropolitan System Projects | 510.8 |
| **Municipal System Projects** | |
| Annual Allocations | $293.1 |
| Brine Management Program | 48.1 |
| Trunk and Interceptor Sewer Projects | 47.4 |
| Other Municipal System Projects | 20.4 |
| Subtotal of Municipal System Projects | 409.0 |
| TOTAL | $919.8 |

(1) Reflects amounts expected to be appropriated during the period indicated without regard to the timing of expenditure of such amounts. See Table 5 for the timing of expenditures.

**Capital Improvement Projects**

**1. Metropolitan System**

**Point Loma Plant Upgrade.** The Point Loma Plant upgrade commenced in 1990, is 56% complete and is expected to be complete in the year 2001. Ongoing capital improvements include upgrade and expansion of the digester facility, upgrade to the chemical feed system and improvements to the headworks, odor control and grit removal systems completed in two stages over the time period shown in Table 4. A new maintenance building, operations building and warehouse facility will also be constructed during the time period shown in Table 4. Access to the Point Loma Plant will be improved with access road improvements and various site and parking improvements. Expansion of the Point Loma Plant is being implemented through construction of a series of projects that will not significantly disrupt wastewater flow during the construction period.

**South Bay Sewer Conveyance System.** The South Bay Sewer Conveyance System includes a pump station, force main and associated sewer pipelines to convey wastewater from the South Bay Wastewater Treatment Plant to the South Bay Water Reclamation Plant (discussed below). Table 4 includes construction and related costs of $25.8 million. This project is expected to be completed in the year 2001. Also included in this category of projects is funding of $16.5 million for design, environmental and land acquisition costs to secure a site for an additional pump station and related pipeline to serve the South Bay Wastewater Treatment Plant (discussed below) scheduled for construction after the year 2010. Preliminary estimates for the cost of this pump station and related

pipeline exceed $100 million. Table 4 also includes $71 million for environmental, design, land acquisition and construction for the System Flow Stabilization Project. Though average flows from the South Bay region are expected to remain within the capacity of the South Metro Interceptor (until construction of the South Bay Wastewater Treatment Plant) there are still possible spill situations (during peak flows along with unusual weather patterns) that led to the addition of the System Flow Stabilization Project to provide for the routing to and temporary storage of peak flows.

**South Bay Water Reclamation Plant.** The South Bay Water Reclamation Plant will provide up to tertiary treatment of sewage and is being built near the IBWC primary treatment facility in the Tijuana River Valley. Table 4 includes construction and related costs for completion of the South Bay Water Reclamation Plant of $80.5 million and $8.7 million in final construction and related costs for completion of a bridge that will provide access to the South Bay Water Reclamation Plant. The South Bay Water Reclamation Plant is planned to be completed by the year 2001 and will have a 7 mgd capacity. The source of funding for the reclaimed water distribution system has not yet been determined.

**South Bay Wastewater Treatment Plant.** The South Bay Wastewater Treatment Plant will provide secondary treatment of sewage and have a 21 mgd capacity. Table 4 includes design, environmental, engineering and permitting costs in the amount of $26.3 million for the South Bay Wastewater Treatment Plant which is scheduled to be built after 2010 (total estimated cost for first phase of this project will be approximately $366 million) on the same site as the IBWC primary treatment facility and South Bay Water Reclamation Plant. The construction of the South Bay Wastewater Treatment Plant will be required when growth in the area exceeds the requirements of OPRA for the Point Loma Plant and growth in flows exceeds the capacity of the South Metro Interceptor. The scheduling of construction of the South Bay Wastewater Treatment Plant after 2010 is dependent on the City's obtaining certain amendments to OPRA. See "ACTIONS UNDER THE CLEAN WATER ACT -- Relief From Secondary Treatment Requirement."

**Major Interceptors (North and South).** Table 4 includes accelerated scope of work (from 2004 to 1999) for design and construction work on the South Metro Interceptor to repair seven concrete manholes, a 65-foot steel access shaft and additional internal rehabilitation of the 108-inch pipe. The acceleration was deemed advisable given results of inspection of portions of the pipeline. Table 4 reflects additional design, construction and environmental mitigation costs related to the further rehabilitation of the North Metro Interceptor.

**Mission Valley Water Reclamation Plant.** The Mission Valley Water Reclamation Plant is intended to provide up to tertiary treatment of sewage and is to be located on land purchased at a cost of $7 million from the Water Department in San Diego's Mission Valley on Camino Del Rio North east of the intersection of Interstates 8 and 805. Table 4 includes design, permitting, administrative and preliminary costs totaling $16.2 million. A remaining $115 million in construction and related costs is scheduled beyond the time period shown in Table 4 (beyond June 30, 2006). The Mission Valley Water Reclamation Plant is one of the system-wide options for providing the final 8 mgd of a 45 mgd total water reclamation system capacity by the year 2010 as required by the waiver described above under "ACTIONS UNDER THE CLEAN WATER ACT -- Relief From Secondary Treatment Requirements." If this alternative to meeting the water reclamation requirements is selected, design would begin in 2004. Alternatively if another more operationally or cost preferable alternative is selected, this project would be closed out and the budget used to fund the preferred alternative project.

**Centrate Treatment Facility.** The Centrate Treatment Facility will treat centrate, which is the liquid removed during the dewatering of biosolids at the Metropolitan Biosolids Center. This project has been added to the Wastewater Capital Improvement Program since 1997. Table 4 includes design and initial construction costs for the Centrate Treatment Facility, which is estimated to have a completion cost of $75.6 million. This treatment would assist the City in complying with the requirements of OPRA at the Point Loma Plant. This facility may not be built if the City obtains certain legislative amendments to reduce the requirements of OPRA. See "ACTIONS UNDER CLEAN WATER ACT -- Relief From Secondary Treatment Requirements."

**Environmental Monitoring and Technical Services Laboratory.** This project has been added to the Wastewater Capital Improvement Program since 1997. Table 4 includes the design and construction of Phase I of the project which includes a two story 34,000 square foot administrative and public support facility along with an ocean monitoring laboratory. Completion of the project is expected in 2010 at a cost of approximately $30 million.

**Other Metropolitan System Projects.** Annual allocations in an aggregate amount of $42 million for repair and upgrade of the Point Loma Plant, the North City Plant, the Metropolitan Biosolids Center and South Bay Water Reclamation Plant are included in Table 4. Table 4 also includes costs of $36.8 million for the Wastewater Operations Management Network ("COMNET"), a system-wide standardized means of providing the Metropolitan System with process control and monitoring. COMNET includes plant support as well as system communications. In addition to this central COMNET project, each individual facility project has its own COMNET cost element for instrumentation and software specific to that facility. A pooled contingency for all of the Metropolitan System projects is also included in Table 4.

**2. Municipal System**

The rehabilitation and expansion of the Municipal System is included in the Wastewater System Capital Improvement Program. The projects include the replacement of deteriorated concrete sewer collector lines, rehabilitation of sewer pumping stations and construction of new interceptor lines and pump stations as described below. In addition, infrastructure of the Wastewater System Capital Improvement Program for the Municipal System also includes those projects required in the Final Order. The estimated cost of the projects required by the Final Order is $171 million.

**Annual Allocations.** Annual allocations are included in a capital budget each year to cover projects that are not identified until after the beginning of the budget year. Table 4 includes $176.7 million in appropriations for the annual allocation for sewer main replacements. Included in this figure are over 200 projects, including the $171 million in projects required by the Final Order noted above, an allowance for additional sewer mains related to new development, and other replacement work identified by the MWWD's extensive sewer main televising program. Table 4 also includes costs for the annual allocation for emergency construction and the design, construction and related costs for 49 sewer pump station restorations under the annual allocation for sewer pump stations.

**Brine Management Program.** These projects provide the means to dispose of non-polluting industrial brine from the City's growing industrial park in the Rancho Bernardo area of the City without transporting it through costly treatment at the City of Escondido's Hale Avenue Treatment Plant. The three projects included in Table 4 include the design, construction and related costs for Brine Management Force Main and Pump Station and the construction and related costs of Brine Management Program Gravity Line and the City's portion of design and construction costs for the expansion of the San Elijo Outfall. The San Elijo Outfall is not owned by the City and is not part of the Wastewater System.

**Trunk and Interceptor Sewer Projects.** These projects provide for the replacement, rehabilitation, expansion, or construction of existing sewer lines and new sewer lines. These projects are typically larger and more expensive than projects funded through the annual allocations described above. Table 4 includes design, construction and related costs for sixteen stand-alone projects.

**Other Municipal Projects.** Table 4 includes costs for the replacement, expansion or construction of existing sewer pump stations and new pump stations. Table 4 also includes the costs to install energy efficient equipment at the San Pasqual Water Reclamation Treatment Plant and the costs to provide for the telemetry control system for the Municipal System. Also included in Table 4 are the final construction and related costs for the Metropolitan Operations Center Relocation project to complete the movement of the Collections Division equipment storage facility to an adjacent warehouse to allow space to further consolidate MWWD administrative support staff. Table 4 also includes a pooled contingency for all of the Municipal System projects.

**Contract Disputes**

From time to time, the City is engaged in disputes with contractors and subcontractors working on the Wastewater System Capital Improvement Program. Currently, there are a number of pending contract disputes with vendors or contractors that claim an aggregate amount of $21 million.

# EXHIBIT NO. 10

NEW ISSUE - BOOK ENTRY ONLY

*In the opinion of Orrick, Herrington & Sutcliffe LLP, Los Angeles, California and Webster & Anderson, Oakland, California, Co-Bond Counsel, based upon an analysis of existing laws, regulations, rulings and court decisions, and assuming, among other matters, compliance with certain covenants, interest on the Series 1999 Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 and is exempt from State of California personal income taxes. In the further opinion of Co-Bond Counsel, interest on the Series 1999 Bonds is not a specific preference item for purposes of the federal individual or corporate alternative minimum taxes, although Co-Bond Counsel observe that such interest is included in adjusted current earnings when calculating corporate alternative minimum taxable income. Co-Bond Counsel express no opinion regarding any other tax consequences related to the ownership or disposition of, or the accrual or receipt of interest on, the Series 1999 Bonds. See "TAX MATTERS."*

# $315,410,000
# PUBLIC FACILITIES FINANCING AUTHORITY OF THE CITY OF SAN DIEGO
## Sewer Revenue Bonds, Series 1999A and Series 1999B
(Payable Solely From Installment Payments Secured By Wastewater System Net Revenues)

Dated: March 1, 1999 Due: May 15, as shown on the inside cover page

The Series 1999A Bonds and the Series 1999B Bonds (collectively, the "Series 1999 Bonds") are issuable as fully registered bonds and when initially issued will be registered in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York ("DTC"). Purchases of the Series 1999 Bonds will be made in book-entry form only, in denominations of $5,000 or any integral multiple thereof, through brokers and dealers who are, or who act through, DTC Participants. Beneficial Owners of the Series 1999 Bonds will not be entitled to receive physical delivery of bond certificates so long as DTC or a successor securities depository acts as the securities depository with respect to the Series 1999 Bonds. So long as DTC or its nominee is the registered owner of the Series 1999 Bonds, reference herein to Bondholders or registered owners shall mean Cede & Co., as aforesaid, and payments of principal of and interest on the Series 1999 Bonds will be made directly to DTC by State Street Bank and Trust Company of California, N.A., as Trustee. Disbursement of such payments to DTC Participants is the responsibility of DTC and disbursement of such payments to the Beneficial Owners is the responsibility of DTC Participants. See "DESCRIPTION OF THE SERIES 1999 BONDS — Book-Entry-Only System." Interest on the Series 1999 Bonds is payable on May 15 and November 15 of each year, commencing November 15, 1999.

The Series 1999 Bonds are subject to optional and mandatory redemption prior to maturity as described herein.

Proceeds of the Series 1999A Bonds are to be applied to (i) pay for certain capital improvements to the Metropolitan System of the City of San Diego (the "City"), (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds (defined below) and (iii) to pay certain costs of issuance. Proceeds of the Series 1999B Bonds are to be applied to (i) pay for certain capital improvements to the Municipal System of the City, (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds and (iii) to pay certain costs of issuance.

The payment of principal of and interest on the Series 1999 Bonds, excluding the Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 (collectively, the "Insured Series 1999 Bonds"), when due will be guaranteed by a municipal bond insurance policy issued simultaneously with the delivery of the Insured Series 1999 Bonds. **The Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 are not insured.**

FGIC. Financial Guaranty Insurance Company

FGIC is a registered service mark used by Financial Guaranty Insurance Company, a private company not affiliated with any U.S. Government agency.

The Series 1999 Bonds are limited obligations of the Public Facilities Financing Authority of the City of San Diego (the "Authority") payable solely from Revenues, which Revenues include Installment Payments to be made by the City to the Authority from Net System Revenues pursuant to an Installment Purchase Agreement, as amended and supplemented, including as supplemented by the 1999-1 Supplement to the Master Installment Purchase Agreement, each between the Authority and the City, and amounts on deposit in the funds and accounts established under the Indenture (other than amounts on deposit in the Rebate Fund). The City has pledged Net System Revenues pursuant to the Installment Purchase Agreement to the payment of the Installment Payments. The Series 1999 Bonds are issued on a parity with the Authority's Sewer Revenue Bonds, Series 1993, Series 1995 and Series 1997 (collectively, the "Outstanding Parity Bonds").

The obligation of the City to make Installment Payments does not constitute an obligation of the City for which the City is obligated to levy or pledge any form of taxation or for which the City has levied or pledged any form of taxation. Neither the pledge made by the Authority, nor the obligation of the City to make Installment Payments, creates a legal or equitable pledge, charge, lien or encumbrance upon any of the City's property, or upon its income, receipts or revenues other than Net System Revenues. The Authority has no taxing power.

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SEE MATURITY SCHEDULES ON INSIDE FRONT COVER

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Bear, Stearns & Co. Inc. NationsBanc Montgomery Securities LLC

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March 2, 1999

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**Table 4**
**EXPECTED WASTEWATER SYSTEM CAPITAL IMPROVEMENT PROGRAM APPROPRIATIONS**
**(July 1, 1998 through June 30, 2006)**

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| Other Metropolitan System Projects | 104.6 |
| Subtotal Metropolitan System Projects | 510.8 |
| **Municipal System Projects** | |
| Annual Allocations | $293.1 |
| Brine Management Program | 48.1 |
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| Other Municipal System Projects | 20.4 |
| Subtotal of Municipal System Projects | 409.0 |
| TOTAL | $919.8 |

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**Capital Improvement Projects**

**1. Metropolitan System**

**Point Loma Plant Upgrade.** The Point Loma Plant upgrade commenced in 1990, is 56% complete and is expected to be complete in the year 2001. Ongoing capital improvements include upgrade and expansion of the digester facility, upgrade to the chemical feed system and improvements to the headworks, odor control and grit removal systems completed in two stages over the time period shown in Table 4. A new maintenance building, operations building and warehouse facility will also be constructed during the time period shown in Table 4. Access to the Point Loma Plant will be improved with access road improvements and various site and parking improvements. Expansion of the Point Loma Plant is being implemented through construction of a series of projects that will not significantly disrupt wastewater flow during the construction period.

**South Bay Sewer Conveyance System.** The South Bay Sewer Conveyance System includes a pump station, force main and associated sewer pipelines to convey wastewater from the South Bay Wastewater Treatment Plant to the South Bay Water Reclamation Plant (discussed below). Table 4 includes construction and related costs of $25.8 million. This project is expected to be completed in the year 2001. Also included in this category of projects is funding of $16.5 million for design, environmental and land acquisition costs to secure a site for an additional pump station and related pipeline to serve the South Bay Wastewater Treatment Plant (discussed below) scheduled for construction after the year 2010. Preliminary estimates for the cost of this pump station and related

pipeline exceed $100 million. Table 4 also includes $71 million for environmental, design, land acquisition and construction for the System Flow Stabilization Project. Though average flows from the South Bay region are expected to remain within the capacity of the South Metro Interceptor (until construction of the South Bay Wastewater Treatment Plant) there are still possible spill situations (during peak flows along with unusual weather patterns) that led to the addition of the System Flow Stabilization Project to provide for the routing to and temporary storage of peak flows.

**South Bay Water Reclamation Plant.** The South Bay Water Reclamation Plant will provide up to tertiary treatment of sewage and is being built near the IBWC primary treatment facility in the Tijuana River Valley. Table 4 includes construction and related costs for completion of the South Bay Water Reclamation Plant of $80.5 million and $8.7 million in final construction and related costs for completion of a bridge that will provide access to the South Bay Water Reclamation Plant. The South Bay Water Reclamation Plant is planned to be completed by the year 2001 and will have a 7 mgd capacity. The source of funding for the reclaimed water distribution system has not yet been determined.

**South Bay Wastewater Treatment Plant.** The South Bay Wastewater Treatment Plant will provide secondary treatment of sewage and have a 21 mgd capacity. Table 4 includes design, environmental, engineering and permitting costs in the amount of $26.3 million for the South Bay Wastewater Treatment Plant which is scheduled to be built after 2010 (total estimated cost for first phase of this project will be approximately $366 million) on the same site as the IBWC primary treatment facility and South Bay Water Reclamation Plant. The construction of the South Bay Wastewater Treatment Plant will be required when growth in the area exceeds the requirements of OPRA for the Point Loma Plant and growth in flows exceeds the capacity of the South Metro Interceptor. The scheduling of construction of the South Bay Wastewater Treatment Plant after 2010 is dependent on the City's obtaining certain amendments to OPRA. See "ACTIONS UNDER THE CLEAN WATER ACT -- Relief From Secondary Treatment Requirement."

**Major Interceptors (North and South).** Table 4 includes accelerated scope of work (from 2004 to 1999) for design and construction work on the South Metro Interceptor to repair seven concrete manholes, a 65-foot steel access shaft and additional internal rehabilitation of the 108-inch pipe. The acceleration was deemed advisable given results of inspection of portions of the pipeline. Table 4 reflects additional design, construction and environmental mitigation costs related to the further rehabilitation of the North Metro Interceptor.

**Mission Valley Water Reclamation Plant.** The Mission Valley Water Reclamation Plant is intended to provide up to tertiary treatment of sewage and is to be located on land purchased at a cost of $7 million from the Water Department in San Diego's Mission Valley on Camino Del Rio North east of the intersection of Interstates 8 and 805. Table 4 includes design, permitting, administrative and preliminary costs totaling $16.2 million. A remaining $115 million in construction and related costs is scheduled beyond the time period shown in Table 4 (beyond June 30, 2006). The Mission Valley Water Reclamation Plant is one of the system-wide options for providing the final 8 mgd of a 45 mgd total water reclamation system capacity by the year 2010 as required by the waiver described above under "ACTIONS UNDER THE CLEAN WATER ACT -- Relief From Secondary Treatment Requirements." If this alternative to meeting the water reclamation requirements is selected, design would begin in 2004. Alternatively if another more operationally or cost preferable alternative is selected, this project would be closed out and the budget used to fund the preferred alternative project.

**Centrate Treatment Facility.** The Centrate Treatment Facility will treat centrate, which is the liquid removed during the dewatering of biosolids at the Metropolitan Biosolids Center. This project has been added to the Wastewater Capital Improvement Program since 1997. Table 4 includes design and initial construction costs for the Centrate Treatment Facility, which is estimated to have a completion cost of $75.6 million. This treatment would assist the City in complying with the requirements of OPRA at the Point Loma Plant. This facility may not be built if the City obtains certain legislative amendments to reduce the requirements of OPRA. See "ACTIONS UNDER CLEAN WATER ACT -- Relief From Secondary Treatment Requirements."

**Environmental Monitoring and Technical Services Laboratory.** This project has been added to the Wastewater Capital Improvement Program since 1997. Table 4 includes the design and construction of Phase I of the project which includes a two story 34,000 square foot administrative and public support facility along with an ocean monitoring laboratory. Completion of the project is expected in 2010 at a cost of approximately $30 million.

**Other Metropolitan System Projects.** Annual allocations in an aggregate amount of $42 million for repair and upgrade of the Point Loma Plant, the North City Plant, the Metropolitan Biosolids Center and South Bay Water Reclamation Plant are included in Table 4. Table 4 also includes costs of $36.8 million for the Wastewater Operations Management Network ("COMNET"), a system-wide standardized means of providing the Metropolitan System with process control and monitoring. COMNET includes plant support as well as system communications. In addition to this central COMNET project, each individual facility project has its own COMNET cost element for instrumentation and software specific to that facility. A pooled contingency for all of the Metropolitan System projects is also included in Table 4.

## 2. Municipal System

The rehabilitation and expansion of the Municipal System is included in the Wastewater System Capital Improvement Program. The projects include the replacement of deteriorated concrete sewer collector lines, rehabilitation of sewer pumping stations and construction of new interceptor lines and pump stations as described below. In addition, infrastructure of the Wastewater System Capital Improvement Program for the Municipal System also includes those projects required in the Final Order. The estimated cost of the projects required by the Final Order is $171 million.

**Annual Allocations.** Annual allocations are included in a capital budget each year to cover projects that are not identified until after the beginning of the budget year. Table 4 includes $176.7 million in appropriations for the annual allocation for sewer main replacements. Included in this figure are over 200 projects, including the $171 million in projects required by the Final Order noted above, an allowance for additional sewer mains related to new development, and other replacement work identified by the MWWD's extensive sewer main televising program. Table 4 also includes costs for the annual allocation for emergency construction and the design, construction and related costs for 49 sewer pump station restorations under the annual allocation for sewer pump stations.

**Brine Management Program.** These projects provide the means to dispose of non-polluting industrial brine from the City's growing industrial park in the Rancho Bernardo area of the City without transporting it through costly treatment at the City of Escondido's Hale Avenue Treatment Plant. The three projects included in Table 4 include the design, construction and related costs for Brine Management Force Main and Pump Station and the construction and related costs of Brine Management Program Gravity Line and the City's portion of design and construction costs for the expansion of the San Elijo Outfall. The San Elijo Outfall is not owned by the City and is not part of the Wastewater System.

**Trunk and Interceptor Sewer Projects.** These projects provide for the replacement, rehabilitation, expansion, or construction of existing sewer lines and new sewer lines. These projects are typically larger and more expensive than projects funded through the annual allocations described above. Table 4 includes design, construction and related costs for sixteen stand-alone projects.

**Other Municipal Projects.** Table 4 includes costs for the replacement, expansion or construction of existing sewer pump stations and new pump stations. Table 4 also includes the costs to install energy efficient equipment at the San Pasqual Water Reclamation Treatment Plant and the costs to provide for the telemetry control system for the Municipal System. Also included in Table 4 are the final construction and related costs for the Metropolitan Operations Center Relocation project to complete the movement of the Collections Division equipment storage facility to an adjacent warehouse to allow space to further consolidate MWWD administrative support staff. Table 4 also includes a pooled contingency for all of the Municipal System projects.

### Contract Disputes

From time to time, the City is engaged in disputes with contractors and subcontractors working on the Wastewater System Capital Improvement Program. Currently, there are a number of pending contract disputes with vendors or contractors that claim an aggregate amount of $21 million.

# EXHIBIT NO. 11

1999

NEW ISSUE - BOOK ENTRY ONLY

*In the opinion of Orrick, Herrington & Sutcliffe LLP, Los Angeles, California and Webster & Anderson, Oakland, California, Co-Bond Counsel, based upon an analysis of existing laws, regulations, rulings and court decisions, and assuming, among other matters, compliance with certain covenants, interest on the Series 1999 Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 and is exempt from State of California personal income taxes. In the further opinion of Co-Bond Counsel, interest on the Series 1999 Bonds is not a specific preference item for purposes of the federal individual or corporate alternative minimum taxes, although Co-Bond Counsel observe that such interest is included in adjusted current earnings when calculating corporate alternative minimum taxable income. Co-Bond Counsel express no opinion regarding any other tax consequences related to the ownership or disposition of, or the accrual or receipt of interest on, the Series 1999 Bonds. See "TAX MATTERS."*

# $315,410,000
# PUBLIC FACILITIES FINANCING AUTHORITY OF THE CITY OF SAN DIEGO
## Sewer Revenue Bonds, Series 1999A and Series 1999B
(Payable Solely From Installment Payments Secured By Wastewater System Net Revenues)

Dated: March 1, 1999 Due: May 15, as shown on the inside cover page

The Series 1999A Bonds and the Series 1999B Bonds (collectively, the "Series 1999 Bonds") are issuable as fully registered bonds and when initially issued will be registered in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York ("DTC"). Purchases of the Series 1999 Bonds will be made in book-entry form only, in denominations of $5,000 or any integral multiple thereof, through brokers and dealers who are, or who act through, DTC Participants. Beneficial Owners of the Series 1999 Bonds will not be entitled to receive physical delivery of bond certificates so long as DTC or a successor securities depository acts as the securities depository with respect to the Series 1999 Bonds. So long as DTC or its nominee is the registered owner of the Series 1999 Bonds, reference herein to Bondholders or registered owners shall mean Cede & Co., as aforesaid, and payments of principal of and interest on the Series 1999 Bonds will be made directly to DTC by State Street Bank and Trust Company of California, N.A., as Trustee. Disbursement of such payments to DTC Participants is the responsibility of DTC and disbursement of such payments to the Beneficial Owners is the responsibility of DTC Participants. See "DESCRIPTION OF THE SERIES 1999 BONDS — Book-Entry-Only System." Interest on the Series 1999 Bonds is payable on May 15 and November 15 of each year, commencing November 15, 1999.

The Series 1999 Bonds are subject to optional and mandatory redemption prior to maturity as described herein.

Proceeds of the Series 1999A Bonds are to be applied to (i) pay for certain capital improvements to the Metropolitan System of the City of San Diego (the "City"), (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds (defined below) and (iii) to pay certain costs of issuance. Proceeds of the Series 1999B Bonds are to be applied to (i) pay for certain capital improvements to the Municipal System of the City, (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds and (iii) to pay certain costs of issuance.

The payment of principal of and interest on the Series 1999 Bonds, excluding the Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 (collectively, the "Insured Series 1999 Bonds"), when due will be guaranteed by a municipal bond insurance policy issued simultaneously with the delivery of the Insured Series 1999 Bonds. **The Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 are not insured.**

FGIC. Financial Guaranty Insurance Company

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The Series 1999 Bonds are limited obligations of the Public Facilities Financing Authority of the City of San Diego (the "Authority") payable solely from Revenues, which Revenues include Installment Payments to be made by the City to the Authority from Net System Revenues pursuant to an Installment Purchase Agreement, as amended and supplemented, including as supplemented by the 1999-1 Supplement to the Master Installment Purchase Agreement, each between the Authority and the City, and amounts on deposit in the funds and accounts established under the Indenture (other than amounts on deposit in the Rebate Fund). The City has pledged Net System Revenues pursuant to the Installment Purchase Agreement to the payment of the Installment Payments. The Series 1999 Bonds are issued on a parity with the Authority's Sewer Revenue Bonds, Series 1993, Series 1995 and Series 1997 (collectively, the "Outstanding Parity Bonds").

**The obligation of the City to make Installment Payments does not constitute an obligation of the City for which the City is obligated to levy or pledge any form of taxation or for which the City has levied or pledged any form of taxation. Neither the pledge made by the Authority, nor the obligation of the City to make Installment Payments, creates a legal or equitable pledge, charge, lien or encumbrance upon any of the City's property, or upon its income, receipts or revenues other than Net System Revenues. The Authority has no taxing power.**

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SEE MATURITY SCHEDULES ON INSIDE FRONT COVER

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Bear, Stearns & Co. Inc. NationsBanc Montgomery Securities LLC

The Chapman Company First Albany Corporation Prudential Securities

March 2, 1999

## WASTEWATER SYSTEM REGULATORY REQUIREMENTS

### General

The Wastewater System is subject to regulations imposed by the Clean Water Act. The regulatory requirements are administered by the United States Environmental Protection Agency (the "EPA"), the California State Water Resources Control Board (the "State Board") and the San Diego Regional Water Quality Control Board (the "Regional Board"). Regulations of these agencies deal primarily with the quality of effluent which may be discharged from the Wastewater System, the disposal of sludge generated by the Wastewater System, the discharge of pollutants into groundwater, and the nature of waste material (particularly industrial waste) discharged into the collection system. The Point Loma Plant functions as an advanced primary treatment plant and the North City Plant functions as a tertiary treatment plant under the Clean Water Act.

On November 9, 1995, the City received from the EPA a five-year waiver of the secondary treatment requirements for the Point Loma Plant based on the successful implementation of certain requirements contained in OPRA. See "ACTIONS UNDER THE CLEAN WATER ACT -- Relief From Secondary Treatment Requirements" for information regarding the extension of the waiver and the possible legislative amendments to OPRA. The waiver allowed the City to obtain a modified NPDES permit. The City must operate the Wastewater System according to the discharge limitations set forth in its NPDES permit in order to comply with federally mandated effluent quality and disposal criteria. The NPDES permit and the waiver both expire on November 9, 2000 and the City will need to apply for successive five-year extensions in order to continue to be exempt from the secondary treatment standards of the Clear Water Act.

To comply with other federal regulations concerning the discharge of waste materials into the Wastewater System, the City must administer and enforce industrial pretreatment limitation standards upon industrial users of the Wastewater System. The City has had an industrial waste program in effect since the early 1970s. The City's industrial waste ordinance sets forth water quality standards that industrial users must meet and provides enforcement procedures for violators. The Industrial Waste Division of the MWWD is currently responsible for monitoring an average of 1,000 permitted industries located in the Metropolitan System service area. In addition, each Participating Agency is required to permit and monitor all industries within its respective service area. While each Participating Agency as a condition of the Regional Wastewater Disposal Agreement is required to comply with quality standards set by the City, the City, at the urging of the EPA, has required separate pretreatment agreements with each Participating Agency to ensure industrial pretreatment requirements are met. All Participating Agencies have entered into such pretreatment agreements.

As a condition of having received federal EPA grant funds under the Clean Water Act for the planning and construction of various improvements to the Wastewater System, the City is subject to additional regulatory requirements. For example, a federal EPA grant of approximately $76 million that the City received and used for the construction of the North City Plant provides that the City shall attempt to meet the goal of beneficial reuse of 25% of the flows treated at the North City Plant by December 31, 2003 and 50% by December 31, 2010. The goal of 25% beneficial reuse by 2003 can be achieved by the existing reclaimed water distribution system that is owned and operated by the City's Water Department. The City is currently evaluating the various alternatives for compliance with the goal of 50% beneficial reuse by 2010. If the City were found by the EPA to have not met the conditions of this grant or any other federal EPA grants, the City could be required to return the grant moneys to the EPA.

Among other grant-related requirements are guidelines which must be followed concerning planning methodologies, design criteria, construction activities, and the operation, maintenance and financing of facilities. As another condition of its past receipt of federal grants, the State Board, as the delegate of the EPA, must approve the sewer service charge structures of the City and the Participating Agencies. Such service charge structures require the recovery of annual operations, maintenance and replacement costs from users of the system in a proportionate manner according to the customer's level of use. Such factors as volume, infiltration/inflow, delivery flow rate, and strength of sewage are to be considered for determining proportionate use. Sewer service charge rates for all retail users are reviewed annually and established at a level necessary to generate sufficient revenues to recover the annual operations, maintenance and replacement costs. Sewer service charge rates for users are established to recognize the volume and strength characteristics of wastewater contributed to the Wastewater System. The City's rate structure

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acknowledging duties to bill customers based on strength

# EXHIBIT NO. 12

1999

NEW ISSUE - BOOK ENTRY ONLY

*In the opinion of Orrick, Herrington & Sutcliffe LLP, Los Angeles, California and Webster & Anderson, Oakland, California, Co-Bond Counsel, based upon an analysis of existing laws, regulations, rulings and court decisions, and assuming, among other matters, compliance with certain covenants, interest on the Series 1999 Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 and is exempt from State of California personal income taxes. In the further opinion of Co-Bond Counsel, interest on the Series 1999 Bonds is not a specific preference item for purposes of the federal individual or corporate alternative minimum taxes, although Co-Bond Counsel observe that such interest is included in adjusted current earnings when calculating corporate alternative minimum taxable income. Co-Bond Counsel express no opinion regarding any other tax consequences related to the ownership or disposition of, or the accrual or receipt of interest on, the Series 1999 Bonds. See "TAX MATTERS."*

# $315,410,000
# PUBLIC FACILITIES FINANCING AUTHORITY OF THE CITY OF SAN DIEGO
## Sewer Revenue Bonds, Series 1999A and Series 1999B
(Payable Solely From Installment Payments Secured By Wastewater System Net Revenues)

Dated: March 1, 1999 Due: May 15, as shown on the inside cover page

The Series 1999A Bonds and the Series 1999B Bonds (collectively, the "Series 1999 Bonds") are issuable as fully registered bonds and when initially issued will be registered in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York ("DTC"). Purchases of the Series 1999 Bonds will be made in book-entry form only, in denominations of $5,000 or any integral multiple thereof, through brokers and dealers who are, or who act through, DTC Participants. Beneficial Owners of the Series 1999 Bonds will not be entitled to receive physical delivery of bond certificates so long as DTC or a successor securities depository acts as the securities depository with respect to the Series 1999 Bonds. So long as DTC or its nominee is the registered owner of the Series 1999 Bonds, reference herein to Bondholders or registered owners shall mean Cede & Co., as aforesaid, and payments of principal of and interest on the Series 1999 Bonds will be made directly to DTC by State Street Bank and Trust Company of California, N.A., as Trustee. Disbursement of such payments to DTC Participants is the responsibility of DTC and disbursement of such payments to the Beneficial Owners is the responsibility of DTC Participants. See "DESCRIPTION OF THE SERIES 1999 BONDS — Book-Entry-Only System." Interest on the Series 1999 Bonds is payable on May 15 and November 15 of each year, commencing November 15, 1999.

The Series 1999 Bonds are subject to optional and mandatory redemption prior to maturity as described herein.

Proceeds of the Series 1999A Bonds are to be applied to (i) pay for certain capital improvements to the Metropolitan System of the City of San Diego (the "City"), (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds (defined below) and (iii) to pay certain costs of issuance. Proceeds of the Series 1999B Bonds are to be applied to (i) pay for certain capital improvements to the Municipal System of the City, (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds and (iii) to pay certain costs of issuance.

The payment of principal of and interest on the Series 1999 Bonds, excluding the Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 (collectively, the "Insured Series 1999 Bonds"), when due will be guaranteed by a municipal bond insurance policy issued simultaneously with the delivery of the Insured Series 1999 Bonds. **The Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 are not insured.**

FGIC. Financial Guaranty Insurance Company

FGIC is a registered service mark used by Financial Guaranty Insurance Company, a private company not affiliated with any U.S. Government agency.

The Series 1999 Bonds are limited obligations of the Public Facilities Financing Authority of the City of San Diego (the "Authority") payable solely from Revenues, which Revenues include Installment Payments to be made by the City to the Authority from Net System Revenues pursuant to an Installment Purchase Agreement, as amended and supplemented, including as supplemented by the 1999-1 Supplement to the Master Installment Purchase Agreement, each between the Authority and the City, and amounts on deposit in the funds and accounts established under the Indenture (other than amounts on deposit in the Rebate Fund). The City has pledged Net System Revenues pursuant to the Installment Purchase Agreement to the payment of the Installment Payments. The Series 1999 Bonds are issued on a parity with the Authority's Sewer Revenue Bonds, Series 1993, Series 1995 and Series 1997 (collectively, the "Outstanding Parity Bonds").

**The obligation of the City to make Installment Payments does not constitute an obligation of the City for which the City is obligated to levy or pledge any form of taxation or for which the City has levied or pledged any form of taxation. Neither the pledge made by the Authority, nor the obligation of the City to make Installment Payments, creates a legal or equitable pledge, charge, lien or encumbrance upon any of the City's property, or upon its income, receipts or revenues other than Net System Revenues. The Authority has no taxing power.**

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Bear, Stearns & Co. Inc. NationsBanc Montgomery Securities LLC

The Chapman Company First Albany Corporation Prudential Securities

March 2, 1999

## WASTEWATER SYSTEM REGULATORY REQUIREMENTS

### General

The Wastewater System is subject to regulations imposed by the Clean Water Act. The regulatory requirements are administered by the United States Environmental Protection Agency (the "EPA"), the California State Water Resources Control Board (the "State Board") and the San Diego Regional Water Quality Control Board (the "Regional Board"). Regulations of these agencies deal primarily with the quality of effluent which may be discharged from the Wastewater System, the disposal of sludge generated by the Wastewater System, the discharge of pollutants into groundwater, and the nature of waste material (particularly industrial waste) discharged into the collection system. The Point Loma Plant functions as an advanced primary treatment plant and the North City Plant functions as a tertiary treatment plant under the Clean Water Act.

On November 9, 1995, the City received from the EPA a five-year waiver of the secondary treatment requirements for the Point Loma Plant based on the successful implementation of certain requirements contained in OPRA. See "ACTIONS UNDER THE CLEAN WATER ACT -- Relief From Secondary Treatment Requirements" for information regarding the extension of the waiver and the possible legislative amendments to OPRA. The waiver allowed the City to obtain a modified NPDES permit. The City must operate the Wastewater System according to the discharge limitations set forth in its NPDES permit in order to comply with federally mandated effluent quality and disposal criteria. The NPDES permit and the waiver both expire on November 9, 2000 and the City will need to apply for successive five-year extensions in order to continue to be exempt from the secondary treatment standards of the Clear Water Act.

To comply with other federal regulations concerning the discharge of waste materials into the Wastewater System, the City must administer and enforce industrial pretreatment limitation standards upon industrial users of the Wastewater System. The City has had an industrial waste program in effect since the early 1970s. The City's industrial waste ordinance sets forth water quality standards that industrial users must meet and provides enforcement procedures for violators. The Industrial Waste Division of the MWWD is currently responsible for monitoring an average of 1,000 permitted industries located in the Metropolitan System service area. In addition, each Participating Agency is required to permit and monitor all industries within its respective service area. While each Participating Agency as a condition of the Regional Wastewater Disposal Agreement is required to comply with quality standards set by the City, the City, at the urging of the EPA, has required separate pretreatment agreements with each Participating Agency to ensure industrial pretreatment requirements are met. All Participating Agencies have entered into such pretreatment agreements.

As a condition of having received federal EPA grant funds under the Clean Water Act for the planning and construction of various improvements to the Wastewater System, the City is subject to additional regulatory requirements. For example, a federal EPA grant of approximately $76 million that the City received and used for the construction of the North City Plant provides that the City shall attempt to meet the goal of beneficial reuse of 25% of the flows treated at the North City Plant by December 31, 2003 and 50% by December 31, 2010. The goal of 25% beneficial reuse by 2003 can be achieved by the existing reclaimed water distribution system that is owned and operated by the City's Water Department. The City is currently evaluating the various alternatives for compliance with the goal of 50% beneficial reuse by 2010. If the City were found by the EPA to have not met the conditions of this grant or any other federal EPA grants, the City could be required to return the grant moneys to the EPA.

Among other grant-related requirements are guidelines which must be followed concerning planning methodologies, design criteria, construction activities, and the operation, maintenance and financing of facilities. As another condition of its past receipt of federal grants, the State Board, as the delegate of the EPA, must approve the sewer service charge structures of the City and the Participating Agencies. Such service charge structures require the recovery of annual operations, maintenance and replacement costs from users of the system in a proportionate manner according to the customer's level of use. Such factors as volume, infiltration/inflow, delivery flow rate, and strength of sewage are to be considered for determining proportionate use. Sewer service charge rates for all retail users are reviewed annually and established at a level necessary to generate sufficient revenues to recover the annual operations, maintenance and replacement costs. Sewer service charge rates for users are established to recognize the volume and strength characteristics of wastewater contributed to the Wastewater System. The City's rate structure

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has been reviewed by the State Board and no grant funds or costs under grant funded programs have been disallowed based on the nature of the rate structures.

In addition to federal requirements, the City must also comply with water quality based effluent State requirements, otherwise known as the State Ocean Plan. Another State law concerned with control of water quality is the Porter-Cologne Water Quality Control Act of 1969, as amended. The Porter-Cologne Act directly addresses the problem of water reclamation and reuse. A declared policy of the law is that the people of the State of California have a primary interest in the development of facilities to reclaim wastewater to supplement existing surface and underground water supplies in order to meet their water requirements. The legislative intent was to undertake all possible development of water reclamation facilities to make reclaimed water available for use. The law requires the State Department of Health Services to establish statewide reclamation criteria for each type of use where such use involves public health. The City's proposed water reclamation projects are subject to the Porter-Cologne Act and are being designed in consultation with State officials to comply with its requirements.

The City believes that it is in compliance with all federal and state laws relating to the Wastewater System.

**Certain Compliance Actions and Other Litigation**

On February 8, 1996, the Regional Board accepted a proposal offered by the City to resolve all outstanding enforcement and liability issues relating to alleged sewer overflows involving the Wastewater System and inadequate reporting of such events. Without admitting any liability for pending issues related to sewer overflows and reporting, the City agreed to a cash payment of $350,000 and approximately one million dollars total in environmental credit projects extending over five years, from 1996 to 2001. This settlement resulted in a full satisfaction of all issues between the City and the Regional Board through the date of settlement. To date, all requirements of the settlement have been met and there are no pending complaints involving the City before the Regional Board.

The City is not presently involved in nor has received notice of any claim pertaining to regulation relief.

## ACTIONS UNDER THE CLEAN WATER ACT

**General**

In 1972, Congress enacted the Clean Water Act, which among other things, directs the EPA to monitor and to regulate the discharge of pollution into navigable water ways and to enforce the requirement that all wastewater treatment plants in the nation provide full secondary treatment for sewage. In 1977, Congress amended the Clean Water Act to allow waivers of secondary treatment standards for certain ocean discharges. In September 1979, the City submitted an application to the EPA for a waiver from the secondary treatment standards based upon the EPA's proposed waiver regulations. The EPA tentatively approved the City's waiver application in September 1981. A revised waiver application incorporating updated flow projections was submitted to the EPA in November 1983. However, in September 1986, the EPA reversed its tentative approval of the City's 1979 waiver application and tentatively denied the City's 1979 and 1983 applications. In February 1987, the City Council decided to discontinue its efforts to obtain a waiver. However, see "Relief From Secondary Treatment Requirements" below for information regarding the waiver from secondary treatment standards of the Clean Water Act which the City received in 1995 and which expires in November 2000.

**Litigation and Final Order**

In July 1988, the United States of America, acting through the Department of Justice and the EPA, and the State of California filed suit against the City in U.S. District Court for alleged violations of the Clean Water Act, its NPDES permit, sewer overflows, and alleged irregularities in the City's pretreatment program that regulates industrial waste. The plaintiffs sought injunctive relief and monetary damages for alleged effluent limit violations, failure to meet secondary treatment standards, past sewer spills, and pretreatment violations. The lawsuit was divided into a penalty proceeding and a remedies proceeding.

# EXHIBIT NO. 13

1999

NEW ISSUE - BOOK ENTRY ONLY

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# $315,410,000
# PUBLIC FACILITIES FINANCING AUTHORITY OF THE CITY OF SAN DIEGO
## Sewer Revenue Bonds, Series 1999A and Series 1999B
(Payable Solely From Installment Payments Secured By Wastewater System Net Revenues)

Dated: March 1, 1999

Due: May 15, as shown on the inside cover page

The Series 1999A Bonds and the Series 1999B Bonds (collectively, the "Series 1999 Bonds") are issuable as fully registered bonds and when initially issued will be registered in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York ("DTC"). Purchases of the Series 1999 Bonds will be made in book-entry form only, in denominations of $5,000 or any integral multiple thereof, through brokers and dealers who are, or who act through, DTC Participants. Beneficial Owners of the Series 1999 Bonds will not be entitled to receive physical delivery of bond certificates so long as DTC or a successor securities depository acts as the securities depository with respect to the Series 1999 Bonds. So long as DTC or its nominee is the registered owner of the Series 1999 Bonds, reference herein to Bondholders or registered owners shall mean Cede & Co., as aforesaid, and payments of principal of and interest on the Series 1999 Bonds will be made directly to DTC by State Street Bank and Trust Company of California, N.A., as Trustee. Disbursement of such payments to DTC Participants is the responsibility of DTC and disbursement of such payments to the Beneficial Owners is the responsibility of DTC Participants. See "DESCRIPTION OF THE SERIES 1999 BONDS — Book-Entry-Only System." Interest on the Series 1999 Bonds is payable on May 15 and November 15 of each year, commencing November 15, 1999.

The Series 1999 Bonds are subject to optional and mandatory redemption prior to maturity as described herein.

Proceeds of the Series 1999A Bonds are to be applied to (i) pay for certain capital improvements to the Metropolitan System of the City of San Diego (the "City"), (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds (defined below) and (iii) to pay certain costs of issuance. Proceeds of the Series 1999B Bonds are to be applied to (i) pay for certain capital improvements to the Municipal System of the City, (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds and (iii) to pay certain costs of issuance.

The payment of principal of and interest on the Series 1999 Bonds, excluding the Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 (collectively, the "Insured Series 1999 Bonds"), when due will be guaranteed by a municipal bond insurance policy issued simultaneously with the delivery of the Insured Series 1999 Bonds. The Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 are <u>not</u> insured.

FGIC. Financial Guaranty Insurance Company

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Bear, Stearns & Co. Inc. NationsBanc Montgomery Securities LLC

The Chapman Company First Albany Corporation Prudential Securities

March 2, 1999

## WASTEWATER SYSTEM REGULATORY REQUIREMENTS

### General

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On November 9, 1995, the City received from the EPA a five-year waiver of the secondary treatment requirements for the Point Loma Plant based on the successful implementation of certain requirements contained in OPRA. See "ACTIONS UNDER THE CLEAN WATER ACT -- Relief From Secondary Treatment Requirements" for information regarding the extension of the waiver and the possible legislative amendments to OPRA. The waiver allowed the City to obtain a modified NPDES permit. The City must operate the Wastewater System according to the discharge limitations set forth in its NPDES permit in order to comply with federally mandated effluent quality and disposal criteria. The NPDES permit and the waiver both expire on November 9, 2000 and the City will need to apply for successive five-year extensions in order to continue to be exempt from the secondary treatment standards of the Clear Water Act.

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has been reviewed by the State Board and no grant funds or costs under grant funded programs have been disallowed based on the nature of the rate structures.

In addition to federal requirements, the City must also comply with water quality based effluent State requirements, otherwise known as the State Ocean Plan. Another State law concerned with control of water quality is the Porter-Cologne Water Quality Control Act of 1969, as amended. The Porter-Cologne Act directly addresses the problem of water reclamation and reuse. A declared policy of the law is that the people of the State of California have a primary interest in the development of facilities to reclaim wastewater to supplement existing surface and underground water supplies in order to meet their water requirements. The legislative intent was to undertake all possible development of water reclamation facilities to make reclaimed water available for use. The law requires the State Department of Health Services to establish statewide reclamation criteria for each type of use where such use involves public health. The City's proposed water reclamation projects are subject to the Porter-Cologne Act and are being designed in consultation with State officials to comply with its requirements.

The City believes that it is in compliance with all federal and state laws relating to the Wastewater System.

### Certain Compliance Actions and Other Litigation

On February 8, 1996, the Regional Board accepted a proposal offered by the City to resolve all outstanding enforcement and liability issues relating to alleged sewer overflows involving the Wastewater System and inadequate reporting of such events. Without admitting any liability for pending issues related to sewer overflows and reporting, the City agreed to a cash payment of $350,000 and approximately one million dollars total in environmental credit projects extending over five years, from 1996 to 2001. This settlement resulted in a full satisfaction of all issues between the City and the Regional Board through the date of settlement. To date, all requirements of the settlement have been met and there are no pending complaints involving the City before the Regional Board.

The City is not presently involved in nor has received notice of any claim pertaining to regulation relief.

## ACTIONS UNDER THE CLEAN WATER ACT

### General

In 1972, Congress enacted the Clean Water Act, which among other things, directs the EPA to monitor and to regulate the discharge of pollution into navigable water ways and to enforce the requirement that all wastewater treatment plants in the nation provide full secondary treatment for sewage. In 1977, Congress amended the Clean Water Act to allow waivers of secondary treatment standards for certain ocean discharges. In September 1979, the City submitted an application to the EPA for a waiver from the secondary treatment standards based upon the EPA's proposed waiver regulations. The EPA tentatively approved the City's waiver application in September 1981. A revised waiver application incorporating updated flow projections was submitted to the EPA in November 1983. However, in September 1986, the EPA reversed its tentative approval of the City's 1979 waiver application and tentatively denied the City's 1979 and 1983 applications. In February 1987, the City Council decided to discontinue its efforts to obtain a waiver. However, see "Relief From Secondary Treatment Requirements" below for information regarding the waiver from secondary treatment standards of the Clean Water Act which the City received in 1995 and which expires in November 2000.

### Litigation and Final Order

In July 1988, the United States of America, acting through the Department of Justice and the EPA, and the State of California filed suit against the City in U.S. District Court for alleged violations of the Clean Water Act, its NPDES permit, sewer overflows, and alleged irregularities in the City's pretreatment program that regulates industrial waste. The plaintiffs sought injunctive relief and monetary damages for alleged effluent limit violations, failure to meet secondary treatment standards, past sewer spills, and pretreatment violations. The lawsuit was divided into a penalty proceeding and a remedies proceeding.

# EXHIBIT NO. 14

(916) 739-4426
(916) 739-2300 FAX

SEP 18 1991

Mr. Charles Yackly
Deputy Water Utilities
Department Director
City of San Diego
First Interstate Plaza
401 B Street, Suite 400
San Diego, CA 92101-4227

Dear Mr. Yackly:

FINAL REVENUE PROGRAM APPROVAL -- CITY OF SAN DIEGO, CLEAN WATER GRANT PROJECT NO. C-06-1092-210, -510, -520, -530 AND -540

The City of Chula Vista recently received approval of their final revenue program and sewer use ordinance. All member agencies of the City of San Diego Wastewater Treatment Facilities now have an approved revenue program and sewer use ordinance. Congratulations, the City of San Diego has complied with all the appropriate revenue program requirements applicable to the above referenced projects.

Implementation and maintenance of the user charge system is a requirement of the grant regulations (refer to 40 CFR 35.2208). Both the user charge system and sewer use ordinance must be implemented for the useful life of the facilities. The California State Water Resources Control Board, Division of Clean Water Programs, must be notified when either of these ordinances/resolutions are changed. In addition, your agency must maintain records necessary to document compliance with these requirements.

If you have any questions about this letter, please contact me at (916) 739-4426.

Sincerely,

ORIGINAL SIGNED BY

Ronald R. Blair
Revenue Program Specialist

cc: Ms. Trina Blake
City of San Diego
First Interstate Plaza
401 B Street, Suite 400
San Diego, CA 92101-4227

bcc: Fred Johansen, DCWP
Christine Bailey, DCWP

RBLAIR/DYEE/ATDISK3:SANDIEGO.LTR/17 SEP 91

| SURNAME | RBlair 9/10/91 | [illegible] 9/91 | | |
|---|---|---|---|---|

SWRCB1158

# EXHIBIT NO. 15

MWWDPROG

1999066679

STATE REVOLVING FUND LOCAL MATCH LOAN PROGRAM CONTRACT
BETWEEN THE
STATE WATER RESOURCES CONTROL BOARD
AND
**CITY OF SAN DIEGO**

CONTRACT NO. 7-807-550-0
LOCAL MATCH LOAN NO. C-06-4383-110

This Local Match loan contract is made this 17th day of July, 1997, between the State of California, acting by and through the State Water Resources Control Board, hereafter referred to as the "SWRCB", and **City of San Diego**, a municipality of the State of California, hereafter referred to as the "Agency".

WHEREAS:

1. The federal Clean Water Act (33 U.S.C.A. §1251 et seq.) and state law (Division 7, Chapter 6.5, California Water Code) authorize the SWRCB to enter into contracts with municipalities and other public agencies for financial assistance for construction of publicly owned treatment works; and

2. The Agency has made application for a Local Match loan related to construction of the Project hereafter described, and said Project has been determined by the SWRCB to be eligible for a Local Match loan pursuant to applicable federal and state laws, rules, regulations and guidance; and

3. The SWRCB has authorized Local Match loan funding for the Project hereafter described. (See SWRCB Resolution No. 97-079, approved on September 18, 1997).

NOW, THEREFORE, It is Agreed as Follows:

SECTION 1. PROJECT DESCRIPTION.

The Project, commonly known as **Point Loma Digesters 7 and 8, and Gas System Upgrade**, generally consists of **two new anaerobic digesters at the City of San Diego Point Loma Wastewater Treatment Plant to expand the existing plant digestion capacity. The gas recovery and heating systems will also be expanded and upgraded**, as more particularly described in the Local Match loan application of the Agency and the approved plans and specifications for the Project.

SECTION 2. INCORPORATION OF DOCUMENTS; ORDER OF PRECEDENCE; GENERAL AGENCY COMMITMENTS.

This contract incorporates herein, or by reference, the documents listed below. In the event of any inconsistency in the contract documents, except as otherwise specifically provided, the inconsistency shall be resolved by giving precedence in the following order:

(1) The provisions of this Local Match loan contract document; (2) the Local Match loan Contract Special Conditions (**Exhibit A**); (3) the Approval to Award letter (**Exhibit B**); (4) the Approved Plans and Specifications and Applicable Effluent Limitations (**Exhibit C**); (5) the Plans and Specifications Approval letters (**Exhibit D**); (6) the Facilities Plan Approval letter (**Exhibit E**); (7) the Preliminary Local Match loan Repayment Schedule and any amendments thereto (**Exhibit F**); and (8) the Local Match loan Contract Standard Conditions (**Exhibit G**).

The Agency accepts and agrees to comply with all terms, provisions, conditions, and commitments of this contract, including all incorporated documents, and to fulfill all assurances, declarations, representations, and commitments made by the Agency in its application, accompanying documents, and communications filed in support of its request for Local Match loan.

SECTION 3. STATE MATCH ACCOUNT.

The Agency will establish a local state match account. The Agency will deposit sufficient funds in the account to make payments to the contractor(s) in an amount equal to the percentage of federal contributions required by the federal Clean Water Act to be matched with state funds (currently 16.667%) and will include the required state match amount in all payments made to the contractor(s).

SECTION 4. ESTIMATED COST OF PROJECT.

The estimated reasonable cost of the Project at the time of SWRCB Approval, including associated planning and design costs, is **ten million nine hundred thousand** dollars (**$10,900,000**) to the Agency.

SECTION 5. MAXIMUM LOCAL MATCH LOAN AMOUNT.

Subject to all of the terms, provisions, and condition of this contract, and subject to the availability of federal funds, the SWRCB will make a Local Match loan from the State Revolving Fund loan, created by Water Code Section 13477, in an amount not to exceed the maximum sum of **twelve million seven hundred twenty seven thousand one hundred four** dollars (**$12,727,104**) to the Agency. This amount is based on the Approval to Award letter from the SWRCB dated November 13, 1997 (Exhibit B), and includes **ten million six hundred five thousand eight hundred seventy-eight** dollars (**$10,605,878**) from the Federal Revolving Fund Loan Account and **two million one hundred twenty one thousand two hundred twenty-six** dollars (**$2,121,226**) from the Agency local state match account described in Section 3.

Although the actual loan amount is higher than the Board Approved amount, it is within the approved amount in the ATA letter and consistent with SRF Policy, Section XV.D, allowing the loan to be issued for up to one hundred fifty percent (150%) of the Board Approved amount.

SECTION 6. INTEREST RATE.

The Local Match loan interest rate shall be set at zero percent per annum.

SECTION 7. COMPLETION OF PROJECT.

The Agency agrees to expeditiously proceed with and complete construction of the Project in substantial accordance with Project plans and specifications approved by the SWRCB.

SECTION 8. PROJECT CERTIFICATION.

One year after Project completion, the Agency shall certify to the SWRCB whether or not the Project, as of that date, meets applicable design specifications and effluent limitations. If the Agency cannot certify that the Project meets such specifications and limitations at that time, the Agency will, at its own expense and in a timely manner, expeditiously make all needed corrections and perform all additional work necessary to allow affirmative certification for the Project.

Failure to submit an affirmative certification within 15 months, or a negative certification with a corrective action report that meets the above requirements and is satisfactory to the Division within 15 months, of the project completion date will result in an interest penalty of 0.1 percent per day being assessed on the outstanding Local Match loan balance due. The interest penalty will begin on the first day after expiration of the appropriate deadline.

SECTION 9. DISBURSEMENT.

Local Match loan funds will be disbursed in accordance with the disbursement provisions of Exhibit G attached hereto.

SECTION 10. REPAYMENT OF LOCAL MATCH LOAN.

Local Match loan funds, including the state match described in Section 3, shall be repaid in accordance with the provisions of Exhibit G, attached hereto, and as indicated in appropriate Local Match loan Repayment Schedules in Exhibit F, also attached hereto.

SECTION 11. DEDICATED SOURCE OF REVENUE.

The Agency shall adopt an ordinance or resolution designating a source of revenue for repayment of this Local Match loan. The dedicated source of revenue shall comply with the requirements of the federal Clean Water Act and any applicable federal and state laws, rules and regulations and shall have received SWRCB approval.

The Agency shall at all times maintain sufficient revenue to provide reasonable assurance of repayment of this Local Match loan.

SECTION 12. SUBORDINATION AND FUTURE LOCAL DEBT.

A. The obligation of the Agency to make all payments required by this contract to the SWRCB solely from Net System Revenues is subordinate in right of payment to Parity Obligations existing on the date of execution of this contract and additional Parity Obligations incurred pursuant to Section 11 (B) below.

B. The Agency may incur additional Parity Obligations (the payments of which are senior or prior in right to the payment by the Agency of its obligations required by this contract (and all other contracts between the Agency and the SWRCB that, by their terms, expressly provide therefore)) provided that:

1. All Parity Obligations (including the Parity Obligations proposed to be incurred) shall have an "A" rating (without regard to any refinement or gradation of such rating category by a numerical modifier or otherwise) or better by at least two nationally recognized rating agencies.

2. The Agency fixes, prescribes and collects rates and charges for the Wastewater Service which will be sufficient to ensure that Net System Revenues to pay the obligations required by this contract are at least 1.1 times the current year's debt service on the obligations required by this contract.

C. For purposes of this Section and Article 15, Paragraph (D) of Exhibit G the capitalized terms "Net System Revenues" and "Parity Obligations" and "Wastewater Service" shall have the meanings given to such terms in the certain Master Installment Purchase Agreement, dated as of September 1, 1993, between the Agency and the Public Facilities Financing Authority of the City of San Diego, as originally executed and as it may from time to time be amended or supplemented in accordance with the provisions thereof.

SECTION 13. FINANCIAL MANAGEMENT SYSTEM AND STANDARDS.

The Agency agrees to comply with federal standards for financial management systems. The Agency agrees that, at a minimum, its fiscal control and accounting procedures will be sufficient to permit preparation of reports required by the federal government and tracing of Local Match loan funds to a level of expenditure adequate to establish that such funds have not been used in violation of federal or state law or the terms of this contract. To the extent applicable, the Agency agrees to be bound by and to comply with the provisions and requirements of the federal Single Audit Act of 1984 (Pub. L. 98-502) and Office of Management and Budget (OMB) Circular No. A-128.

SECTION 14. ACCOUNTING STANDARDS.

The Agency will maintain separate Project accounts in accordance with generally accepted government accounting standards including those contained in the "Standards for Audit of Governmental Organizations, Programs, Activities and Functions" promulgated by the U.S. General Accounting Office.

SECTION 15. PROHIBITED CONTRACT.

The Agency agrees that it will preclude its contractors and subcontractors from contracting with any party which is debarred, suspended, or otherwise excluded from or ineligible for, participation in federal assistance programs under Executive Order 12549, "Debarment and Suspension".

SECTION 16. COPYRIGHTS.

The Agency agrees that the U.S. Environmental Protection Agency shall have a royalty-free, nonexclusive and irrevocable license to reproduce, publish, otherwise use, and to authorize others to use, for federal government purposes: (a) the copyright in any work developed under this Local Match loan contract and (b) any rights of copyright which the Agency may purchase where costs of such purchase are reimbursed with Local Match loan funds.

SECTION 17. USER CHARGE SYSTEM.

The Agency shall adopt and maintain in effect a user charge system which at all times complies with the requirements of Section 204(b)(1) of the federal Clean Water Act and applicable federal and state rules, regulations and guidelines.

SECTION 18. OPERATION AND MAINTENANCE.

The Agency agrees to properly staff, operate and maintain all portions of the Project during its useful life in accordance with all applicable federal and state laws, rules and regulations.

SECTION 19. USEFUL LIFE OF PROJECT.

For purposes of this contract, the parties agree that the useful life of the Project is 20 years from and after Project completion.

SECTION 20. ASSIGNABILITY.

To the extent permitted by federal and state laws, rules, and regulations, the SWRCB may, assign, grant a security interest in, or otherwise encumber this contract and any right, or rights hereunder, including any payment or payments to be received hereunder.

SECTION 21. STATE REVIEWS AND INDEMNIFICATION.

The parties agree that review or approval of Project plans and specifications by the SWRCB is for administrative purposes only and does not relieve the Agency of its responsibility to properly plan, design, construct, operate, and maintain the Project. As between the SWRCB and the Agency, theAgency agrees that it has sole responsibility for proper planning, design, construction, operation, and maintenance of the Project, and the Agency agrees to indemnify the SWRCB, the State of California and their officers, agents, and employees against and to hold the same free and harmless from any and all claims, demands, damages, losses, costs, expenses, or liability due or incident to planning, design, construction, operation, or maintenance of the Project.

SECTION 22. TERM.

This contract shall take effect upon Department of General Services' approval of the contract, and the contract shall remain in effect for the useful life of the Project or until the date of final Local Match loan repayment, whichever period is longer, unless sooner terminated pursuant to the provisions hereof.

Contract No. 7-807-550-0
Loan No. C-06-4383-110

IN WITNESS THEREOF, the parties have executed this contract on the dates set forth below.

**CITY OF SAN DIEGO**
(AGENCY NAME)

By: _____
Authorized Representative

Michael T. Uberuaga
Typed Name

City Manager
Title

By: _____
Designated Representative

George I. Loveland
Typed Name

Deputy City Manager
Title

Dated: 11/28/99

STATE OF CALIFORNIA
STATE WATER RESOURCES CONTROL BOARD

By: _____, Chief
Division of Administrative Services

Dated: _____

STATE OF CALIFORNIA
DEPARTMENT OF GENERAL SERVICES

(STAMP)

_____

# EXHIBIT NO. 16

# Dennis Kahlie - Grants Loans Info

**From:** Richard Enriquez
**To:** Dennis Kahlie
**Date:** 3/16/2004 9:41 AM
**Subject:** Grants Loans Info
**CC:** Maureen Brungardt

---

Breakdown you requested.
EPA = 11
BOR = 9
NadBank = 1
State = 5

DK 03803

# REVENUE PROGRAM INFORMATION GRANTS AND LOANS

## SRF LOANS

SRF Loan #C-06-4383-110,
Project: Point Loma Digesters 7& 8
Loan Amount: $12,727,104

SRF Loan # C-06-4542-110
Project: Point Loma Central Boilers
Loan Amount: $8,021,329

SRF Loan #-C-06-4119-410
Project: South Bay Water Reclamation Plant, Package 2
Loan Amount: $3,030,421

SRF Loan #C-06-4119-510
Project: South Bay Water Reclamation Plant, Package 3
Loan Amount: $40,464,525

SRF Loan# C-06-4690-110
Project: Point Loma Maintenance Building Expansion
Loan Amount $1,031,653,

Note - These are only the ones referenced in Board's 11/26/03 letter. There have been many more grants from Bay-Bed and EPA.

SRF Loan# C-06-4650-110
Project: South Bay Reclamation Sewers and Pump Station Package A
Loan Amount: $10,453,781

SRF Loan# C-06-4650-210
Project: South Bay Reclamation Sewers and Pump Station Package B
Loan Amount: $4,520,949

SRF Loan# C-06-4718-110
Project: Point Loma Digesters C1 & C2
Loan Amount: $9,709,702

8 SRF LOANS
$89,959,464

SRF Loan# C-06-4703-110
Environmental Monitoring and Technical Services Lab
Loan Amount: $12,111,202 **(Note: Do not have signed contract for this project)**

SRF Loan# C-06-4703-110
Project: Otay River Pump Station, Conveyance System
Loan Amount: $8,303,180 **(Note: Do not have signed contract for this project)**

## GRANTS

Grant# C-06-1092-210
Project: South Bay Land Outfall
Grant Amount: $8,107,642

Grant# C-06-1092-510
Project: Construction of West Point Loma Interceptor
Grant Amount: $5,127,480

Grant# C-06-1092-520
Project: Construction of Improvements at Pump Station #2
Grant Amount: $1,602,368

Grant# C-06-1092-530
Project: Purchase/Construction of Engine Generator Catalytic Converter, Scum and Sludge Collection Equipment
Grant Amount: $4,622,782

Grant# C-06-1092-540
Project: Construction of Headworks, Odor Control Towers and Sedimentatary Basins 7&8
Grant Amount: $15,828,529

5 GRANTS
$35,288,801

TOTAL GRANTS & LOANS
$125,248,265

**GRANTS**

| | |
|---|---|
| EPA | 160,226,065. |
| BOR | 25,289,327. |
| NADBANK | 17,202,462. |
| STATE GRANTS | 15,796,858. |
| Subtotal | 218,514,712. |

**OUTSTANDING SRF LOANS**

| | | | |
|---|---|---|---|
| Point Loma Digesters 7& 8 | 89,959,464 | 12,727,104 | ✓ |
| Point Loma Central Boilers | | 8,021,329 | ✓ |
| South Bay Water Reclamation Plant, Package 2 | | 3,030,421 | ✓ |
| South Bay Water Reclamation Plant, Package 3 | | 40,464,525 | ✓ |
| Point Loma Maintenance Building Expansion | | 1,031,653 | ✓ |
| South Bay Reclamation Sewers and Pump Station Package A | | 10,453,781 | ✓ |
| South Bay Reclamation Sewers and Pump Station Package B | | 4,520,949 | ✓ |
| Point Loma Digesters C1&C2 | | 9,709,702 | ✓ |
| Otay River Pump Station | | 8,303,180 | NO CONT. |
| Environmental Monitoring & Tech. Srvcs. Lab | | 12,111,202 | NO CONT. |
| Point Loma 4th Pump | | 3,500,000 | NO CONT. |
| Subtotal | | 113,873,846. | |

**LOANS IN PROCESS OF BEING APPROVED**

| | | |
|---|---|---|
| Point Loma Grit Processing Improvements | 24,600,000 | NO CONT |
| Point Loma S1 & S2 Digester Upgrade | 11,700,000 | NO CONT. |
| Subtotal | 36,300,000. | |

**TOTAL** **$ 368,688,558.00**

Summary -

Grants 218,514,712

SRF 89,959,464

308,474,176

3/16/2004

DK 03804

**ATTORNEY TO CLIENT CORRESPONDENCE FOR CONFIDENTIAL USE ONLY**

**Office of**
**The City Attorney**
**City of San Diego**

**MEMORANDUM**
**MS 59**

**(619) 236-6220**

**DATE:** November 14, 2002

**TO:** Honorable Mayor and City Council

**FROM:** Mary Vattimo, City Treasurer and Kelly J. Salt, Deputy City Attorney

**SUBJECT:** Significant Exposure to Litigation: Metropolitan Wastewater Department's Compliance With Federal and State Loan and Grant Guidelines

---

RECOMMENDATION: Direct the City Manager to perform and implement the findings of a Cost of Service Study [CSS] for the City of San Diego's [City] sewer rates and charges, and bring such sewer rates and charges into compliance with Federal Clean Water Act grant conditions and State Revolving Fund loan requirements by ensuring the City's wastewater user fees be proportionate to the cost of providing the services.

COUNCIL DISTRICT: All

## INTRODUCTION

Recently, a question was raised about the need to perform and implement the findings of a cost of service study of the City's wastewater user fees and charges. This memorandum addresses that issue.

In sum, the City currently has approximately $370 million in outstanding loans and grants related to improving the Metropolitan Wastewater System. A condition of those grants and loans is that the City's user fees and charges be "proportionate." To ensure compliance with these conditions, the City must perform a Cost of Service Study of the City's sewer rates and charges. Failure to



For USAO 7.26.05
Part of SEC COS Subpoena

comply with these conditions and requirements may result in litigation for the repayment of the grant monies and acceleration of the repayment of the loan monies. Additionally, failure to comply may result in the loss of future State Revolving Loan Fund [SRF] loan monies.

## BACKGROUND

### A. Clean Water Grants and State Revolving Fund Loans

Since the late 1970's, the Metropolitan Wastewater Department [MWWD] has received a series of federal and state Clean Water Grants and SRF loans, that have provided the City financial assistance for the construction and improvement of the City's Metropolitan Sewerage System. Each of these grants and loans has required that the City adopt and maintain a user charge system that complies with the Clean Water Act [33 U.S.C. § 1251, *et seq.*] For example, the November 2, 2000 SRF Loan Match Program Contract Between the State Water Resources Control Board [State Board] and the City, provides that the City shall adopt and maintain in effect a user charge system which at all times complies with the requirements of Section 204(b)(1) of the federal Clean Water Act and applicable federal and state rules, regulations and guidelines. Specifically, the Clean Water Act requires a user charge system that charges users in proportion to the cost of providing treatment services. *See* 33 U.S.C. § 1284(b) and 40 C.F.R. § 35.2140.

The SRF loan program is a joint federal and state program that loans money at a low interest rate to local agencies for construction of wastewater treatment and water reclamation facilities, correction of non-point source and storm drainage pollution problems, and implementation of estuary enhancement activities. The SRF loan program replaced prior Clean Water Act grants and in 1987 was established by amendments to the Clean Water Act. The State Board is the California agency responsible for administering the SRF loan program.

To date, MWWD has received, or has existing proposals for, a total of approximately $370 million in grants and loans under the Clean Water Act grant and SRF loan programs. Approximately $114 million of that amount consists of outstanding SRF loans, with an additional $33 million in the process of being approved. MWWD anticipates it will remain active in the loan application process over the next few years.

Throughout most of the 1980s, when MWWD's wastewater treatment system performed only primary wastewater treatment, MWWD's user charge system moved gradually toward compliance with the Clean Water Act, and, briefly, in the late 1980s, the user charge system was in compliance. With the introduction of secondary treatment facilities in the City's Metropolitan Sewerage System, and the City becoming subject to a revised National Pollutant Discharge Elimination System [NPDES] permit, which required removal of biological components from effluent, the user charge system again became non-compliant.

In the interim, MWWD has continued to enter into SRF loans requiring compliance with the Clean Water Act's proportionate fee system. In its SRF loan applications, MWWD has represented that its user charge system is in compliance with all federal and state requirements.

**B. NPDES Permit for Discharge of Effluent at the Point Loma Ocean Outfall**

On November 9, 1995, the United States Environmental Protection Agency [USEPA] and the Regional Board jointly issued the City a permit, for the City's E.W. Blom Point Loma MWWD Plant [Point Loma] for discharge into the Pacific Ocean through the Point Loma Ocean Outfall. The Permit established requirements for a discharge of up to 205 million gallons per day of advanced primary treated effluent.

On February 11, 2002, the USEPA and the California Regional Water Quality Control Board [Regional Board] jointly proposed issuance of a draft renewal of the Permit. As modified, the Permit will continue the initial Permit's requirement that the City remove 80% of Total Suspended Solids [TSS] and 58% of Biochemical Oxygen Demand [BOD] from the effluent discharged from the Point Loma Ocean Outfall. The Final Permit was issued September 13, 2002 and became effective October 16, 2002.

**C. MWWD Cost of Service Study**

In 1999, at the direction of the City Council, the City Treasurer's office on behalf of MWWD began the process of preparing a CSS for the City's Metropolitan Sewerage System. By April 2000, a consultant had been selected and had begun preparing the CSS.

The CSS was intended to determine how, if at all, MWWD's user charge system must be modified to make the City's cost allocation method for wastewater treatment costs compliant with the Clean Water Act. Specifically, the issue was whether, and if so, how, the City's cost allocation system must be modified to take into account the costs of removing biological components (BOD or Chemical Oxygen Demand [COD]) from wastewater. In conjunction with the CSS, a stakeholder's group of industrial users discharging to Point Loma was also selected to meet and offer recommendations concerning the CSS.

The Regional Board is aware that the City has undertaken the CSS. A final draft of the CSS was prepared for presentation and adoption by the City Council; however, due to concerns raised in a prior closed session with the City Council regarding the matters discussed herein, finalization of the report and its presentation was delayed. As a result of that delay, changes in municipal wastewater flow volumes and other factors, the CSS will require updating to insure that an equitable apportionment of current costs is achieved prior to its presentation and adoption by the Council.

**D. MWWD's Allocation of Wastewater Treatment Costs**

**(1) Existing Allocation of Wastewater Treatment Costs**

In addition to providing service for its retail customers throughout the City, MWWD provides transportation, treatment and disposal of wastewater for fifteen other cities and water/sanitation



For USAO 7.26.05
Part of SEC COS Subpoena

districts [Participating Agencies].[1] MWWD provides service to the Participating Agencies on a contract basis. Before 1997, the Participating Agencies were charged for the costs incurred in processing their wastewater solely based on quantity. Following a review and audit of the City's user fee system, the State Board determined that the fee system for the Participating Agencies did not comply with the Clean Water Act because it relied solely on the flow of wastewater. To become compliant, the State Board required the City to use a strength-based billing system that would include, in addition to flow, charges for wastewater strength, as determined by sampling and testing for TSS and BOD. In response, and for administrative reasons, MWWD proposed using TSS and COD to measure strength. The State Board approved this method in November 1997. This is the method that MWWD has used for billing the Participating Agencies since 1997.

In contrast, MWWD's retail customers are charged based on the components of flow and TSS. There is no biological component, either BOD or COD, to the retail customer's user charge system.

(2) **Proposed Changes to the Allocation of Wastewater Treatment Costs**

In a May 2001 letter to the State Board, the City, in conjunction with the stakeholders group involved in the CSS, presented three alternative cost allocation methodologies for review and possible approval. The three alternative methodologies were:

(a) Allocating to all users, both Participating Agencies and retail customers, the same unit cost for wastewater treatment services, based on percentage of TSS and BOD removal at various MWWD plants. Overall allocation under this method would be: 65.73% to flow, 18.87% to TSS, and 15.40% to BOD. [This approach is consistent with that utilized for billing the Participating Agencies since 1997.]

(b) Straight TSS Method [STSS]. This method would retain method (a), above, at all MWWD treatments plants other than Point Loma. For Point Loma, it would allocate 94% of the strength allocation costs to TSS removal and six percent to BOD removal. This allocation method is based on the premise that the City's NPDES Permit requires removal of 58% BOD and 80% TSS at Point Loma. However, the processes used to achieve the 58% BOD removal *also* results in the removal of 86% TSS. Because satisfying the NPDES permit for BOD removal results in the removal of 86% TSS, this stakeholder sponsored proposal would allocate all O&M and capital costs to TSS up to the cost to achieve 80% TSS, then shift all remaining costs to achieve TSS from 80% to 86% only to BOD. Overall allocation under this method would be: 66.92% to flow, 25.46% to TSS, and 7.61% to BOD.

---

[1] The participating agencies are: the Cities of Chula Vista, Coronado, Del Mar, El Cajon, Imperial Beach, La Mesa, National City and Poway; and the Lakeside-Alpine Sanitation District, Lemon Grove Sanitation District, East Otay Mesa Sewer Maintenance District, Otay Water District, Spring Valley Sanitation District, Padre Dam Municipal Water District and the Wintergardens Sewer Maintenance District.



For USAO 7.26.05
Part of SEC COS Subpoena

(c) Modified TSS Method. This method would extend method (b), above, to all three MWWD treatment pants. Overall allocation under this method would be: 66.92% to flow, 23.23% to TSS, and 9.85% to BOD.

In a July 2001 letter responding to the City's submitted alternatives, the State Board specifically disapproved methods (2) and (3), above, noting that the City's NPDES permit requires removal of *both* BOD and TSS and therefore, the cost allocations must be fully proportionate to both BOD and TSS from the start. The State Board's position is that methods (2) and (3) fail to allocate any costs to BOD until the TSS removal requirement has been met. Therefore, these methods both fail to comply with the Clean Water Act requirement that costs be allocated proportionately.

Finally, the State Board letter provided that, before the State Board would approve a new method of cost allocation, the City must provide data that demonstrate that the allocation was proportional to actual costs, as required by the Clean Water Act. The revenue program guidelines for SRF loans provide that the City must have a Regional Board approved revenue program in place as a condition of receiving its SRF loan, and that any City rate changes must be reviewed and approved by the State Board.

**DISCUSSION**

Although MWWD has not been in compliance with Clean Water Act standards for its user charge system through much of the time it has been receiving the Clean Water grants and loans, MWWD has generally been moving toward compliance, e.g., the City added strength-based billing for Participating Agencies in 1997; and, in 1999, the City began preparing the COSS to determine what, if any, changes are required for the City user fee system to comply.

The typical loan contract that MWWD has entered into for financial assistance for the construction and improvement of the City's Metropolitan Sewerage System includes an acceleration provision. This provision permits immediate acceleration of the loan if the City violates a material provision of the contract.

While the State Board has not provided written notice of termination of any of the loan contracts, the State Board staff, in conversations with MWWD staff, has indicated that MWWD's user charge system does not comply with the Clean Water Act. Additionally, the State Board is aware that the City has undertaken the COSS. The typical loan contract provides that, in any litigation between the State Board and the City arising from the contract, the prevailing party is entitled to reasonable costs and/or attorney fees.

In light of the Clean Water Act's requirement of a proportionate fee system, and the SRF loan program's condition of compliance with the Clean Water Act, the City should finalize and adopt the findings of an updated COSS. If the City does not proceed, it risks losing its SRF loans, which would have a severe and immediate impact on the City's budget and ability to proceed with necessary improvements.



For USAO 7.26.05
Part of SEC COS Subpoena

**RECOMMENDATION**

The City has approximately $370 million in grants and loans, either outstanding or proposed, from the state and federal government that have provided financial assistance for the construction and improvement of the City's Metropolitan Sewerage System. Each of these grants and loans requires the City to maintain a user charge system that is compliant with the Clean Water Act. Currently, the City's user charge system does not comply with the Clean Water Act.

Each of the loan contracts permits immediately acceleration of loan repayments by the City upon breach of the contract. Thus, if the acceleration provision is invoked, the City could be required to immediately repay all of the outstanding loans. Additionally, the federal and state governments could conceivably request repayment of the grants received by the City if the City is found to have been out of compliance with grant requirements.

Finally, in any litigation concerning the loan contracts, the prevailing party is entitled to receive attorney fees and costs.

To avoid the possible acceleration of the repayment of approximately $370 million in Clean Water grant and SRF loan monies, and to ensure the continuing availability of SRF loans for the City's MWWD program, the City should perform and implement the findings of a Cost of Service Study and continue to take steps toward making the City's wastewater user fees and charges proportionate to the cost of providing the wastewater conveyance, transmission, and treatment services.



For USAO 7.26.05
Part of SEC COS Subpoena

# EXHIBIT NO. 17

# State Water Resources Control Board

Division of Financial Assistance
1001 I Street, Sacramento, California 95814
P.O. Box 944212, Sacramento, California 94244-2120
(916) 341-5700 ♦ FAX (916) 341-5707 ♦ www.swrcb.ca.gov

Tammineen
Secretary for
Environmental
Protection

Arnold Schwarzenegger
Governor


NOV 26 2003

CERTIFIED MAIL NO. 7099 3400 004 7568 7881
Return Receipt Requested

RECEIVED
DEC 1 2003
City Manager

Mr. Michael T. Uberuaga
City Manager
City of San Diego
202 C Street, MS 9A
San Diego, CA 92101-4806

Dear Mr. Uberuaga:

FINAL REVENUE PROGRAM REQUIREMENT – CITY OF SAN DIEGO (CITY), CLEAN WATER GRANT PROJECTS NOS . C-06-1092-210, -510, -520, -530 & -540; STATE REVOLVING FUND (SRF) LOAN PROJECTS NOS. C-06-4119-410, -510, C-06-4383-110, C-06-4542-110, C-06-4650-110, -210, C-06-4690-110, C-06-4703-110, C-06-4718-110, C-06-4721-110

While reviewing the files for the above referenced projects, I was unable to find any documentation indicating the City implemented their wastewater revenue program approved by this office on September 17, 1991.

Implementation and maintenance of the wastewater user charge system is a condition of both federal Clean Water Grants and state SRF loans. The wastewater user charge system must conform to the requirements of Clean Water Grant regulations for the useful life of the grant funded facilities. The user charge system must also conform to the requirements contained in SRF loan contracts until the loans are discharged. [Note: the grant requirements and loan requirements are the same except for termination date.] In addition, your agency must maintain records necessary to document compliance with these requirements.

Please submit a copy of the City ordinance (or resolution) adopting the wastewater rate system that was previously approved. The adopted rate system must generate sufficient revenue to fund the annual operation and maintenance of the wastewater facilities and charges must be based on each user's (or user group's) proportionate contribution to total flow, BOD (or COD) and TSS loadings.

Please submit the requested document(s) to this office within 90 days of receipt of this letter.

If you have any questions about this letter, please contact me at (916) 341-5642.

Sincerely,

Ronald R. Blair
Sanitary Engineering Associate

# EXHIBIT NO. 18

(916) 227-4489
(916) 227-4349 FAX

Mr. Jack McGrory
City Manager
City of San Diego
202 C Street
San Diego, CA 92101-4230-

Dear Mr. McGrory:

REVENUE PROGRAM REVIEW -- CITY OF SAN DIEGO, CLEAN WATER GRANT PROJECT NO. C-06-1092

I wish to express my appreciation for the cooperation the staff of the City of San Diego (City) gave me during my recent visit to your office. The following information is requested by November 1, 1994, to complete my review of the City's compliance with the requirements of USEPA's Clean Water Grant requirements.

1. Please explain the purpose and rational of the "reverse repurchase agreement" item that appears in the wastewater budgets and audits.

2. Please provide the legal basis for charging the wastewater fund for "use of city owned right-of-way. Also provide the data that was used to determine the amount that is charged for this item.

3. Please provide the rational for charging "outside city" direct billed accounts twice the normal rate for sewer service. Under USEPA regulations the City must charge all users in proportion to the cost of providing treatment services.

In addition, the City must adopt the following charges to bring its wastewater user charge system into compliance with the requirements of the existing and past Clean Water Grants.

a. The City must modify their agreements with all participating agencies to include charges for BOD and TSS content as well as flow discharged into City facilities.

b. The City must include septage discharges into their rate ordinance/resolution. The City is accepting discharges from septage haulers. However, I was unable to find any mention of septage haulers in the City rate codes.

c. The City must develop forecast unit costs, including appropriate indirect markups, for wastewater flow, BOD removal and TSS removal. These unit costs should be based on the prior year's costs and forecast increases. The forecast unit costs must be transmitted to all participating agencies as soon as possible each year to allow them to implement any needed rate adjustments prior to the start of the next fiscal year.

Please provide the information requested in Items 1-3, above and a timetable for compliance with Items a-c by November 1, 1994. If you are unable to meet this deadline please contact me at (916) 227-4489.

Sincerely,

Ronald R. Blair
Revenue Program Specialist

bcc: John Herren, CWP
San Marcos Trng Ctr
Bruce Posthumus, San Diego Regional Water Quality Control Board

# EXHIBIT NO. 19

SEP 30, 1998

Ms. Hedy R. Griffiths
Supervising Management Analyst,
Agency Contracts
Metropolitan Wastewater, Public Works
City of San Diego
600 'B' Street, Suite 500
San Diego, CA 92101-4587

Dear Ms. Griffiths:

PROPOSED REGIONAL WASTEWATER DISPOSAL AGREEMENT - CITY OF SAN DIEGO, CLEAN WATER GRANT PROJECTS NOS. C-06-1092

I have reviewed the executed contract, submitted with your letter of August 31, 1998, between the City of San Diego (City) and the 15 Participating Agencies for treatment and disposal of wastewater in the City's Metropolitan Sewerage System.

The contract as submitted by the City appears to comply with requirements of the Water Resources Control Board's Revenue Program Guidelines and provisions of US-EPA's Clean Water Grant Contracts and Program regulations.

If you have any questions about this letter, please contact me at (916) 227-4489.

Sincerely,

Ronald R. Blair
Revenue Program Specialist

cc: Ms. Helen McKinley
Water Division
Environmental Protection Agency,
Region 9
75 Hawthorne Street
San Francisco, CA 94105

bc: Ed Anton, DCWP
Jim Putman, DCWP
Fred Johansen, DCWP
Mike Harper, DCWP

# EXHIBIT NO. 20

# State Water Resources Control Board

Division of Financial Assistance
1001 I Street, Sacramento, California 95814
P.O. Box 944212, Sacramento, California 94244-2120
(916) 341-5700 ♦ FAX (916) 341-5707 ♦ www.swrcb.ca.gov

Terry Tamminen
Secretary for Environmental Protection

Arnold Schwarzenegger
Governor


NOV 26 2003

CERTIFIED MAIL NO. 7099 3400 004 7568 7881
Return Receipt Requested

RECEIVED
DEC 1 2003
City Manager

Mr. Michael T. Uberuaga
City Manager
City of San Diego
202 C Street, MS 9A
San Diego, CA 92101-4806

Dear Mr. Uberuaga:

FINAL REVENUE PROGRAM REQUIREMENT – CITY OF SAN DIEGO (CITY), CLEAN WATER GRANT PROJECTS NOS . C-06-1092-210, -510, -520, -530 & -540; STATE REVOLVING FUND (SRF) LOAN PROJECTS NOS. C-06-4119-410, -510, C-06-4383-110, C-06-4542-110, C-06-4650-110, -210, C-06-4690-110, C-06-4703-110, C-06-4718-110, C-06-4721-110

While reviewing the files for the above referenced projects, I was unable to find any documentation indicating the City implemented their wastewater revenue program approved by this office on September 17, 1991.

Implementation and maintenance of the wastewater user charge system is a condition of both federal Clean Water Grants and state SRF loans. The wastewater user charge system must conform to the requirements of Clean Water Grant regulations for the useful life of the grant funded facilities. The user charge system must also conform to the requirements contained in SRF loan contracts until the loans are discharged. [Note: the grant requirements and loan requirements are the same except for termination date.] In addition, your agency must maintain records necessary to document compliance with these requirements.

Please submit a copy of the City ordinance (or resolution) adopting the wastewater rate system that was previously approved. The adopted rate system must generate sufficient revenue to fund the annual operation and maintenance of the wastewater facilities and charges must be based on each user's (or user group's) proportionate contribution to total flow, BOD (or COD) and TSS loadings.

Please submit the requested document(s) to this office within 90 days of receipt of this letter.

If you have any questions about this letter, please contact me at (916) 341-5642.

Sincerely,

Ronald R. Blair
Sanitary Engineering Associate

# EXHIBIT NO. 21

# CITY OF SAN DIEGO
# SEWER COST-OF-SERVICE REPORT

PREPARED FOR: CITY OF SAN DIEGO
FINANCING SERVICES
202 C STREET, MS-7B
SAN DIEGO, CALIFORNIA 92101

PREPARED BY THE TEAM OF: PINNACLEONE
CHESTER ENGINEERS

MAY 14, 1998

DK 07566

# CITY OF SAN DIEGO
# SEWER COST-OF- SERVICE REPORT

## I. EXECUTIVE SUMMARY

Purpose of the Report.

The purpose of this report is to determine the costs of providing wastewater collection, conveyance, and treatment services to the City of San Diego and the Participating Agencies outside the City and to establish rates based on those costs. Operation, maintenance, and replacement (OM&R) costs, debt service costs, and costs for planned capital improvements were allocated to the cost-causative components of the wastewater system and were divided by the total plant loadings to determine unit costs for flow, suspended solids (SS), and chemical oxygen demand (COD). The contribution of each user or user class was then multiplied by the unit cost for each parameter to establish a sewer rate in proportion to the user's demand on the system. The procedure used in preparing this report meets with the requirements of the State Water Resources Control Board (SWRCB). Cost information from this report will be used to prepare the Wastewater System Revenue Program that must be submitted to the SWRCB for approval.

City's Current Billing System and Changes to be Made.

The City's current system bills sewer customers within the City based on their flow and suspended solids contributions to the system. However, the organic strength of the sewage is not factored into sewer bills for City customers. Participating Agencies in the Metropolitan sewer system are billed on the basis of flow, suspended solids, and organic strength. The costs of providing wastewater collection, conveyance, and treatment services to the City of San Diego and the Participating Agencies in total based upon flow, suspended solids, and organic strength are determined so that all of the entities pay their "fair and equitable" share for collection, treatment, and disposal/reuse of the total wastewater flow, including suspended solids content and organic strength loading.

Changes are made so that costs are allocated within the City to individual customer classes so that the revenue generated by each user class is in proportion to the customer's demand on the system. Annual revenue requirements for the Metro wastewater system and the City's Municipal (Muni) wastewater system through 2003 were provided by the City for use in determining rates that would be charged to users that reflect their contributions to flow, suspended solids and organic strength.

The report includes the:

- Executive Summary,
- Introduction,
- Summary of the SWRCB requirements for revenue programs including the procedures to be used in developing a revenue program,
- A description of the wastewater system that serves the City of San Diego and the Participating Agencies (see subsection IV.F for the definition of Participating Agencies) and the organizational structure of the department that oversees the operation of the sewer

# EXHIBIT NO. 22

# CLOSED SESSION REPORT [X] CITY OF SAN DIEGO [] OTHER (See below)

NOT A PUBLIC RECORD
until the information in this box is completed, signed by an authorized representative of the City Attorney's Office and stamped in the space below

Date Litigation Concluded: _____, 200____

By: _____

Title: _____

[STAMP HERE]

**TITLE** Number of cases: one (sewer rates)
anticipated litigation DCA Salt

**DATE OF CLOSED SESSION:** 1/29, **2002**

[] **REAL PROPERTY NEGOTIATIONS** G.C. § 54956.8
[] Ongoing/Status Report
[] Final Approval of Agreement **(D)**
Substance of Agreement: _____
[] Final approval dependent on other party

[X] **LITIGATION** G.C. § 54956.9
[](a) Pending [X](b)(1) Significant Exposure [](b)(2) Authorizing Session [](c) Initiating
[] Defend Litigation **(D)**
[] Seek Appellate Review **(D)**
[] Amicus Participation
[] Settlement Offer To Be Conveyed
[] Initiate Litigation or Intervene **(D)**
[X] Status Report
[] Refrain from Seeking Appellate Review **(D)**
[] Other (see below)
[] Acceptance of Signed Settlement Offer **(D)**
[] Contingent Acceptance of Signed Offer
[] Non-Disclosure of Litigation Recommended (check if yes): [X] See Report
[] Interfere with service of process [] Impair ability to settle

[] **CLAIMS DISPOSITION** G.C. § 54956.95
[] Offer Made [] Offer Accepted [] See Report

[] **DECISION ON EMPLOYMENT STATUS** G.C. § 54957
[] Appoint **(D)** [] Employ **(D)** [] Accept Resignation **(D)** [] Discipline **(D)**
[] Dismissal or Nonrenewal (disclose after exhaustion of administrative remedies) [] Performance Evaluation
Title: _____
Change in Compensation: _____

[] **LABOR NEGOTIATIONS** G.C. § 54957.6
[] Ongoing/Status Report
[] Final Approval of Agreement **(D)** Other Party to Negotiation: _____
Item Approved: _____

[] **PUBLIC SECURITY THREAT** G.C. § 54957

**ATTENDEES:**
[X] City Mgr [ ] Asst City Mgr [X] Sr Dep City Mgr (Loveland)
[X] City Atty [X] Exec Asst City Atty [X] Asst City Atty (Girard)
[X] City Auditor
[X] Other ___Pat Frazier, Rich Mendes, Kelly Salt, Dennis Kahlie___

[X] VOTE [] NO VOTE NECESSARY

COMMENTS: Note and file. City Attorney to analyze

| Name | Yea | No | Absent |
|---|---|---|---|
| District 1 | | | X |
| District 2 | X | | |
| District 3 | X | | |
| District 4 | | X | |
| District 5 | X | | |
| District 6 | | X | |
| District 7 | X | | |
| District 8 | X | | |
| Mayor | X | | |
| ing Tally | 6 | 2 | 1 |

APPROVED: _____

**NOTE: (D) DISCLOSE FOLLOWING CLOSED SESSION**

L:\LDEVANEY\CLSDSESS\01 29 02\sewer.wpd

# EXHIBIT NO. 23

November 18, 2002

To: City Attorney Casey Gwinn
From: Councilmember Donna Frye
Re: November 19, 2002 Closed Session

Dear Casey,

I am writing to express my strong concerns about the legality of meeting in closed session on November 19, 2002 to discuss Item #7. In my opinion,this item does not meet the requirements of California Government Code section 54956.9(b)(1) regarding significant exposure to litigation, and should, therefore, be held in open session. While I rely upon the City Attorney for legal advice, it is the action of docketing #7 by your office that is causing me such concern and conflict.

I am also concerned about the circumstances under which this item was docketed and previously discussed in closed session, since the action did not involve pending litigation, anticipated litigation, or significant exposure to litigation. After researching the Brown Act requirements this weekend, I believe the action taken at that meeting was not authorized by some specific exemption and was done solely because it was considered controversial. Moreover, it is a direct result of the prior action in closed session that Item #7 has been docketed for the November 19, 2002 closed session.

I am requesting that you provide to me, in writing, a brief explanation and the specific sections of the Brown Act that:

- allow Item #7 to be docketed for closed session on November 19, 2002
- allowed the docketing of and past action taken in closed session (to withhold information from the public)
- provide necessary action to cure or correct the past action if it is determined that it was in violation of the Brown Act

I am also requesting that you provide me with a copy of the closed session docket for this item from earlier this year when it was first heard in closed session, the City Attorney memorandum that noticed the item and a copy of the existing study referenced in Item #7 per the Public Records Act.

I take my duties and obligations as a city councilmember very seriously and have been quite concerned about the issue discussed in Item #7 from the time it was first heard in closed session. The best I knew to do after the closed session, was to ask publicly that the study referenced in Item #7 be released. Despite the fact

that it is a public document and its existence was common knowledge, when I asked about the study in open session I was told it did not exist.

Due to the urgency of this, I would appreciate your immediate attention and written response.

Thank you,

Donna

# EXHIBIT NO. 24

**International Specialty Products, Inc.**
2145 East Belt Street, San Diego, CA 92113

August 4, 2003

Larry Dolson
Business Representative
Operating Engineers Local 501
444 West Cedar Street
San Diego, CA 92101

Subject: Political Efforts for ISP and CPKelco to Avoid Unfair Wastewater Charges

Dear Larry

The purpose of this letter is to explain a looming City policy development which would put a tremendous and unfair burden on both ISP's and CPKelco's food ingredients manufacturing facilities in San Diego, and to ask for your assistance in addressing this problem by political activity. I'm writing on behalf of both businesses.

The issue is the imposition of a new charge for "COD" in wastewater discharged by San Diego sewer customers. COD ("chemical oxygen demand") is a measure of organic matter present in wastewater. Most cities employ costly secondary treatment processes to remove fine or dissolved organic matter before discharge to rivers, bays or shallow ocean outfalls. Most cities also include expensive COD charges in their wastewater rates.

San Diego is unique in that the deep ocean outfall at the Point Loma Wastewater Treatment Plant makes discharge of non-toxic organic matter environmentally safe. Hence, San Diego is one of the few cities in the country that uses an advanced primary treatment process to remove settleable solids, but requires no secondary treatment prior to discharge. So San Diego has never needed to include a charge for COD in their wastewater rate structure.

Because wastewater from any food plant, like ours, naturally contains a high concentration of organic matter, the imposition of a COD charge would be a dramatic cost impact that would threaten our plants' viability. That's why we were so alarmed when City staff began proposing COD charges a couple years ago. We estimate COD charges would cost ISP's plant alone about a million dollars per year, based on the rate structure they were proposing. The impact on CPKelco, would be even greater. Other businesses impacted include restaurants, and other food processing plants. But impact on residents would be negligible, and impact on essentially all other businesses or industries would be very small.

A COD charge would be understandable if the City was incurring costs to treat this organic material, but with Point Loma Treatment Plant not requiring secondary treatment, it's hard to understand why. It appears that one or two key City staff members are pushing to implement a wastewater rate structure more like other cities, because they believe it will make it easier to deal

with Sacramento when seeking State funds. But having a COD charge in San Diego is unfair to us, and to other food industry companies, and really doesn't help anyone else.

Therefore, our goal is to dissuade the City from implementing a COD charge.

During recent City Council budget debates, Councilmember Donna Frye requested a detailed cost-of-service study for water costs. We believe her goal is to question the low fee charged developers for new water service. ISP has no problem with her request. However, the City Manager's office took this opportunity to also promise a sewer cost-of-service study, which we know will include a recommendation for implementing COD charges. The City Manager's plan is to present this study to the City Council in September.

Our goal is to maintain the status quo by preventing the COD charge issue from moving forward Last year when an earlier version of the sewer cost-of-service study was under review, we received help from Councilmember Byron Wear. He championed the issue, and persuaded all Council Members except Donna Frye to vote in closed session to table the study indefinitely, along with COD charges. So we have a history of council support.

This year, possible ways to prevent the adoption of COD charges are to request the City Manager directly to delete COD charges from the cost-of-service study, to ask the Mayor to so direct the City Manager, to ask Councilmember Frye to so direct the City Manager, or to ask assistance from Jim Madaffer in tabling the study, (chair of the Natural Resources and Culture Committee). We could also ask help from any of the other Council Members who voted with Wear last year, including Scott Peters, Brian Maienschein, Ralph Inzunza and Toni Atkins.

At the same time, we plan to seek support from the State Water Resources Control Board for not requiring a COD charge, thus undercutting any City staff rationale for the charge. The State has not been pushing San Diego to implement a COD charge, but there has been some correspondence during the past decade indicating that they consider it proper. We now have some very strong contacts at the State Water Resources Control Board who have the authority, and may be willing, to state that COD charges are not necessary in San Diego's case, at least not now.

If we are unsuccessful in keeping the sewer cost-of-service study off the City Council docket, then we would seek to have it handled in closed session. If it ends up on the open session docket, then we plan to lobby as many Council Members as needed to vote it down. If we are unsuccessful in preventing a COD charge, then we would seek to minimize it, and to delay or phase-in its implementation.

No interest group or constituency is pushing for implementation of COD charges. COD charges would not result in higher City revenues, because by law new COD charges must reduce existing sewer charges for flow and suspended solids by an equivalent amount. No agency is currently pushing for COD charges. No one would be significantly helped by COD charges in San Diego. Since the Point Loma Treatment Plant we discharge to does not have secondary treatment, no significant costs to the City are caused by COD in our waste water. Furthermore, the discharge permit for the Point Loma plant will be in flux for at least the next five years, which means that

any implementation of COD charges would be subject to major revision, or possible rescission, for the foreseeable future. There just is not any immediate reason to implement COD charges.

Even so, it could be a tough political battle to keep City staff from implementing COD charges. As one who has a real stake in the success of the ISP and CPKelco businesses in San Diego, we would really appreciate the help you could give us. As you know, both plants are under tremendous cost pressure from foreign competition, and are struggling to keep our heads above water. New costs in the range of $1MM per year each really do threaten the future of our plants here in San Diego.

Policy makers many times assume that business interests and labor interests are at odds with each other. When the two join together on an issue, it can make a strong statement that gets politicians' attention. Our working successfully together on this issue could mean the viability of ISP and CPKelco in San Diego, and our ability to continue to provide employment for members of the IUOE.

Would you be willing to work with us to influence City policy makers to avoid COD charges? If so, could we meet together this week to discuss in detail how to proceed? Please call Paul Altamirano at ~~(760)~~ 557-3106 to respond.

We appreciate your attention to this important issue.

Sincerely

David McKinley

David McKinley
Mgr., Environmental, Safety & Health

# EXHIBIT NO. 25

**Office of**
**The City Attorney**
**City of San Diego**

**MEMORANDUM**
**MS 59**

**533-5800**

11/75

**DATE:** November

**TO:** Councilmember Christine Kehoe

**FROM:** City Attorney

**SUBJECT:** Sewer Cost-of-Service Report

---

I have carefully reviewed your November 1, 1999 memorandum regarding the recent Sewer Cost-of-Service Report and the significant issues it raises.

A common, but erroneous, conclusion is drawn from the Report at duplicate Tables I-1 and VIII-10 (attached) that reflect substantial *decreases* in residential sewer rates. This, however, is a comparison of the existing rate structure for all user classes compared to a study-derived new rate incorporating an organic loading component (chemical oxygen demand or COD) to all customers. The body of the Report more completely explains Tables I-1 and VIII-10:

> Sewer service charges using the information and methodology of this study are shown in Table VIII-10. *This is for a sample of City customers and assuming the new rates began in 1998. The 1997 and 1998 charges based on current rates are shown for comparison. The 1998 charges as computed in this report are based on strength based rates.* The 1998 strength based billing ("SBB") includes rates for flow, COD and SS but does not include a base fee or a sewer cap based on winter water use. The strength based billing rate is a straight line calculation using the flow, COD, and SS contributed by each customer multiplied by the unit cost for each parameter.

Sewer Cost-of-Service Report at page 33 [emphasis added]

Hence the Report does not show any existing disproportionality among existing customer classes (all are charged based on flow and suspended solids), but rather a comparison of a proposed rate structure (all are charged for flow, suspended solids, and chemical oxygen demand) to the existing.



For USAO 7.26.05
Part of SEC COS Subpoena

Since the Report does not disclose an existing disproportionality based on the existing structure, it does not present a Proposition 218 issue. Nevertheless, the Report presents important policy issues on needed modifications to the City's rate structure which, when updated, we understand you will bring forward to the Natural Resources and Culture Committee.

CASEY GWINN, City Attorney

By
Ted Bromfield
Deputy City Attorney

TB:mb
Attachments:
Report Tables I-1 and VIII-10



For USAO 7.26.05
Part of SEC COS Subpoena

# EXHIBIT NO. 26

NO EXHIBIT WITH THIS FOOTNOTE

# EXHIBIT NO. 27

(916) 739-4426
(916) 739-2300 FAX

SEP 18 1991

Mr. Charles Yackly
Deputy Water Utilities
Department Director
City of San Diego
First Interstate Plaza
401 B Street, Suite 400
San Diego, CA 92101-4227

Dear Mr. Yackly:

FINAL REVENUE PROGRAM APPROVAL -- CITY OF SAN DIEGO, CLEAN WATER GRANT PROJECT NO. C-06-1092-210, -510, -520, -530 AND -540

The City of Chula Vista recently received approval of their final revenue program and sewer use ordinance. All member agencies of the City of San Diego Wastewater Treatment Facilities now have an approved revenue program and sewer use ordinance. Congratulations, the City of San Diego has complied with all the appropriate revenue program requirements applicable to the above referenced projects.

Implementation and maintenance of the user charge system is a requirement of the grant regulations (refer to 40 CFR 35.2208). Both the user charge system and sewer use ordinance must be implemented for the useful life of the facilities. The California State Water Resources Control Board, Division of Clean Water Programs, must be notified when either of these ordinances/resolutions are changed. In addition, your agency must maintain records necessary to document compliance with these requirements.

If you have any questions about this letter, please contact me at (916) 739-4426.

Sincerely,

ORIGINAL SIGNED BY

Ronald R. Blair
Revenue Program Specialist

cc: Ms. Trina Blake
City of San Diego
First Interstate Plaza
401 B Street, Suite 400
San Diego, CA 92101-4227

bcc: Fred Johansen, DCWP
Christine Bailey, DCWP

RBLAIR/DYEE/ATDISK3:SANDIEGO.LTR/17 SEP 91

| | | | |
|---|---|---|---|
| SURNAME | RBlair 9/10/91 | [illegible] 9/91 | |

SWRCB1158

# EXHIBIT NO. 28

(916) 227-4489
(916) 227-4349 FAX

Mr. Jack McGrory
City Manager
City of San Diego
202 C Street
San Diego, CA 92101-4230-

Dear Mr. McGrory:

REVENUE PROGRAM REVIEW -- CITY OF SAN DIEGO, CLEAN WATER GRANT PROJECT NO. C-06-1092

I wish to express my appreciation for the cooperation the staff of the City of San Diego (City) gave me during my recent visit to your office. The following information is requested by November 1, 1994, to complete my review of the City's compliance with the requirements of USEPA's Clean Water Grant requirements.

1. Please explain the purpose and rational of the "reverse repurchase agreement" item that appears in the wastewater budgets and audits.

2. Please provide the legal basis for charging the wastewater fund for "use of city owned right-of-way. Also provide the data that was used to determine the amount that is charged for this item.

3. Please provide the rational for charging "outside city" direct billed accounts twice the normal rate for sewer service. Under USEPA regulations the City must charge all users in proportion to the cost of providing treatment services.

In addition, the City must adopt the following charges to bring its wastewater user charge system into compliance with the requirements of the existing and past Clean Water Grants.

a. The City must modify their agreements with all participating agencies to include charges for BOD and TSS content as well as flow discharged into City facilities.

b. The City must include septage discharges into their rate ordinance/resolution. The City is accepting discharges from septage haulers. However, I was unable to find any mention of septage haulers in the City rate codes.

c. The City must develop forecast unit costs, including appropriate indirect markups, for wastewater flow, BOD removal and TSS removal. These unit costs should be based on the prior year's costs and forecast increases. The forecast unit costs must be transmitted to all participating agencies as soon as possible each year to allow them to implement any needed rate adjustments prior to the start of the next fiscal year.

Please provide the information requested in Items 1-3, above and a timetable for compliance with Items a-c by November 1, 1994. If you are unable to meet this deadline please contact me at (916) 227-4489.

Sincerely,

Ronald R. Blair
Revenue Program Specialist

bcc: John Herren, CWP
San Marcos Trng Ctr
Bruce Posthumus, San Diego Regional Water Quality Control Board

# EXHIBIT NO. 29

1999

NEW ISSUE - BOOK ENTRY ONLY

*In the opinion of Orrick, Herrington & Sutcliffe LLP, Los Angeles, California and Webster & Anderson, Oakland, California, Co-Bond Counsel, based upon an analysis of existing laws, regulations, rulings and court decisions, and assuming, among other matters, compliance with certain covenants, interest on the Series 1999 Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 and is exempt from State of California personal income taxes. In the further opinion of Co-Bond Counsel, interest on the Series 1999 Bonds is not a specific preference item for purposes of the federal individual or corporate alternative minimum taxes, although Co-Bond Counsel observe that such interest is included in adjusted current earnings when calculating corporate alternative minimum taxable income. Co-Bond Counsel express no opinion regarding any other tax consequences related to the ownership or disposition of, or the accrual or receipt of interest on, the Series 1999 Bonds. See "TAX MATTERS."*

# $315,410,000
# PUBLIC FACILITIES FINANCING AUTHORITY OF THE CITY OF SAN DIEGO
## Sewer Revenue Bonds, Series 1999A and Series 1999B
(Payable Solely From Installment Payments Secured By Wastewater System Net Revenues)

Dated: March 1, 1999

Due: May 15, as shown on the inside cover page

The Series 1999A Bonds and the Series 1999B Bonds (collectively, the "Series 1999 Bonds") are issuable as fully registered bonds and when initially issued will be registered in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York ("DTC"). Purchases of the Series 1999 Bonds will be made in book-entry form only, in denominations of $5,000 or any integral multiple thereof, through brokers and dealers who are, or who act through, DTC Participants. Beneficial Owners of the Series 1999 Bonds will not be entitled to receive physical delivery of bond certificates so long as DTC or a successor securities depository acts as the securities depository with respect to the Series 1999 Bonds. So long as DTC or its nominee is the registered owner of the Series 1999 Bonds, reference herein to Bondholders or registered owners shall mean Cede & Co., as aforesaid, and payments of principal of and interest on the Series 1999 Bonds will be made directly to DTC by State Street Bank and Trust Company of California, N.A., as Trustee. Disbursement of such payments to DTC Participants is the responsibility of DTC and disbursement of such payments to the Beneficial Owners is the responsibility of DTC Participants. See "DESCRIPTION OF THE SERIES 1999 BONDS — Book-Entry-Only System." Interest on the Series 1999 Bonds is payable on May 15 and November 15 of each year, commencing November 15, 1999.

The Series 1999 Bonds are subject to optional and mandatory redemption prior to maturity as described herein.

Proceeds of the Series 1999A Bonds are to be applied to (i) pay for certain capital improvements to the Metropolitan System of the City of San Diego (the "City"), (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds (defined below) and (iii) to pay certain costs of issuance. Proceeds of the Series 1999B Bonds are to be applied to (i) pay for certain capital improvements to the Municipal System of the City, (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds and (iii) to pay certain costs of issuance.

The payment of principal of and interest on the Series 1999 Bonds, excluding the Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 (collectively, the "Insured Series 1999 Bonds"), when due will be guaranteed by a municipal bond insurance policy issued simultaneously with the delivery of the Insured Series 1999 Bonds. **The Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 are not insured.**

FGIC. Financial Guaranty Insurance Company

FGIC is a registered service mark used by Financial Guaranty Insurance Company, a private company not affiliated with any U.S. Government agency.

The Series 1999 Bonds are limited obligations of the Public Facilities Financing Authority of the City of San Diego (the "Authority") payable solely from Revenues, which Revenues include Installment Payments to be made by the City to the Authority from Net System Revenues pursuant to an Installment Purchase Agreement, as amended and supplemented, including as supplemented by the 1999-1 Supplement to the Master Installment Purchase Agreement, each between the Authority and the City, and amounts on deposit in the funds and accounts established under the Indenture (other than amounts on deposit in the Rebate Fund). The City has pledged Net System Revenues pursuant to the Installment Purchase Agreement to the payment of the Installment Payments. The Series 1999 Bonds are issued on a parity with the Authority's Sewer Revenue Bonds, Series 1993, Series 1995 and Series 1997 (collectively, the "Outstanding Parity Bonds").

**The obligation of the City to make Installment Payments does not constitute an obligation of the City for which the City is obligated to levy or pledge any form of taxation or for which the City has levied or pledged any form of taxation. Neither the pledge made by the Authority, nor the obligation of the City to make Installment Payments, creates a legal or equitable pledge, charge, lien or encumbrance upon any of the City's property, or upon its income, receipts or revenues other than Net System Revenues. The Authority has no taxing power.**

This cover page contains certain information for general reference only. It is not a summary of the issue. Investors are advised to read the entire Official Statement to obtain information essential to the making of an informed decision.

SEE MATURITY SCHEDULES ON INSIDE FRONT COVER

*The Series 1999 Bonds will be offered when, as and if issued and received by the Underwriters, subject to the approval of validity by Orrick, Herrington & Sutcliffe LLP, Los Angeles, California and Webster & Anderson, Oakland, California, Co-Bond Counsel, and to certain other conditions. Certain legal matters in connection with the Series 1999 Bonds will be passed upon by Casey Gwinn, Esq., City Attorney of the City of San Diego and General Counsel to the Authority and Orrick, Herrington & Sutcliffe LLP, Los Angeles, California, Disclosure Counsel. O'Melveny & Myers LLP has acted as counsel to the Underwriters for specified purposes. See "CERTAIN LEGAL MATTERS." It is expected that the Series 1999 Bonds will be available for delivery through DTC in New York, New York, on or about March 17, 1999.*

Bear, Stearns & Co. Inc. NationsBanc Montgomery Securities LLC

The Chapman Company First Albany Corporation Prudential Securities

March 2, 1999

## WASTEWATER SYSTEM REGULATORY REQUIREMENTS

### General

The Wastewater System is subject to regulations imposed by the Clean Water Act. The regulatory requirements are administered by the United States Environmental Protection Agency (the "EPA"), the California State Water Resources Control Board (the "State Board") and the San Diego Regional Water Quality Control Board (the "Regional Board"). Regulations of these agencies deal primarily with the quality of effluent which may be discharged from the Wastewater System, the disposal of sludge generated by the Wastewater System, the discharge of pollutants into groundwater, and the nature of waste material (particularly industrial waste) discharged into the collection system. The Point Loma Plant functions as an advanced primary treatment plant and the North City Plant functions as a tertiary treatment plant under the Clean Water Act.

On November 9, 1995, the City received from the EPA a five-year waiver of the secondary treatment requirements for the Point Loma Plant based on the successful implementation of certain requirements contained in OPRA. See "ACTIONS UNDER THE CLEAN WATER ACT -- Relief From Secondary Treatment Requirements" for information regarding the extension of the waiver and the possible legislative amendments to OPRA. The waiver allowed the City to obtain a modified NPDES permit. The City must operate the Wastewater System according to the discharge limitations set forth in its NPDES permit in order to comply with federally mandated effluent quality and disposal criteria. The NPDES permit and the waiver both expire on November 9, 2000 and the City will need to apply for successive five-year extensions in order to continue to be exempt from the secondary treatment standards of the Clear Water Act.

To comply with other federal regulations concerning the discharge of waste materials into the Wastewater System, the City must administer and enforce industrial pretreatment limitation standards upon industrial users of the Wastewater System. The City has had an industrial waste program in effect since the early 1970s. The City's industrial waste ordinance sets forth water quality standards that industrial users must meet and provides enforcement procedures for violators. The Industrial Waste Division of the MWWD is currently responsible for monitoring an average of 1,000 permitted industries located in the Metropolitan System service area. In addition, each Participating Agency is required to permit and monitor all industries within its respective service area. While each Participating Agency as a condition of the Regional Wastewater Disposal Agreement is required to comply with quality standards set by the City, the City, at the urging of the EPA, has required separate pretreatment agreements with each Participating Agency to ensure industrial pretreatment requirements are met. All Participating Agencies have entered into such pretreatment agreements.

As a condition of having received federal EPA grant funds under the Clean Water Act for the planning and construction of various improvements to the Wastewater System, the City is subject to additional regulatory requirements. For example, a federal EPA grant of approximately $76 million that the City received and used for the construction of the North City Plant provides that the City shall attempt to meet the goal of beneficial reuse of 25% of the flows treated at the North City Plant by December 31, 2003 and 50% by December 31, 2010. The goal of 25% beneficial reuse by 2003 can be achieved by the existing reclaimed water distribution system that is owned and operated by the City's Water Department. The City is currently evaluating the various alternatives for compliance with the goal of 50% beneficial reuse by 2010. If the City were found by the EPA to have not met the conditions of this grant or any other federal EPA grants, the City could be required to return the grant moneys to the EPA.

Among other grant-related requirements are guidelines which must be followed concerning planning methodologies, design criteria, construction activities, and the operation, maintenance and financing of facilities. As another condition of its past receipt of federal grants, the State Board, as the delegate of the EPA, must approve the sewer service charge structures of the City and the Participating Agencies. Such service charge structures require the recovery of annual operations, maintenance and replacement costs from users of the system in a proportionate manner according to the customer's level of use. Such factors as volume, infiltration/inflow, delivery flow rate, and strength of sewage are to be considered for determining proportionate use. Sewer service charge rates for all retail users are reviewed annually and established at a level necessary to generate sufficient revenues to recover the annual operations, maintenance and replacement costs. Sewer service charge rates for users are established to recognize the volume and strength characteristics of wastewater contributed to the Wastewater System. The City's rate structure

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acknowledging data is bill customers based on strength

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has been reviewed by the State Board and no grant funds or costs under grant funded programs have been disallowed based on the nature of the rate structures.

In addition to federal requirements, the City must also comply with water quality based effluent State requirements, otherwise known as the State Ocean Plan. Another State law concerned with control of water quality is the Porter-Cologne Water Quality Control Act of 1969, as amended. The Porter-Cologne Act directly addresses the problem of water reclamation and reuse. A declared policy of the law is that the people of the State of California have a primary interest in the development of facilities to reclaim wastewater to supplement existing surface and underground water supplies in order to meet their water requirements. The legislative intent was to undertake all possible development of water reclamation facilities to make reclaimed water available for use. The law requires the State Department of Health Services to establish statewide reclamation criteria for each type of use where such use involves public health. The City's proposed water reclamation projects are subject to the Porter-Cologne Act and are being designed in consultation with State officials to comply with its requirements.

The City believes that it is in compliance with all federal and state laws relating to the Wastewater System.

**Certain Compliance Actions and Other Litigation**

On February 8, 1996, the Regional Board accepted a proposal offered by the City to resolve all outstanding enforcement and liability issues relating to alleged sewer overflows involving the Wastewater System and inadequate reporting of such events. Without admitting any liability for pending issues related to sewer overflows and reporting, the City agreed to a cash payment of $350,000 and approximately one million dollars total in environmental credit projects extending over five years, from 1996 to 2001. This settlement resulted in a full satisfaction of all issues between the City and the Regional Board through the date of settlement. To date, all requirements of the settlement have been met and there are no pending complaints involving the City before the Regional Board.

The City is not presently involved in nor has received notice of any claim pertaining to regulation relief.

## ACTIONS UNDER THE CLEAN WATER ACT

**General**

In 1972, Congress enacted the Clean Water Act, which among other things, directs the EPA to monitor and to regulate the discharge of pollution into navigable water ways and to enforce the requirement that all wastewater treatment plants in the nation provide full secondary treatment for sewage. In 1977, Congress amended the Clean Water Act to allow waivers of secondary treatment standards for certain ocean discharges. In September 1979, the City submitted an application to the EPA for a waiver from the secondary treatment standards based upon the EPA's proposed waiver regulations. The EPA tentatively approved the City's waiver application in September 1981. A revised waiver application incorporating updated flow projections was submitted to the EPA in November 1983. However, in September 1986, the EPA reversed its tentative approval of the City's 1979 waiver application and tentatively denied the City's 1979 and 1983 applications. In February 1987, the City Council decided to discontinue its efforts to obtain a waiver. However, see "Relief From Secondary Treatment Requirements" below for information regarding the waiver from secondary treatment standards of the Clean Water Act which the City received in 1995 and which expires in November 2000.

**Litigation and Final Order**

In July 1988, the United States of America, acting through the Department of Justice and the EPA, and the State of California filed suit against the City in U.S. District Court for alleged violations of the Clean Water Act, its NPDES permit, sewer overflows, and alleged irregularities in the City's pretreatment program that regulates industrial waste. The plaintiffs sought injunctive relief and monetary damages for alleged effluent limit violations, failure to meet secondary treatment standards, past sewer spills, and pretreatment violations. The lawsuit was divided into a penalty proceeding and a remedies proceeding.

# EXHIBIT NO. 30

1999

NEW ISSUE - BOOK ENTRY ONLY

*In the opinion of Orrick, Herrington & Sutcliffe LLP, Los Angeles, California and Webster & Anderson, Oakland, California, Co-Bond Counsel, based upon an analysis of existing laws, regulations, rulings and court decisions, and assuming, among other matters, compliance with certain covenants, interest on the Series 1999 Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 and is exempt from State of California personal income taxes. In the further opinion of Co-Bond Counsel, interest on the Series 1999 Bonds is not a specific preference item for purposes of the federal individual or corporate alternative minimum taxes, although Co-Bond Counsel observe that such interest is included in adjusted current earnings when calculating corporate alternative minimum taxable income. Co-Bond Counsel express no opinion regarding any other tax consequences related to the ownership or disposition of, or the accrual or receipt of interest on, the Series 1999 Bonds. See "TAX MATTERS."*

# $315,410,000
# PUBLIC FACILITIES FINANCING AUTHORITY OF THE CITY OF SAN DIEGO
## Sewer Revenue Bonds, Series 1999A and Series 1999B
(Payable Solely From Installment Payments Secured By Wastewater System Net Revenues)

Dated: March 1, 1999

Due: May 15, as shown on the inside cover page

The Series 1999A Bonds and the Series 1999B Bonds (collectively, the "Series 1999 Bonds") are issuable as fully registered bonds and when initially issued will be registered in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York ("DTC"). Purchases of the Series 1999 Bonds will be made in book-entry form only, in denominations of $5,000 or any integral multiple thereof, through brokers and dealers who are, or who act through, DTC Participants. Beneficial Owners of the Series 1999 Bonds will not be entitled to receive physical delivery of bond certificates so long as DTC or a successor securities depository acts as the securities depository with respect to the Series 1999 Bonds. So long as DTC or its nominee is the registered owner of the Series 1999 Bonds, reference herein to Bondholders or registered owners shall mean Cede & Co., as aforesaid, and payments of principal of and interest on the Series 1999 Bonds will be made directly to DTC by State Street Bank and Trust Company of California, N.A., as Trustee. Disbursement of such payments to DTC Participants is the responsibility of DTC and disbursement of such payments to the Beneficial Owners is the responsibility of DTC Participants. See "DESCRIPTION OF THE SERIES 1999 BONDS — Book-Entry-Only System." Interest on the Series 1999 Bonds is payable on May 15 and November 15 of each year, commencing November 15, 1999.

The Series 1999 Bonds are subject to optional and mandatory redemption prior to maturity as described herein.

Proceeds of the Series 1999A Bonds are to be applied to (i) pay for certain capital improvements to the Metropolitan System of the City of San Diego (the "City"), (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds (defined below) and (iii) to pay certain costs of issuance. Proceeds of the Series 1999B Bonds are to be applied to (i) pay for certain capital improvements to the Municipal System of the City, (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds and (iii) to pay certain costs of issuance.

The payment of principal of and interest on the Series 1999 Bonds, excluding the Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 (collectively, the "Insured Series 1999 Bonds"), when due will be guaranteed by a municipal bond insurance policy issued simultaneously with the delivery of the Insured Series 1999 Bonds. **The Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 are not insured.**

FGIC. Financial Guaranty Insurance Company

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The Series 1999 Bonds are limited obligations of the Public Facilities Financing Authority of the City of San Diego (the "Authority") payable solely from Revenues, which Revenues include Installment Payments to be made by the City to the Authority from Net System Revenues pursuant to an Installment Purchase Agreement, as amended and supplemented, including as supplemented by the 1999-1 Supplement to the Master Installment Purchase Agreement, each between the Authority and the City, and amounts on deposit in the funds and accounts established under the Indenture (other than amounts on deposit in the Rebate Fund). The City has pledged Net System Revenues pursuant to the Installment Purchase Agreement to the payment of the Installment Payments. The Series 1999 Bonds are issued on a parity with the Authority's Sewer Revenue Bonds, Series 1993, Series 1995 and Series 1997 (collectively, the "Outstanding Parity Bonds").

**The obligation of the City to make Installment Payments does not constitute an obligation of the City for which the City is obligated to levy or pledge any form of taxation or for which the City has levied or pledged any form of taxation. Neither the pledge made by the Authority, nor the obligation of the City to make Installment Payments, creates a legal or equitable pledge, charge, lien or encumbrance upon any of the City's property, or upon its income, receipts or revenues other than Net System Revenues. The Authority has no taxing power.**

This cover page contains certain information for general reference only. It is not a summary of the issue. Investors are advised to read the entire Official Statement to obtain information essential to the making of an informed decision.

SEE MATURITY SCHEDULES ON INSIDE FRONT COVER

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Bear, Stearns & Co. Inc. NationsBanc Montgomery Securities LLC

The Chapman Company First Albany Corporation Prudential Securities

March 2, 1999

## WASTEWATER SYSTEM REGULATORY REQUIREMENTS

### General

The Wastewater System is subject to regulations imposed by the Clean Water Act. The regulatory requirements are administered by the United States Environmental Protection Agency (the "EPA"), the California State Water Resources Control Board (the "State Board") and the San Diego Regional Water Quality Control Board (the "Regional Board"). Regulations of these agencies deal primarily with the quality of effluent which may be discharged from the Wastewater System, the disposal of sludge generated by the Wastewater System, the discharge of pollutants into groundwater, and the nature of waste material (particularly industrial waste) discharged into the collection system. The Point Loma Plant functions as an advanced primary treatment plant and the North City Plant functions as a tertiary treatment plant under the Clean Water Act.

On November 9, 1995, the City received from the EPA a five-year waiver of the secondary treatment requirements for the Point Loma Plant based on the successful implementation of certain requirements contained in OPRA. See "ACTIONS UNDER THE CLEAN WATER ACT -- Relief From Secondary Treatment Requirements" for information regarding the extension of the waiver and the possible legislative amendments to OPRA. The waiver allowed the City to obtain a modified NPDES permit. The City must operate the Wastewater System according to the discharge limitations set forth in its NPDES permit in order to comply with federally mandated effluent quality and disposal criteria. The NPDES permit and the waiver both expire on November 9, 2000 and the City will need to apply for successive five-year extensions in order to continue to be exempt from the secondary treatment standards of the Clear Water Act.

To comply with other federal regulations concerning the discharge of waste materials into the Wastewater System, the City must administer and enforce industrial pretreatment limitation standards upon industrial users of the Wastewater System. The City has had an industrial waste program in effect since the early 1970s. The City's industrial waste ordinance sets forth water quality standards that industrial users must meet and provides enforcement procedures for violators. The Industrial Waste Division of the MWWD is currently responsible for monitoring an average of 1,000 permitted industries located in the Metropolitan System service area. In addition, each Participating Agency is required to permit and monitor all industries within its respective service area. While each Participating Agency as a condition of the Regional Wastewater Disposal Agreement is required to comply with quality standards set by the City, the City, at the urging of the EPA, has required separate pretreatment agreements with each Participating Agency to ensure industrial pretreatment requirements are met. All Participating Agencies have entered into such pretreatment agreements.

As a condition of having received federal EPA grant funds under the Clean Water Act for the planning and construction of various improvements to the Wastewater System, the City is subject to additional regulatory requirements. For example, a federal EPA grant of approximately $76 million that the City received and used for the construction of the North City Plant provides that the City shall attempt to meet the goal of beneficial reuse of 25% of the flows treated at the North City Plant by December 31, 2003 and 50% by December 31, 2010. The goal of 25% beneficial reuse by 2003 can be achieved by the existing reclaimed water distribution system that is owned and operated by the City's Water Department. The City is currently evaluating the various alternatives for compliance with the goal of 50% beneficial reuse by 2010. If the City were found by the EPA to have not met the conditions of this grant or any other federal EPA grants, the City could be required to return the grant moneys to the EPA.

Among other grant-related requirements are guidelines which must be followed concerning planning methodologies, design criteria, construction activities, and the operation, maintenance and financing of facilities. As another condition of its past receipt of federal grants, the State Board, as the delegate of the EPA, must approve the sewer service charge structures of the City and the Participating Agencies. Such service charge structures require the recovery of annual operations, maintenance and replacement costs from users of the system in a proportionate manner according to the customer's level of use. Such factors as volume, infiltration/inflow, delivery flow rate, and strength of sewage are to be considered for determining proportionate use. Sewer service charge rates for all retail users are reviewed annually and established at a level necessary to generate sufficient revenues to recover the annual operations, maintenance and replacement costs. Sewer service charge rates for users are established to recognize the volume and strength characteristics of wastewater contributed to the Wastewater System. The City's rate structure

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acknowledging duties to bill customers based on strength

All while they know they need to put in organics

has been reviewed by the State Board and no grant funds or costs under grant funded programs have been disallowed based on the nature of the rate structures.

In addition to federal requirements, the City must also comply with water quality based effluent State requirements, otherwise known as the State Ocean Plan. Another State law concerned with control of water quality is the Porter-Cologne Water Quality Control Act of 1969, as amended. The Porter-Cologne Act directly addresses the problem of water reclamation and reuse. A declared policy of the law is that the people of the State of California have a primary interest in the development of facilities to reclaim wastewater to supplement existing surface and underground water supplies in order to meet their water requirements. The legislative intent was to undertake all possible development of water reclamation facilities to make reclaimed water available for use. The law requires the State Department of Health Services to establish statewide reclamation criteria for each type of use where such use involves public health. The City's proposed water reclamation projects are subject to the Porter-Cologne Act and are being designed in consultation with State officials to comply with its requirements.

The City believes that it is in compliance with all federal and state laws relating to the Wastewater System.

**Certain Compliance Actions and Other Litigation**

On February 8, 1996, the Regional Board accepted a proposal offered by the City to resolve all outstanding enforcement and liability issues relating to alleged sewer overflows involving the Wastewater System and inadequate reporting of such events. Without admitting any liability for pending issues related to sewer overflows and reporting, the City agreed to a cash payment of $350,000 and approximately one million dollars total in environmental credit projects extending over five years, from 1996 to 2001. This settlement resulted in a full satisfaction of all issues between the City and the Regional Board through the date of settlement. To date, all requirements of the settlement have been met and there are no pending complaints involving the City before the Regional Board.

The City is not presently involved in nor has received notice of any claim pertaining to regulation relief.

## ACTIONS UNDER THE CLEAN WATER ACT

**General**

In 1972, Congress enacted the Clean Water Act, which among other things, directs the EPA to monitor and to regulate the discharge of pollution into navigable water ways and to enforce the requirement that all wastewater treatment plants in the nation provide full secondary treatment for sewage. In 1977, Congress amended the Clean Water Act to allow waivers of secondary treatment standards for certain ocean discharges. In September 1979, the City submitted an application to the EPA for a waiver from the secondary treatment standards based upon the EPA's proposed waiver regulations. The EPA tentatively approved the City's waiver application in September 1981. A revised waiver application incorporating updated flow projections was submitted to the EPA in November 1983. However, in September 1986, the EPA reversed its tentative approval of the City's 1979 waiver application and tentatively denied the City's 1979 and 1983 applications. In February 1987, the City Council decided to discontinue its efforts to obtain a waiver. However, see "Relief From Secondary Treatment Requirements" below for information regarding the waiver from secondary treatment standards of the Clean Water Act which the City received in 1995 and which expires in November 2000.

**Litigation and Final Order**

In July 1988, the United States of America, acting through the Department of Justice and the EPA, and the State of California filed suit against the City in U.S. District Court for alleged violations of the Clean Water Act, its NPDES permit, sewer overflows, and alleged irregularities in the City's pretreatment program that regulates industrial waste. The plaintiffs sought injunctive relief and monetary damages for alleged effluent limit violations, failure to meet secondary treatment standards, past sewer spills, and pretreatment violations. The lawsuit was divided into a penalty proceeding and a remedies proceeding.

# EXHIBIT NO. 31

2003

PRELIMINARY OFFICIAL STATEMENT DATED AUGUST 26, 2003

NEW ISSUES – BOOK ENTRY ONLY

Ratings: Moody's: Aaa
Standard & Poor's: AAA
Fitch: AAA
(See "Ratings" herein)

*In the opinion of Orrick, Herrington & Sutcliffe LLP, Los Angeles, California, and Webster & Anderson, Oakland, California, Co-Bond Counsel, based upon an analysis of existing laws, regulations, rulings and court decisions, and assuming, among other matters, the accuracy of certain representations and compliance with certain covenants, interest on the Series 2003 Subordinated Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 and is exempt from State of California personal income taxes. In the further opinion of Co-Bond Counsel, interest on the Series 2003 Subordinated Bonds is not a specific preference item for purposes of the federal individual or corporate alternative minimum taxes, although Co-Bond Counsel observe that such interest is included in adjusted current earnings when calculating corporate alternative minimum taxable income. Co-Bond Counsel express no opinion regarding any other tax consequences related to the ownership or disposition of, or the accrual or receipt of interest on, the Series 2003 Subordinated Bonds. See "TAX MATTERS."*

# $505,550,000*

# PUBLIC FACILITIES FINANCING AUTHORITY OF THE CITY OF SAN DIEGO

## Subordinated Sewer Revenue Bonds, Series 2003A and Series 2003B

**(Payable Solely From Subordinated Installment Payments Secured By Wastewater System Net Revenues)**

**Dated: Date of Delivery** **Due: May 15, as shown on the inside cover page**

The Series 2003A Subordinated Bonds and the Series 2003B Subordinated Bonds (collectively, the "Series 2003 Subordinated Bonds") are issuable as fully registered bonds and when initially issued will be registered in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York ("DTC"). Purchases of the Series 2003 Subordinated Bonds will be made in book-entry form only, in denominations of $5,000 or any integral multiple thereof, through brokers and dealers who are, or who act through, DTC Participants. Beneficial Owners of the Series 2003 Subordinated Bonds will not be entitled to receive physical delivery of bond certificates so long as DTC or a successor securities depository acts as the securities depository with respect to the Series 2003 Subordinated Bonds. So long as DTC or its nominee is the registered owner of the Series 2003 Subordinated Bonds, reference herein to Bondholders or registered owners shall mean Cede & Co., as aforesaid, and payments of principal of and interest on the Series 2003 Subordinated Bonds will be made directly to DTC by Wells Fargo Bank, National Association, as Trustee. Disbursement of such payments to DTC Participants is the responsibility of DTC and disbursement of such payments to the Beneficial Owners is the responsibility of DTC Participants. Interest on the Series 2003 Subordinated Bonds is payable on May 15 and November 15 of each year, commencing May 15, 2004.

**The Series 2003 Subordinated Bonds are subject to optional and mandatory redemption prior to maturity as described herein.**

Proceeds of the Series 2003A Subordinated Bonds are to be applied: (1) to acquire certain capital improvements to the Metropolitan System (as defined herein); (2) to fund a portion of the debt service reserve fund and to pay a portion of the fees relating to any Reserve Fund Credit Facility (as defined herein) securing the Series 2003 Subordinated Bonds; (3) to refund a portion of the Outstanding Parity Bonds (as defined herein); and (4) to pay certain costs of issuance relating to the issuance of the Series 2003A Subordinated Bonds. Proceeds of the Series 2003B Subordinated Bonds are to be applied: (1) to acquire certain capital improvements to the Municipal System (as defined herein); (2) to fund a portion of the debt service reserve fund and to pay a portion of the fees associated with any Reserve Fund Credit Facility securing the Series 2003 Subordinated Bonds; and (3) to pay certain costs of issuance relating to the issuance of the Series 2003B Subordinated Bonds.

The payment of principal of and interest on the Series 2003 Subordinated Bonds when due will be guaranteed by a municipal bond insurance policy issued simultaneously with the delivery of the Series 2003 Subordinated Bonds.

FGIC. Financial Guaranty Insurance Company

FGIC is a registered service mark used by Financial Guaranty Insurance Company, a private company not affiliated with any U.S. Government agency.

The Series 2003 Subordinated Bonds are limited obligations of the Authority payable solely from Revenues. Revenues include: (1) the 2003 Subordinated Installment Payments to be made by the City of San Diego (the "City") to the Authority (as more fully described herein); and (2) amounts on deposit in the funds and accounts established under the Subordinated Indenture (as defined herein) (other than amounts on deposit in the Rebate Fund (as defined herein)). The 2003 Subordinated Installment Payments are secured by a second priority lien on, and are payable solely from, the Net System Revenues (as defined herein). The 2003 Subordinated Installment Payments are subordinated in right of payment to the Installment Payments securing the Outstanding Parity Bonds (as defined herein), and any other Parity Obligations (as defined herein) that may be issued from time to time in accordance with the Installment Purchase Agreement (as defined herein). All Parity Obligations, including the Installment Payments securing the Outstanding Parity Bonds, are secured by a first priority lien on the Net System Revenues. See "SECURITY FOR THE SERIES 2003 SUBORDINATED BONDS."

**The obligation of the City to make 2003 Subordinated Installment Payments does not constitute an obligation of the City for which the City is obligated to levy or pledge any form of taxation or for which the City has levied or pledged any form of taxation. Neither the pledge made by the Authority, nor the obligation of the City to make 2003 Subordinated Installment Payments, creates a legal or equitable pledge, charge, lien or encumbrance upon any of the City's property, or upon its income, receipts or revenues, other than Net System Revenues. The Authority has no taxing power.**

THIS COVER PAGE CONTAINS CERTAIN INFORMATION FOR GENERAL REFERENCE ONLY. IT IS NOT A SUMMARY OF THE ISSUE. INVESTORS ARE ADVISED TO READ THE ENTIRE OFFICIAL STATEMENT TO OBTAIN INFORMATION ESSENTIAL TO THE MAKING OF AN INFORMED DECISION.

SEE MATURITY SCHEDULES ON INSIDE FRONT COVER

*The Series 2003 Subordinated Bonds will be offered when, as and if issued and received by the Underwriters, subject to the approval of validity by Orrick, Herrington & Sutcliffe LLP, Los Angeles, California, and Webster & Anderson, Oakland, California, Co-Bond Counsel, and to certain other conditions. Certain legal matters in connection with the Series 2003 Subordinated Bonds will be passed upon by Casey Gwinn, Esq., City Attorney of the City of San Diego and General Counsel to the Authority and Orrick, Herrington & Sutcliffe LLP, Los Angeles, California, Disclosure Counsel. Sidley Austin Brown & Wood LLP has acted as counsel to the Underwriters for specified purposes. See "CERTAIN LEGAL MATTERS." It is expected that the Series 2003 Subordinated Bonds will be available for delivery through DTC in New York, New York, on or about September 23, 2003.*

UBS FINANCIAL SERVICES INC.

MERRILL LYNCH & CO. REDWOOD SECURITIES GROUP, INC.

This Preliminary Official Statement and the information contained herein are subject to completion and amendment without notice. These securities may not be sold nor may offers to buy be accepted prior to the time the Official Statement is delivered in final form. Under no circumstances shall this Preliminary Official Statement constitute an offer to sell or the solicitation of an offer to buy, nor shall there be any sale of these securities in any jurisdiction in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of any such jurisdiction.

a good faith effort to meet the conditions of this grant, the City could be required to return the grant monies to the EPA.

Among other grant-related requirements are guidelines which must be followed concerning planning methodologies, design criteria, construction activities, and the operation, maintenance and financing of facilities. As another condition of its past receipt of federal grants, the State Board, as the delegate of the EPA, must approve the sewer service charge structures of the City and the Participating Agencies. Such service charge structures require the recovery of annual operations, maintenance and replacement costs from users of the system in a proportionate manner according to the customer's level of use. Such factors as volume, infiltration/inflow, delivery flow rate, and strength of sewage are to be considered for determining proportionate use. Sewer service charge rates for all retail users are reviewed periodically and established at a level necessary to generate sufficient revenues to recover the annual operations, maintenance and replacement costs. Sewer service charge rates for users are established to recognize the volume and strength characteristics of wastewater contributed to the Wastewater System. The City's rate structure has been reviewed by the State Board and no grant funds or costs under grant funded programs have been disallowed based on the nature of the rate structures.

In addition to federal requirements, the City must also comply with effluent water-quality based State requirements, otherwise known as the State Ocean Plan. Another State law concerned with control of water quality is the Porter-Cologne Water Quality Control Act of 1969, as amended. The Porter-Cologne Act directly addresses the issues of water reclamation and reuse. A declared policy of the law is that the people of the State of California have a primary interest in the development of facilities to reclaim wastewater to supplement existing surface and underground water supplies to meet their water requirements. The legislative intent was to undertake all possible development of water reclamation facilities to make reclaimed water available for use. The law requires the State Department of Health Services to establish statewide reclamation criteria for each type of use where such use involves public health. The City's proposed water reclamation projects are subject to the Porter-Cologne Act and are being designed in consultation with State officials to comply with its requirements. Furthermore, a different State law requires that the City make a good faith effort to divert at least 50% of all solid waste from landfill disposal by December 31, 2004. For the current calendar year to date, the City estimates that it is diverting approximately 42% of solid waste from landfill disposal.

## ACTIONS RELATING TO TREATMENT OF SEWAGE

### General

In general, the Clean Water Act requires that all wastewater treatment plants in the nation provide secondary treatment for sewage before it is discharged into waterways. The Clean Water Act directs the EPA to enforce this requirement. The Clean Water Act allows wastewater treatment plants to apply for a waiver from the secondary treatment standards for certain ocean discharges (a "Treatment Waiver"). The Clean Water Act grants the EPA the discretion to grant or deny any Treatment Waiver. When the EPA grants or denies a Treatment Waiver, the EPA's action is difficult to reverse.

To renew the Point Loma Discharge Permit and the South Bay Discharge Permit, the City must comply with the secondary treatment requirements of the Clean Water Act, or obtain a Treatment Waiver. Since the enactment of the Clean Water Act, the Point Loma Plant only treats sewage to an advanced primary treatment level, and has relied on successive Treatment Waivers to discharge sewage into the ocean. The South Bay Reclamation Plant complies with the secondary treatment requirements of the Clean Water Act, and, thus, has no need for a Treatment Waiver.

Between 1979 and 1987, the City submitted an application, and augmented the same from time to time, for a Treatment Waiver for the Point Loma Plant. This effort was unsuccessful, and the application was withdrawn in February 1987. Since the Point Loma Plant did not provide secondary treatment of sewage that it discharged into the ocean, after the City withdrew its waiver application in 1987, the Point Loma Plant failed to comply with the Clean Water Act. This, in part, led to the litigation and Final Order that are discussed under "EPA Litigation and Final Order" below. As a result of that litigation and the Final Order, the City Council directed the City's staff to renew its efforts to obtain a Treatment Waiver. As a result of these efforts, at the request of the City, the United States Congress adopted The Ocean Pollution Reduction Act of 1994 ("OPRA"), which was special legislation

# EXHIBIT NO. 32

**Office of**
**The City Attorney**
**City of San Diego**

**MEMORANDUM**

**DATE:** November 15, 1999

**TO:** Casey Gwinn, City Attorney

**FROM:** Ted Bromfield, Deputy City Attorney

**SUBJECT:** Councilmember Kehoe's Memo on Sewer Cost-of-Service Report

---

As you noted, the Cost-of-Service Report and Ms. Kehoe's memo present significant issues on the City's sewer rate structure. In responding to her, I've taken the unusual tack of a short, hopefully diplomatic, response pointing out that the Report does not support her assertion that "single-family homeowners pay almost double." The longer response, more controversial because of my view on Proposition 218, treats her question as a hypothetical and analyzes the Proposition 218 implications.

I recommend the shorter response, but certainly am available to discuss other avenues of response.

Ted

TB:mb
Attachments:2



For USAO 7.26.05
Part of SEC COS Subpoena

# EXHIBIT NO. 33

Sec. 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by th use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

(Sec. 10; 48 Stat. 891; 15 U.S.C. 78j)

[13 FR 8183, Dec. 22, 1948, as amended at 16 FR 7928, Aug. 11, 1951]

curity if, prior to such loan, arrangement, or failure to deliver, the exchange upon which the sale requiring the delivery of such security was effected finds (i) that such sale resulted from a mistake made in good faith, (ii) that due diligence was used to ascertain that the circumstance specified in § 240.10a-1 (c) (1) existed or to obtain the information specified in § 240.10a-1 (c) (2) and (iii) either that the condition of the market at the time the mistake was discovered was such that undue hardship would result from covering the transaction by a "purchase for cash", or that the mistake was made by the seller's broker and the sale was at a price permissible for a short sale under § 240.10a-1 (a) (Sec. 10a, 48 Stat. 891; 15 U. S. C. 78j (a)) [Rule X-10A-2]

CROSS REFERENCE: For interpretative release applicable to § 240.10a-2, see § 241.1571 of this chapter.

MANIPULATIVE AND DECEPTIVE DEVICES AND CONTRIVANCES

§ 240.10b-1 *Prohibition of use of manipulative or deceptive devices or contrivances with respect to certain securities exempted from registration.* The term "manipulative or deceptive device or contrivance," as used in section 10 (b) (48 Stat. 891, 15 U. S. C. 78j (b)), is hereby defined to include any act or omission to act with respect to any security exempted from the operation of section 12 (a) (48 Stat. 892; 15 U. S. C. 78l (a)) pursuant to any section in this part which specifically provides that this section shall be applicable to such security, if such act or omission to act would have been unlawful under section 9 (a) (48 Stat. 889; 15 U. S. C. 78i (a)) or any rule or regulation heretofore or hereafter prescribed thereunder, if done or omitted to be done with respect to a security registered on a national securities exchange, and the use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange to use or employ any such device or contrivance in connection with the purchase or sale of any such security is hereby prohibited. (Sec. 10, 12; 48 Stat. 891, 892, 15 U. S. C. 78j, 78l) [Rule X-10B-1]

CROSS REFERENCES: For applicability of this section, see §§ 240.12a-1 to 240.12a-9. For regulations relating to employment of manipulative and deceptive devices, see § 240.10b-3 and 10b-5. For prohibitions with respect to securities not registered on a national securities exchange, see § 240.10b-4.

§ 240.10b-2 *Solicitation of purchases on an exchange to facilitate distribution of securities.* (a) No person, participating or otherwise financially interested in the primary or secondary distribution of any security of any issuer, shall, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange:

(1) Pay or offer or agree to pay, directly or indirectly, to any person any compensation for soliciting another to purchase any security of the same issuer on a national securities exchange, or for purchasing any security of the same issuer on any such exchange for any account other than the account of the person who pays or is to pay such compensation; or

(2) Sell, offer to sell or induce an offer to buy such security, or deliver such security after sale, if, in connection with such distribution, such person has paid, or has offered or agreed to pay, directly or indirectly, to any person, any compensation for soliciting another to purchase any security of the same issuer on any national securities exchange, or for purchasing any security of the same issuer on any such exchange for any account other than the account of the person who has paid or is to pay such compensation.

(b) No person, participating or otherwise financially interested in the primary or secondary distribution of any security of any issuer, shall cause a purchase or sale of any security of the same issuer on a national securities exchange by paying or offering or agreeing to pay, directly or indirectly, to any person any compensation for soliciting another to purchase such security on any such exchange, or for purchasing such security on any such exchange for any account other than the account of the person who pays or is to pay such compensation.

(c) The provisions of this section shall not apply in respect to any salary paid by a broker or dealer to any person regularly employed by him whose ordinary duties include the solicitation or execution of brokerage orders on a national securities exchange, if such salary represents only ordinary compensation for the discharge by such person of such duties in the regular course of his employment, and is not paid, in whole or in part, directly or indirectly, for the inducement by such person of the purchase or sale on a national securities exchange of any security of the issuer of the security in the primary or secondary distribution of which such broker or dealer is participating or otherwise financially interested.

(d) (1) The provisions of this section shall not apply to any transaction involving the payment of a special commission to a person acting as a broker for a purchaser by a person selling any security described in this paragraph, where such payment is made pursuant to the terms of an effective plan authorizing the payment of special commissions in connection with a distribution of securities, which plan has been filed with the Commission by a national securities exchange: *Provided,* That such person, at the time he pays, or offers or agrees to pay, any such commission does not know or have reasonable grounds to believe that transactions connected with such distribution are being carried out in violation of such plan. This exemption shall be available only in respect of securities listed and registered on a national securities exchange, or of securities admitted to unlisted trading privileges on any such exchange where the issuer (i) has any security listed and registered on any such exchange and has filed the annual and other periodic reports required pursuant to the Securities Exchange Act of 1934 (48 Stat. 88, et seq., 15 U. S. C. 78a-hh), or (ii) has any security registered under the Securities Act of 1933 (48 Stat. 74, et seq., 15 U. S. C. 77a-aa) and has filed the annual and other periodic reports required pursuant to section 15 (d) of the Securities Exchange Act of 1934 (49 Stat. 1377; 15 U. S. C. 78o), or (iii) is a holding company registered under the Public Utility Holding Company Act of 1935 (49 Stat. 803, et seq., 15 U. S. C. 79a-Z-5) and has filed the annual and other periodic reports required pursuant to such Act, or a subsidiary of any such company, or (iv) is registered under the Investment Company Act of 1940 (54 Stat. 789, et seq., 15 U. S. C. 80a-1-53) and has filed the annual and other periodic reports required pursuant to such act.

(2) For the purposes of this rule a plan filed with the Commission by a national securities exchange shall not become effective unless the Commission, having due regard for the public interest and for the protection of investors, declares the plan to be effective. The Commission in its declaration may impose such terms and conditions relating to the provisions of the plan and the period of its effectiveness as it deems necessary or appropriate in the public interest or for the protection of investors. (Sec. 10, 48 Stat. 891; 15 U. S. C. 78j) [Rule X-10B-2]

CROSS REFERENCE: For interpretative release applicable to § 240.10b-2, see § 241.1411 of this chapter.

§ 240.10b-3 *Employment of manipulative and deceptive devices.* It shall be unlawful for any broker or dealer, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, to use or employ, in connection with the purchase or sale of any security otherwise than on a national securities exchange, any act, practice, or course of business defined by the Commission to be included within the term "manipulative, deceptive, or other fraudulent device or contrivance", as such term is used in section 15 (c) (1) of the act. (Sec. 10, 48 Stat. 891, sec. 2, 52 Stat. 1075; 15 U. S. C. 78j, 78l) [Rule X-10B-3]

CROSS REFERENCES: See also § 240.10b-5. For regulation relating to prohibition of manipulative or deceptive devices, see §§ 140.10b-1. For the term "manipulative, deceptive, or other fraudulent device or contrivance" as used in section 15 (c) (1) of the act, see §§ 240.15c-2 to 240.15c1-9.

§ 240.10b-5 *Employment of manipulative and deceptive devices by any purchaser of a security.* It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud.

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

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connection with the purchase or sale any security. (Sec. 10; 48 Stat. 891, U. S. C. 78j) [Rule X-10B-5]

EXEMPTION OF CERTAIN SECURITIES FROM SECTION 11 (d) (1)

§ 240.11d1-1 *Exemption of certain securities from section 11 (d) (1)* A security shall be exempt from the provisions of section 11 (d) (1) with respect to any transaction by a broker and dealer who, directly or indirectly, extends or maintains or arranges for the extension or maintenance of credit on the security to or for a customer if:

(a) The broker and dealer has not sold the security to the customer or bought the security for the customer's account; or

(b) The security is acquired by the customer in exchange with the issuer thereof for an outstanding security of the same issuer on which credit was lawfully maintained for the customer at the time of the exchange; or

(c) The customer is a broker or dealer or bank; or

(d) The security is acquired by the customer through the exercise of a right evidenced by a warrant or certificate expiring within 90 days after issuance, provided such right was originally issued to the customer as a stockholder of the corporation issuing the security upon which credit is to be extended, or as a stockholder of a company distributing such security in order to effectuate the provisions of section 11 of the Public Utility Holding Company Act of 1935. The right shall be deemed to be issued to the customer as a stockholder if he actually owned the stock giving rise to the right when such right accrued, even though such stock was not registered in his name; and in determining such fact the broker and dealer may rely upon a signed statement of the customer which the broker and dealer accepts in good faith; or

(e) Such broker and dealer would otherwise be subject to the prohibition of section 11 (d) (1) with respect to 50% or less of all the securities of the same class which are outstanding or currently being distributed, and such broker and dealer sold the security to the customer or bought the security for the customer's account on a day when he was not participating in the distribution of any new issue of such security. A broker-dealer shall be deemed to be participating in a distribution of a new issue if (1) he owns, directly or indirectly, any undistributed security of such issue, or (2) he is engaged in any stabilizing activities to facilitate a distribution of such issue, or (3) he is a party to any syndicate agreement under which such stabilizing activities are being or may be undertaken, or (4) he is a party to an executory agreement to purchase or distribute such issue. (Sec. 3, 11, 48 Stat. 882, 891, 15 U. S. C. 78c; 78k) [Rule X-11D1-1]

SECURITIES EXEMPTED FROM REGISTRATION

§ 240.12a-1 *Temporary exemption from section 12 (a) of the act of certain securities of banks.* (a) The following securities of banks shall be exempt from the operation of section 12 (a) of the act to and including the one hundred and twentieth day after the filing of applications on the form appropriate for such securities shall be authorized: (1) Securities as to which temporary registration expired on June 30, 1935; (2) securities of the same issuer heretofore or hereafter issued in exchange for, or resulting from a modification of any securities exempted from the operation of section 12 (a) of the act by this section; and (3) additional shares of common stock, heretofore or hereafter issued, if common stock of the same issuer and of the same class is exempted from the operation of section 12 (a) of the act by this section.

(b) Sections 240.7c2-1 and 240.10b-1 shall be applicable to all securities exempted from the operation of section 12 (a) of the act by this section. (Secs. 3 (a) (12), 12 (a) 48 Stat. 882, 892; 15 U. S. C. 78c (a) (12) 78l (a)) [Rule X-12A-1]

§ 240.12a-2 *Temporary exemption from section 12 (a) of the act of certain securities secured by property which, or a leasehold interest in which, is owned by a person not the original issuer of such security; prohibition of use of manipulative or deceptive devices or contrivances with respect thereto.*

(a) Any security which is secured by property which, or a leasehold interest in which, is now owned by a person who was not the original issuer of such security, shall be exempt from the operation of section 12 (a) of the act (48 Stat. 892; 15 U. S. C. 781 (a)) to and including the respective dates indicated below, and for such longer period, if any as would have been applicable under § 240.12a-1 or § 240.12a-3, if such security had been a security of such owner or lessee:

(1) If temporary registration of such security expired on June 30, 1935, such exemption shall continue to and including November 5, 1935, unless either of the following conditions is satisfied, in which event such exemption shall continue to and including April 30, 1936:

(i) An application for the registration of such security has been filed by the original issuer or by such owner or lessee.

(ii) Such owner or lessee has filed with the exchange and with the Commission a statement conforming to the requirements of paragraph (b) of this section as the same existed prior to this amendment.

(2) If such security was listed on an exchange at the time a temporary exemption from registration was granted to such exchange, and shall have continued to be so listed until registration of such exchange became effective, such exemption shall continue to and including April 30, 1936.

If registration pursuant to section 12 (b) (c) and (d) (48 Stat. 892, 893; 15 U. S. C. 781 (b) (c) (d)) shall become effective as to any obligation evidenced by any such security, such exemption shall forthwith terminate as to such obligation.

(b) Any security exempted by paragraph (a) of this section from the operation of section 12 (a) of the act shall continue to be exempt from the operation of said section 12 (a) to the extent necessary to render lawful the effecting of transactions therein on any national securities exchange on which such security is now listed, until this section shall be revoked, or modified, if on or before the twentieth day preceding the expiration of the exemption provided by said paragraph (a) the owner or lessee of the property securing the same shall file with such exchange, and with the Commission, a statement with respect to such security or, if such owner or lessee is personally liable upon such security, an application for the registration of such security, conforming to the following requirements. Such statement or application, as the case may be, shall be made upon the form appropriate for registration of securities of such owner or lessee, shall set forth the information required by such form, and shall contain the following additional statement with respect to such security:

(1) That temporary registration of such security expired on June 30, 1935;

(2) That such security is secured by property which is owned or leased by such owner or lessee and, if leased, a brief outline of the principal provisions of such lease, together with a copy of such lease as an exhibit;

(3) That the original issuer has either been dissolved or has no assets (other than nominal assets) except its interest, if any, in such property, and that such security has as its only means of service payments made by such owner or lessee; and

(4) Whether or not such owner or lessee is personally liable upon such securities.

If any such statement or application does not contain the additional statement and exhibit required in subparagraphs (1)-(4) of this paragraph, such additional statement and exhibit may be supplied in an amendment, pursuant to § 240.12b-3, filed on or before such twentieth day. Any such security may be included in any application made by such owner or lessee for the registration of its own securities, provided that it is clearly indicated that the required additional statement is made for the purposes of this section.

If registration pursuant to section 12 (b) (c) and (d) of the act shall become effective as to any obligation evidenced by any such security, such exemption shall forthwith terminate as to such obligation.

(c) Sections 240.7c2-1, 240.10b-1 shall be applicable to all securities exempted from the operation of section 12 (a) of the act by paragraph (a) or (b) of this section. (Secs. 3 (a) (12), 12 (a), 48 Stat. 882, 892; 15 U. S. C. 78c (a) (12), 78l (a)) [Rule X-12A-2]

CROSS REFERENCE: For applicability of this section and §§ 240.12a-1, 240.12a-3 to securities listed on exempted exchange which subsequently becomes registered, see § 240.6b-3.

§ 240.12a-3 *Temporary exemption from section 12 (a) of the act of certain securities of issuers in bankruptcy or receivership or in process of reorganization, prohibition of use of manipulative or deceptive devices or contrivances with respect thereto.* (a) The following securities shall be exempt from the operation of section 12 (a) of the act for the period specified in paragraph (b) of this

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# EXHIBIT NO. 34

**ATTORNEY TO CLIENT**
**CORRESPONDENCE**
**FOR CONFIDENTIAL USE ONLY**

**Office of**
**The City Attorney**
**City of San Diego**

**MEMORANDUM**
**MS 59**

**(619) 236-6220**

**DATE:** November 6, 2001

**TO:** Honorable Mayor and Members of the City Council

**FROM:** Leslie J. Girard, Assistant City Attorney

**SUBJECT:** Furgatch v. San Diego Unified Port District, et al., Court of Appeal D035842; City, et al. v. All Persons Interested, et al., San Diego Superior GIC 763487; Dunkl v. City, et al., U.S. Supreme Court No. 01-136; Skane v. City, et al., San Diego Superior GIC 752505; and anticipated litigation matter: Henderson v. City

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In closed session we will be discussing with you your responsibilities regarding the consideration of the Preliminary Official Statement for the City's ballpark bonds. Our outside counsel, Gerald Boltz and Matt Anhut of Bryan Cave LLP, along with the City's bond counsel, Paul Webber of Orrick Herrington & Sutcliffe LLP, will be discussing these matters with you. Enclosed, for your review prior to the closed session, is a memorandum from Mr. Boltz and Mr. Anhut that generally outlines federal securities laws on this subject.

Enclosure

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October 29, 2001

Leslie J. Girard, Esq.
Assistant City Attorney
City of San Diego
Civil Division - Special Projects
1200 Third Avenue, Suite 1620
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**Privileged and Confidential**
**Attorney-Client Communication**

Re: Review of Disclosure Documents as to Lease Revenue Bonds 2001

Dear Les:

We are writing this letter to provide an overview of the applicable federal securities laws and to provide a framework against which the City Council for the City of San Diego ("City Council") and the Board of Commissioners of the Public Facility Financing Authority of the City of San Diego ("Board of Commissioners") must review and evaluate the Preliminary Official Statement ("POS"), and the Official Statement when completed, prepared in anticipation of the offering of the Lease Revenue Bonds 2001 ("2001 Bonds"). As noted in the POS, the purpose of the bond offering is to finance the construction of a major league baseball park in San Diego, as well as other uses (as described in the POS) relating to the ballpark project (the "Ballpark Project"). In this letter we will not recount the lengthy history relating to the Ballpark Project and the numerous related legal challenges and actions, except to note, however, that in a letter dated September 20, 2001, to the City Attorney, the lawyer who has been the driving force behind various pieces of litigation relating to the Ballpark Project has contended that, because of various changes and alterations, the Ballpark Project should be re-submitted to the voters of San Diego for approval (the "September Letter").

In light of the application of provisions of the federal securities laws, and in particular the obligations imposed on issuers in connection the offering and sale of securities (as described below), and the allegations made in the September Letter, each member of the City Council and the Board of Commissioners must read the POS (and when completed the Official Statement), ask questions as to any area or matter that may seem unclear or need clarification, actively seek

information from the officials of the City or Authority and professionals retained in connection with the proposed offering, and conduct follow-up as to the information supplied.

Overview of the Applicable Federal Securities Laws

While Congress exempted offerings of municipal securities, such as the 2001 Bonds, from the registration requirements of the Securities Act of 1933, and the system of periodic reporting under the Securities Exchange Act of 1934, it did not exempt transactions in municipal securities from the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder. These provisions prohibit any person, including municipal issuers, from making a false or misleading statement of material fact, or omitting any material facts necessary to make statements made by that person not misleading, in connection with the offer, purchase or sale of any security. In the event of a violation of the securities provisions, the SEC has a range of remedies at its disposal, including the authority to seek injunctive relief to stop (in extraordinary circumstances) the offer or sale of securities and the imposition of penalties (which include monetary fines and the placement of limitations on securities related activities). In addition, there is typically a substantial amount of negative publicity that arises in connection with an SEC proceeding.

Although as to certain antifraud provisions, the SEC must show that the person acted with "scienter" -- that is recklessness or an intent to deceive, manipulate, or defraud -- the SEC need only demonstrate that the person acted negligently to establish a violation of other antifraud provisions. To establish negligence, the SEC must show that the defendants failed to conform with the standard of care that a reasonable person would have exercised in like circumstances and position. Of course, there must first be a misstatement or omission of a material fact; however, the lower threshold of negligence provides greater enforcement flexibility to the SEC.

In light of the foregoing, it is critical that the City Council and the Board of Commissioners exercise all due care in reviewing and evaluating the information contained in the POS. As to that information, the statements in the POS "must be viewed as part of a 'mosaic' to see if those statements, in the aggregate, created a misleading impression . . . . The proper test is not the literal truth or the materiality of each positive statement, but the overall misleading impression that it combines to create." *In re Genentech, Inc., Securities Litigation*, 1989, Fed. Sec. L. Rep. (CCH) ¶94, 544 (N.D. Cal. 1989). Moreover, a fact is deemed "material" if there is a " ... substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable [investor]. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

Unfortunately, in the event that there is a challenge to the adequacy of a disclosure document, such challenge occurs with the benefit of hindsight. While it is not appropriate to apply hindsight, as a practical matter it is sometimes difficult to disregard subsequent events, and the impact of those events, in placing the disclosure in the proper context of what had occurred as of the time that the document was created.

The importance of the review of municipal securities disclosure documents was highlighted in connection with an SEC report that was critical of the supervisors of Orange County, California for shortcomings relating to their review of such documents. *Report of Investigation in the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors*, Exchange Act Release No. 36761 (January 24, 1996). As stated by the SEC in the Orange County matter:

> In authorizing the issuance of securities and related disclosure documents, a public official may not authorize disclosure that the official knows to be false; nor may a public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading. When, for example, a public official has knowledge of facts bringing into question the issuer's ability to repay the securities, it is reckless for that official to approve disclosure to investors without taking steps appropriate under the circumstances to prevent the dissemination of materially false or misleading information regarding those facts. **In this matter, such steps could have included becoming familiar with the disclosure documents and questioning the issuer's officials, employees or other agents about the disclosure of those facts.**

*Id.* (emphasis added).

The message communicated by the statements of the SEC in the foregoing report is that members of the body approving disclosure documents cannot simply "rubber-stamp" the document. Rather, each member has the responsibility to demonstrate that he or she was actively involved in the process -- that is, each person must review the disclosure document, inquire as to the source of the information, ask questions of the City officials and other professionals who provided information (as well as ask if there are other sources of information that should be reviewed), and follow-up to ascertain whether the information makes sense in the circumstances. In short, the members of the City Council and the Board of Commissioners must demonstrate that they have satisfied themselves, after diligent inquiry that all material facts have been accurately disclosed, that the POS is not misleading.

Application of the Provisions of Federal Securities Laws to the POS

As discussed above, the primary consideration in regard to the POS is that it not contain a misstatement as to a material fact or omit to state any fact that is necessary so as to make the

statements contained therein not misleading. This standard does not mean that the members of the City Council and the Board of Commissioners cannot rely on the professionals and City officials who have supplied information to be included in the POS. What it does mean, however, is that the members of the City Council and the Board of Commissioners act with reasonable care. This includes, at a minimum: (1) reviewing the entire POS; (2) asking for clarification as to material parts of the POS that a member may need additional guidance; (3) seeking information and asking questions of the officials, employees, and professionals who supplied information to be included in the POS; and (4) asking follow up questions to determine the reasonableness of any assumptions or estimates that were used in the POS. Although significant efforts have been expended to make the information in the POS accurate and understandable, the members of the City Council and the Board of Commissioners should not be hesitant to inquire as to any area that might not be entirely clear.

Also, in light of prior challenges to the Ballpark Project, it is prudent that the City Council make certain that there are no additional disclosure issues that need to be addressed. In particular, the City Council should document whether there is any potential conflict of interest -- whether through a business or financial relationship or transaction -- that might need to be disclosed. In this regard, we recommend that the City Council document that each member has not received anything of value from the Padres, any affiliate of the Padres, or any other person or entity that has a material interest in either the Ballpark Project or the proposed offering of the 2001 Bonds. (Such persons include: Padres, L.P.; Padres Construction, L.P.; Mr. John Moores; JMI Realty, Inc.; JMIR - Downtown Acquisition, LLC; San Diego Ballpark Builders; Clark Construction Group, Inc.; Nielsen Dillingham Builders; Douglas E. Barnhart, Inc.; Hines Interests Limited Partnership; Major League Baseball; Ambac Assurance Corporation; Wells Fargo Corporate Trust; HOK Sports; Merrill Lynch & Co., Inc.; Morgan Stanley & Co., Inc.; I.C. Rideau Lyons & Co.; Redwood Securities Group.)

From the perspective of the securities laws, no precise criteria can be established as to the level or range of financial and business relationships, arrangements and practices that might be problematic. The better practice is to ensure that there is no potential conflict in the first instance by requesting and obtaining written confirmation from each member that he or she did not have any business or financial dealings with any person who might be interested in the Ballpark Project or the 2001 Bond offering.

Finally, the City Council should, as part of its review, address the allegations made in the September Letter. In particular, in the September Letter, the lawyer asserts that changes in the financing and revenue assumptions relating to the Ballpark Project and the ancillary development, the increase in the financial participation by the Redevelopment Agency, the reliance by the City on other revenue sources for the Ballpark Project, any amendments to the MOU, and the change in the scope of the ancillary development mandate that the project again be submitted to the voters of the City for approval. Further, and notwithstanding that the POS had

not been completed or released prior to the date of his letter, the lawyer stated that matters might be "omitted or misstated in the [POS]."

In regard to the allegations made by in the September Letter, portions of the POS relating to the Plan of Financing, the Redevelopment Project, the Risk Factors and Litigation should receive additional attention on review by the City Council and the Board of Commissioners. In particular, the lawyer asserts that the transient occupancy tax and tax increment to be generated from the hotels, office space and other development around the Ballpark Project will not be sufficient to pay for the City's contribution to the Ballpark Project. While the assertion rests upon the assumption that specific revenues were pledged for the project, the allegations highlight the importance of reviewing the financial projections and assumptions underlying the City's commitment and resources available to repay the bonds. In that regard, the members of the City Council and the Board of Commissioners should make use of the resources available through City officials in determining whether any of the assertions warrant further attention.

Although there can be no prediction of what future actions might be brought relating to the Ballpark Project or the offering of the 2001 Bonds, a thorough and careful review of the POS by the members of the City Council and the Board of Commissioners will provide a solid foundation to support any response to -- and hopefully summarily conclude -- potential, future challenges.

Very truly yours,

Gerald E. Boltz

Matthew D. Anhut

# EXHIBIT NO. 35

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

# Codification of Statements on Auditing Standards

## (Including Statements on Standards for Attestation Engagements)

Numbers 1 to 93

# Outstanding Statements on Auditing Standards

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| 1 | Codification of Auditing Standards and Procedures | See Part III of Cross-References to SASs section |
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AICPA

.08 In other cases the auditor may determine that a point estimate is a better estimate than any other amount. In those situations, the auditor would use that amount to determine the reasonableness of the recorded amount. The auditor would compare the point estimate to the amount recorded by the client and include any difference in the aggregation of misstatements.[2]

.09 Section 312.36 indicates that the auditor should be alert to the possibility that management's recorded estimates are clustered at either end of the auditor's range of acceptable amounts, indicating a possible bias on the part of management. Section 312.36 states, in part—

> The auditor should also consider whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the entity's management. For example, if each accounting estimate included in the financial statements was individually reasonable, but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase income, the auditor should reconsider the estimates taken as a whole. In these circumstances, the auditor should reconsider whether other recorded estimates reflect a similar bias and should perform additional audit procedures that address those estimates. In addition, the auditor should be alert to the possibility that management's recorded estimates were clustered at one end of the range of acceptable amounts in the preceding year and clustered at the other end of the range of acceptable amounts in the current year, thus indicating the possibility that management is using swings in accounting estimates to offset higher or lower than expected earnings. If the auditor believes that such circumstances exist, the auditor should consider whether these matters should be communicated to the entity's audit committee, as described in section 380, *Communication With Audit Committees*, paragraphs .08 and .11.

[Issue Date: December, 2000.]

## 3. Quantitative Measures of Materiality in Evaluating Audit Findings

.10 *Question*—Section 312, *Audit Risk and Materiality in Conducting an Audit*, provides guidance to the auditor on evaluating the effect of misstatements on the financial statements under audit. Section 312.10 states, in part—

> The auditor's consideration of materiality is a matter of professional judgment and is influenced by his or her perception of the needs of a reasonable person who will rely on the financial statements.

Section 312.34 further describes the auditor's evaluation of the quantitative aspects of materiality. It states, in part—

> In evaluating whether the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, the auditor should aggregate misstatements that the entity has not corrected in a way that enables him or her to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole.

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[2] See Interpretation No. 14, "Reasonable Estimation of the Amount of a Loss" of FASB Statement No. 5, *Accounting for Contingencies*.

What factors should the auditor consider in assessing the *quantitative* impact of identified misstatements?

.11 *Interpretation*—The quantitative evaluation of identified misstatements is a matter of professional judgment and should reflect a measure of materiality that is based on the element or elements of the financial statements that, in the auditor's judgment, are expected to affect the judgment of a reasonable person who will rely on the financial statements, considering the nature of the reporting entity. For example, it is generally recognized that after-tax income from continuing operations is, in most circumstances, the measure of greatest significance to the financial statement users of entities whose debt or equity securities are publicly traded. Depending on the entity's particular circumstances, other elements of the financial statements that may be useful in making a quantitative assessment of the materiality of identified misstatements include current assets, net working capital, total assets, total revenues, gross profit, total equity, and cash flows from operations. In all instances, the element or elements selected should reflect, in the auditor's judgment, the measures most likely to be considered important by the financial statement users.

.12 *Question*—An entity's after-tax income or loss from continuing operations may be nominal or may fluctuate widely from year to year due to the inclusion in the results of operations of significant, unusual, or infrequently occurring income or expense items. What other quantitative measures could be considered if after-tax income or loss from continuing operations is nominal or fluctuates widely from period to period?

.13 *Interpretation*—In certain circumstances, a quantitative measure of materiality based on after-tax income from continuing operations may not be appropriate. The auditor may identify another element or elements that are appropriate in the circumstances or may compute an amount of current-year after-tax income from continuing operations adjusted to exclude unusual or infrequently occurring items of income or expense.[3]

.14 The selection of an alternate element or elements for use in assessing a quantitative measure of materiality is a matter of the auditor's professional judgment. In choosing an alternate element or elements, the auditor should evaluate the perceived needs of the financial statement users, the particular circumstances that caused the abnormal results for the current year, the likelihood of their recurrence, and any other matters that, in the auditor's judgment, may be relevant to a quantitative assessment of materiality.

[Issue Date: December, 2000.]

## 4. Considering the Qualitative Characteristics of Misstatements

.15 *Question*—Section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .34, states, in part—

> Qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material.

What qualitative factors should the auditor consider in assessing whether misstatements are material?

[3] Paragraph 26 of APB Opinion No. 30, *Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary*

# EXHIBIT NO. 36

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

Release No. 34-34961; File No. S7-5-94

RIN 3235-AG13

Municipal Securities Disclosure

AGENCY: Securities and Exchange Commission.

ACTION: Final Rule.

SUMMARY: The Securities and Exchange Commission ("SEC" or "Commission") is adopting amendments to Rule 15c2-12 under the Securities Exchange Act of 1934 ("Exchange Act") to deter fraud and manipulation in the municipal securities market by prohibiting the underwriting and subsequent recommendation of securities for which adequate information is not available. The amendments prohibit a broker, dealer, or municipal securities dealer ("Participating Underwriter") from purchasing or selling municipal securities unless the Participating Underwriter has reasonably determined that an issuer of municipal securities or an obligated person has undertaken in a written agreement or contract for the benefit of holders of such securities to provide certain annual financial information and event notices to various information repositories; and prohibit a broker, dealer, or municipal securities dealer from recommending the purchase or sale of a municipal security unless it has procedures in place that provide reasonable assurance that it will receive promptly any event notices with respect to that security.

DATES: Effective Date: This rule is effective on July 3, 1995 except for 240.15c2-12(c) which is effective on January 1, 1996.

Compliance Date: 240.15c2-12(b)(5)(i)(A) and 240.15c2-12(b)(5)(i)(B) shall not apply with respect to fiscal years ending prior to January 1, 1996; and 240.15c2-12(d)(2)(ii) and 240.15c2-12(d)(2)(iii) shall not apply to an Offering of municipal securities commencing prior to January 1, 1996.

FOR FURTHER INFORMATION CONTACT: Catherine McGuire, Chief Counsel, Janet W. Russell-Hunter, Attorney, or Paula R. Jenson, Senior Counsel (concerning the rule and release generally), (202) 942-0073, Office of Chief Counsel, Division of Market Regulation, Mail Stop 7-10; Gautam S. Gujral, Attorney (concerning information repositories) (202) 942-0175, Office of Market Supervision, Division of Market Regulation, Mail Stop 5-1, and David A. Sirignano, Senior Legal Adviser to the Director (202) 942-2870, or Amy Meltzer Starr, Attorney (concerning annual financial information, obligated persons, and material events generally), (202) 942-1875, Division of Corporation Finance, Mail Stop 7-6 Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION:

I. Introduction and Summary

The Commission has long been concerned with disclosure in

both the primary and secondary markets for municipal securities.-[1]- As part of the Securities Acts Amendments of

-[1]- Both the Securities Act and the Exchange Act were enacted with broad exemptions for municipal securities from all of their provisions except the antifraud provisions of the Securities Act Section 17(a) and Exchange Act Section 10(b). Municipal securities received special exemptions not only based on considerations of federal-state comity, but also due to the lack of perceived abuses, at the time of enactment, in the municipal securities market as compared with the corporate market. Furthermore, until recently, the

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1975, Congress established a limited regulatory scheme for the municipal securities market. This limited regulatory scheme included mandatory registration of municipal securities brokers and dealers, and the creation of the Municipal Securities Rulemaking Board ("MSRB"). In 1989, acting in response to consistently slow dissemination of information in connection with primary offerings of municipal securities, the Commission, pursuant to its authority under Exchange Act Section 15(c)(2),-[2]- adopted Rule 15c2-12-[3]- and an accompanying interpretation concerning the due diligence obligations of underwriters of municipal securities.-[4]- In 1993, the Commission's Division of Market Regulation conducted a comprehensive review of many aspects of the municipal securities market, including secondary market disclosure.-[5]- Findings in

-[1]-(...continued)
typical purchasers of municipal securities were institutional investors with financial expertise.

-[2]- Section 15(c)(2) of the Exchange Act prohibits municipal securities dealers from effecting any transaction in, or inducing or attempting to induce the purchase or sale of, any municipal security by means of a "fraudulent, deceptive, or manipulative act or practice," and authorizes the Commission, by rules and regulations, to define and prescribe means reasonably designed to prevent such acts and practices. Exchange Act Section 15(c)(2), 15 U.S.C. 78o(c)(2). Rule 15c2-12 also was adopted pursuant to the Commission's authority under Exchange Act Section 2, 3, 10, 15, 15B, and 23; 15 U.S.C. 78b, 78c, 78j, 78o, 78o-4, 78q, and 78w.

-[3]- 17 CFR 240.15c2-12. Rule 15c2-12 was proposed for adoption in 1988, and adopted in 1989. See Securities Exchange Act Release No. 26100 (Sept. 22, 1988), 53 FR 37778 ("1988 Release"); Securities Exchange Act Release No. 26985 (June 28, 1989), 54 FR 28799 ("1989 Release"). Rule 15c2-12 requires an underwriter of municipal securities (1) to obtain and review an issuer's official statement that, except for certain

information, is "deemed final" by an issuer prior to making a purchase, offer, or sale of municipal securities; (2) in negotiated sales, to provide the issuer's most recent preliminary official statement (if one exists) to potential customers; (3) to deliver to customers, upon request, copies of the final official statement for a specified period of time; and (4) to contract to receive, within a specified time, sufficient copies of the issuer's final official statement to comply with the rule's delivery requirement, and the requirements of the rules of the MSRB.

-[4]- The 1989 Release also stated that issuers are primarily responsible for the content of their disclosure documents, and may be held primarily liable under the federal securities laws for misleading disclosure. See 1989 Release at n. 84.

-[5]- Since September, 1993, other initiatives related to the municipal securities market have been taken. On April

(continued...)

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the September, 1993 Staff Report on the Municipal Securities Market ("Staff Report") regarding the growing participation of individual investors, who may not be sophisticated in financial matters, as well as the proliferation of complex derivative municipal securities, underscored the need for improved disclosure practices in both the primary and secondary municipal securities markets.-[6]- Information about the issuer and other obligated persons is as critical to the secondary market,-[7]- where little information about municipal issuers and obligated persons is regularly disseminated, as it is in primary offerings, where, as a general matter, good disclosure practices exist. As one industry group testified, today "secondary market information

-[5]-(...continued)

7, 1994, the Commission approved changes to MSRB rule G-19 concerning suitability of recommendations, and rule G-8 concerning recordkeeping. Securities Exchange Act Release No. 33869 (April 7, 1994), 59 FR 17632. These changes are designed to ensure that dealers, before making recommendations to customers, take appropriate steps to determine that the transaction is suitable. Concurrently, the Commission approved MSRB rule G-37 relating to the linkage between political contributions and the municipal securities business. Securities Exchange Act Release No. 33868 (April 7, 1994), 59 FR 17621. The rule seeks to end "pay to play" abuses in the municipal securities market by prohibiting dealers from conducting certain types of business with an issuer within two years after any contribution by the dealer or certain affiliated

persons of the issuer who could influence the awarding of municipal securities business. On June 20, 1994, the MSRB filed with the Commission a proposal to amend MSRB rule G-14 concerning reports of sales or purchases, and procedures for reporting inter-dealer transactions. Securities Exchange Act Release No. 34458 (July 28, 1994), 59 FR 39803. The proposed rule change is a first step to increase transparency in the municipal securities market by collecting and disseminating information on inter-dealer transactions. On December 19, 1993, the Commission issued a release proposing for public comment amendments to the rule regulating money market funds, Rule 2a-7 under the Investment Company Act of 1940. Investment Company Act Release No. 19959 (Dec. 28, 1993), 58 FR 68585.

-[6]- By 1993, individual investors, including those holding through mutual funds and money market funds, held approximately 76% of municipal debt outstanding, as compared with 44% in 1983. The Bond Buyer, "Holders of Municipal Debt," (July 1, 1994) at 5.

-[7]- The municipal securities market is not the only market for debt securities that suffers from information inefficiencies. For that reason, the Commission also is exploring means to increase the amount of information concerning issuers of corporate debt securities. See Securities Exchange Act Release No. 34139 (June 7, 1994), 59 FR 29453.

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is difficult to come by even for professional municipal analysts, to say nothing of retail investors."-[8]-

Notwithstanding voluntary industry initiatives to improve disclosure, particularly primary market disclosure, the Staff Report recommended that the Commission use its interpretive authority to provide guidance regarding the disclosure obligations of municipal securities participants under the antifraud provisions of the federal securities laws, and that the Commission amend Rule 15c2-12 to prohibit municipal securities dealers from recommending outstanding municipal securities unless the issuer has committed to make available ongoing information regarding its financial condition. In order to assist issuers, brokers, dealers, and municipal securities dealers in meeting their obligations under the antifraud provisions, in March, 1994, the Commission published the Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others ("Interpretive Release"),-[9]- which outlined its views with respect to the disclosure obligations of market participants under the antifraud provisions of the federal securities laws in connection with both primary and secondary market disclosure.

Concurrent with the publication of the Interpretive Release, the Commission published Securities Exchange Act Release No. 33742 ("Proposing Release"),-[10]- which requested comment on amendments to Rule 15c2-12 ("Proposed Amendments") designed to enhance the quality, timing, and dissemination of disclosure in the municipal securities market by placing certain requirements on brokers, dealers, and municipal securities dealers. In

proposing the amendments, the Commission intended to further deter fraud by preventing the underwriting and recommendation of transactions in municipal securities about which little or no current information exists. Brokers, dealers, and municipal

-[8]- Statement of Gerald McBride, Chairman, Municipal Securities Division, Public Securities Association, Before the House Committee on Energy and Commerce, Telecommunications and Finance Subcommittee (October 7, 1993) at 5.

-[9]- Securities Act Release No. 7049 (March 9, 1994), 59 FR 12748.

-[10]- Securities Exchange Act Release No. 33742 (March 9, 1994), 59 FR 12759. Also on March 9, the Commission published Securities Exchange Act Release No. 33743, which proposed the adoption of Rule 15c2-13. Proposed Rule 15c2-13 would have required broker, dealers, and municipal securities dealers to disclose mark-up information in riskless principal transactions in municipal securities; and to disclose when a particular municipal security is not rated by a nationally recognized statistical rating organization ("NRSRO"). Due to the recent development of proposals by the MSRB and market participants to make pricing information available to investors, the Commission has determined to defer the riskless principal mark-up proposal for six months. In addition, the portion of proposed Rule 15c2-13 that would require disclosure if a municipal security is not rated by an NRSRO has been deferred, and will be withdrawn if the MSRB acts to adopt similar amendments to its confirmation rule, Rule G-15. See Securities Exchange Act Release No. 34962 (November 10, 1994).

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securities dealers serve as the link between the issuers whose securities they sell and the investors to whom they recommend securities. Investors, especially individual investors, place their reliance on these securities professionals for their recommendations of municipal securities.

The amendments to Rule 15c2-12 ensure that brokers, dealers, and municipal securities dealers will review the secondary market disclosure practices of issuers and other obligated persons at the time of an offering of municipal securities.-[13]- This scrutiny at the time of initial issuance of municipal securities will result in the dissemination of important information by issuers and other obligated persons throughout the term of the municipal securities. As a result of the amendments, brokers, dealers, and municipal securities dealers will be better able to satisfy their obligation under the federal securities laws to have a reasonable basis on which to recommend municipal securities, as well as their obligations under the rules of the MSRB.

The availability of secondary market disclosure to all municipal securities market participants will enable investors to better protect themselves from misrepresentation or other

fraudulent activities by brokers, dealers, and municipal securities dealers. A lack of consistent secondary market disclosure impairs investors' ability to acquire information necessary to make intelligent, informed investment decisions, and thus, to protect themselves from fraud.

In the Proposing Release, comment was requested on each aspect of the Proposed Amendments, as well as on standards for recognition of nationally recognized municipal securities information repositories ("NRMSIRs"). In response to the request for comments, the Commission received over 390 comment letters representing over 475 groups and individuals. The commenters represented all types of participants in the municipal securities market, including issuers, underwriters, investors, counsel, analysts, financial advisers, banks, insurance providers, disclosure services, and the MSRB.-[14]- The comment letters presented a variety of thoughtful views on the issues raised by the Proposing Release.-[15]- The Commission has determined to

-[13]- Participating Underwriters generally maintain a market in an issue of municipal securities in the period following an offering. Failure by a Participating Underwriter to receive assurances with respect to undertakings to provide secondary market disclosure will increase the difficulty of its formulation of a reasonable basis on which to recommend a municipal security during this period of secondary market trading.

-[14]- Among others, the Commission received 232 letters representing the views of 242 issuers and issuer associations; 52 letters representing the views of 57 brokers, dealers, and municipal securities dealers; and 8 letters representing the views of 8 investors and investor associations.

-[15]- The Commission has given consideration to the views of some commenters who questioned the Commission's authority to adopt the amendments to Rule 15c2-12. See, e.g., Letter of ABA Business Law Section; Letter of Hawkins Delafield & Wood, Letter of NABL. The Commission believes that it has ample authority to adopt the amendments.

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adopt amendments to Rule 15c2-12, with certain modifications that are designed to address concerns expressed by commenters.-[16]- In addition, the suggestions of a group of industry participants that cooperated to assist the Commission in its efforts to improve disclosure in the municipal securities market have been valuable.-[17]-

Commenters across a broad range of market participants supported the goal of improved secondary market disclosure for the municipal securities market, but emphasized that flexibility is necessary, given the diversity that exists in the municipal securities market.-[18]- As adopted, the amendments to Rule 15c2-12 will further that goal by prohibiting underwritings unless there are commitments to provide ongoing disclosure, while, at the same time, providing issuers with significant

flexibility to determine the appropriate nature of that disclosure. The amendments retain the requirement that a Participating Underwriter ascertain that an issuer or obligated person has undertaken to provide secondary market disclosure, including notices of material events, to information repositories, but rely on the parties to the transaction to establish who will provide secondary market disclosure, and what information is material to an understanding of the security being offered.

The amendments build upon and reinforce current market practices that have provided, as a general matter, good quality disclosure in official statements, and extend those practices to the secondary market. As is currently the practice, under the amendments, the participants in an underwriting would continue to determine which persons are material to an understanding of the Offering. Information concerning those persons would be included in the final official statement. Financial information and operating data that is material to an offering at the outset generally remains material throughout the life of the securities.

Under the amendments, that information would be provided on an annual basis. Put simply, the amendments reflect the belief that purchasers in the secondary market need the same level of

-[16]- The comment letters and a summary of the comment letters prepared by Commission staff are contained in Public File No. S7-5-94. See also Public File No. S7-4-94.

-[17]- See Joint Response to the Securities Exchange Commission on Releases Concerning Municipal Securities Market Disclosure prepared by American Bankers Association's Corporate Trust Committee, American Public Power Association, Association of Local Housing Finance Agencies, Council of Infrastructure Financing Authorities, Government Finance Officers Association, National Association of Counties, National Association of State Auditors, Comptrollers and Treasurers, National Council of State Housing Agencies, National Federation of Municipal Analysts, Public Securities Association ("Joint Response").

-[18]- See, e.g., Joint Response; Letter of Chapman and Cutler; Letter of Florida Division of Bond Finance of the State Board of Administration; Letter of J.P. Morgan Securities, Inc.; Letter of National Association of Bond Lawyers ("NABL"); Letter of Orrick, Herrington & Sutcliffe ("Orrick Herrington"); Letter of Public Securities Association ("PSA").

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financial information and operating data in making investment decisions as purchasers in the underwritten offering.

The Proposed Amendments would have prohibited a broker, dealer, or municipal securities dealer from recommending the purchase or sale of a municipal security, unless it had reviewed the annual and event information provided pursuant to the

undertaking. Commenters anticipated that such a prohibition would have a considerable negative impact on secondary market liquidity. Furthermore, brokers, dealers, and municipal securities dealers considered the proposed recommendation prohibition to be problematic from a compliance perspective. The Commission has modified this provision to require instead that brokers, dealers, and municipal securities dealers recommending municipal securities in the secondary market have procedures to obtain material event notices. Because under existing law brokers, dealers, and municipal securities dealers are required to use information disseminated into the marketplace in forming a reasonable basis for recommending securities to investors, the rule does not impose mechanical review requirements on a trade-by-trade basis.

The amendments contain an exemption to minimize the effect on small issuers. Offerings in which neither the issuer nor any obligor is obligated with respect to more than $10 million dollars in municipal securities outstanding following an offering will be exempt from the amendments, on the condition that there is a limited undertaking to provide upon request, or annually to a state information depository, at least the financial information or operating data they customarily prepare, and that is publicly available. In addition, the undertaking must meet the amendment's requirement regarding notices of material events.

## II. Description of Amendments to Rule 15c2-12

### A. Amendments with Respect to the Underwriting of Municipal Securities

Under the amendments to Rule 15c2-12, a broker, dealer, or municipal securities dealer ("Participating Underwriter")-[19]- will be prohibited, subject to certain exemptions, from purchasing or selling municipal securities in connection with a primary offering of municipal securities with an aggregate principal amount of $1,000,000 or more ("Offering"),-[20]- unless the Participating Underwriter has made certain determinations.-[21]- Specifically, the Participating Underwriter must reasonably determine that an issuer of municipal securities or an obligated person, either individually or in combination with other issuers of such municipal securities or other obligated persons,-[22]- has undertaken in a written agreement or contract for the benefit of holders of such securities, to provide, either directly or indirectly through an indenture trustee or a designated agent, certain annual financial

-[19]- See Rule 15c2-12(a).

-[20]- The amendments also include an exemption for small and infrequent issuers. See Section II.D.1., infra.

-[21]- Rule 15c2-12(b)(5)(i).

-[22]- These concepts are discussed in Section II.A.1.b., infra.

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information and event notices to various information repositories.-[23]-

The "reasonable determination" required by the amendments to Rule 15c2-12 must be made by the Participating Underwriter prior to its purchasing or selling municipal securities in connection with an Offering. A Participating Underwriter would, therefore, need to receive assurances from the issuer or obligated persons that such undertakings would be made before agreeing to act as an underwriter. A dealer could look to provisions in the underwriting agreement or bond purchase agreement that describe the undertakings for the benefit of bondholders made elsewhere, such as in a trust indenture, bond resolution, or separate written agreement.-[24]- In a competitively bid offering, such assurances also might be found in a notice of sale. Of course, representations concerning commitments to provide secondary market disclosure, like any other key representations by an issuer, are subject to specific verification, such that a Participating Underwriter has a reasonable basis to believe that such representations are true and accurate. Thus, investigation of an issuer's or obligated person's undertakings to provide secondary market disclosure would be an element of the Participating Underwriter's professional review of offering documents.-[25]-

Because the amendments prohibit Participating Underwriters from purchasing or selling securities in the absence of undertakings in a written agreement or contract, such agreement or contract would have to be in place at the time the issuer delivers the securities to the Participating Underwriter.-[26]- As discussed below, in conditioning the closing of an Offering on the existence of an agreement or contract, this provision of the amendments permits flexibility as to where undertakings for continuing disclosure are memorialized.-[27]-

-[23]- Information repositories are discussed in Section II.C., infra.

-[24]- See Letter of Merrill Lynch, Pierce, Fenner & Smith ("Merrill Lynch").

-[25]- As noted in the 1988 Release, the obligations of managing underwriters and underwriters participating in an offering differ. An underwriter participating in an offering need not duplicate the efforts of the managing underwriter, but must satisfy itself that the managing underwriter reviewed the accuracy of the information in the official statement in a professional manner and therefore had a reasonable basis for its recommendation. Underwriters participating in offerings, however, have a duty to notify the managing underwriter of any factors that suggest inaccuracies in disclosure, or signal the need for additional investigation. See 1988 Release at n. 87.

-[26]- See Letter of Kutak Rock; Letter of Section of Urban, State and Local Government Law, American Bar Association ("ABA Urban Law Section"); Letter of Colorado Municipal Bond Supervisory Board.

-[27]- In contrast to the requirement in Rule 15c2-12(b)(5) that Participating Underwriters reasonably determine that issuers or obligated persons have undertaken to provide secondary market disclosure prior to the time
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The amendments to the definition of final official statement will affect the obligations of Participating Underwriters under Rule 15c2-12. Rule 15c2-12(b)(1) requires that a Participating Underwriter, prior to bidding for, purchasing, offering, or selling municipal securities, obtain and review a DFOS.-[28]- The Commission expects that Participating Underwriters will review the DFOS with a view to ascertaining that it contains information satisfying the definition of final official statement in Rule 15c2-12.-[29]- The Commission further expects that the quality of disclosure in the DFOS will improve in a manner that is commensurate with the changes in final official statement disclosure.-[30]-

Rule 15c2-12(b)(2) requires, for all except competitively bid offerings, from the time a Participating Underwriter has reached an understanding with an issuer of municipal securities

-[27]-(...continued)
they "purchase or sell" municipal securities, Rule 15c2-12(b)(1) requires Participating Underwriters to obtain and review an official statement deemed final by the issuer ("DFOS") prior to the time they "bid for, purchase, offer, or sell" securities. Thus, under Rule 15c2-12(b)(1), in a competitive underwriting, a Participating Underwriter must obtain and review the DFOS prior to placing a bid on an issue of municipal securities. Because the term "offer" encompasses the distribution of a preliminary official statement, as well as oral solicitations of indications of interest, in a negotiated underwriting, a Participating Underwriter is required to obtain and review the DFOS prior to the time it distributes the preliminary official statement to potential investors. If no offers are made, the Participating Underwriter is required to obtain and review the DFOS by the earlier of the time it agrees (whether in principle or by signing the bond purchase agreement) to purchase the bonds, or the first sale of bonds. See Mudge Rose Guthrie Alexander & Ferdon (April 4, 1990); Interpretive Release at Section III.C.6.

-[28]- Information regarding the offering price, interest rate, selling compensation, aggregate principal amount, principal amount per maturity, delivery dates, any other terms or provisions required by an issuer of such securities to be specified in a competitive bid, ratings, other terms of the securities depending on such matters, and the identity of the underwriters, may be omitted from the official statement reviewed by the Participating Underwriter for purposes of Rule 15c2-12(b)(1).

-[29]- Whether information is in fact known or not reasonably ascertainable at the time the Participating Underwriter must obtain and review the DFOS pursuant to the rule is best determined in the context of each offering by the issuer, the Participating Underwriter, and their respective counsel. See Public Securities Association (May 29, 1992)

-[30]- As a practical matter, the DFOS and the preliminary official statement ("POS") are often the same document.

See Mudge Rose Guthrie Alexander & Ferdon (April 4, 1990).

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that it will act as a Participating Underwriter, until the final official statement is available, that the Participating Underwriter send, to any potential customer, no later than the next business day, a copy of the most recent POS, if any. The Commission expects that the Participating Underwriters' obligations with respect to dissemination of the POS will not change.

1. Determining the Required Scope of the Undertaking to Provide Secondary Market Disclosure

Under the amendments as adopted, the financial information and operational data to be provided on an annual basis pursuant to the undertaking will mirror the financial information and operating data contained in the final official statement with respect to both the issuers and obligated persons that will be the subject of the ongoing disclosure, and the type of information provided. The amendments govern the core financial and operational data to be provided. It does not address the textual disclosure typically provided in annual reports, leaving the scope of that disclosure to market practice.-[31]- To clarify the intended quantitative focus of the rule, as adopted, the rule uses the term "financial information and operating data."

a. The Starting Point -- Definition of Final Official Statement

(1) Information Concerning Persons Material to an Evaluation of the Offering

The Proposed Amendments would have revised the definition of final official statement to require that financial and operating information, including audited annual financial statements, regarding the issuer and any significant obligor be included in order to provide a fair presentation of the issuer's and significant obligor's financial condition, results of operations, and cash flow.

Commenters objected to various aspects of the proposed definition, including the general requirement that financial and operating information be presented in the final official statement.-[32]- Commenters also objected that the use of the term "the issuer," in specifying whose financial information should be included in the final official statement, failed to take into account a variety of situations in which the governmental issuer does not have any repayment obligations on the municipal securities (as with conduit issuers), as well as other situations (such as revenue bonds) in which the payments

-[31]- See Association of Local Housing Finance Agencies, Guidelines for Information Disclosure to the Secondary Market (1992); Government Finance Officers Association, Disclosure Guidelines for State and Local Government Securities (Jan. 1991); Healthcare Financial Management Association, Principles and Practices Board, Statement Number 18 - Public Disclosure of Financial and Operating Information by Healthcare Providers (May 1994); National Council of State Housing Agencies, Quarterly Reporting Format for State Housing Finance Agency Single Family Housing Bonds (1989) and Multi-family Disclosure Format (1991); National Federation of Municipal Analysts, Disclosure Handbook for Municipal Securities 1992 Update (Nov. 1992).

-[32]- See, e.g., Letter of Indiana Bond Bank; Letter of Kutak Rock; Letter of NABL; Letter of Texas Public Finance Authority; Letter of Goldman Sachs & Co. ("Goldman Sachs").

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will be derived from entities, enterprises, funds and accounts that do not prepare separate financial statements. Some commenters took the position that in certain instances, inclusion of the financial statements of the general municipal issuer of which the enterprise is a part may be misleading.-[33]-

In view of these comments, the definition of final official statement has been revised to require that financial information and operating data be provided for those persons, entities, enterprises, funds, and accounts that are material to an evaluation of the offering.-[34]- Thus, the definition eliminates the reference to "the" issuer. In addition, the definition no longer requires that the official statement provide information about specific "significant obligors." It leaves to the parties (including the issuer and Participating Underwriters) the determination of whose financial information is material to the offering (including, without limitation, the credit supporting the securities being offered).

The definition does not set its own form and content requirements on the financial information and operating data to be included; in particular, the proposed requirement for audited financial statements has not been adopted. Instead, it provides the flexibility that many commenters asserted is necessary in determining the content and scope of the disclosed financial information and operating data, given the diversity among types of issuers, types of issues, and sources of repayment.-[35]-

The fact that the amendments rely on the final official statement to set the standard for ongoing disclosure should not serve as an incentive for issuers to reduce existing disclosure practices in the preparation of the final official statement. Market discipline and regulatory requirements should ensure that those practices continue at current or improved levels. While issuers remain primarily responsible for the content and accuracy of their disclosures,-[36]- as noted, Participating Underwriters must review the DFOS in a manner consistent with their obligations.

As the Commission recognized in the Interpretive

Release,-[37]- the extensive voluntary guidelines issued by the

-[33]- See, e.g., Letter of Department of Community Trade and Economic Development, State of Washington; Letter of American Public Power Association ("APPA"); Letter of Municipal Treasurer's Association; Letter of Orrick Herrington.

-[34]- See Rule 15c2-12(f)(3).

-[35]- See, e.g., Letter of Association of Local Housing Financing Agencies ("ALHFA"); Letter of Treasurer, State of Connecticut Office of the Treasurer ("Treasurer of the State of Connecticut"); Letter of Council of Development Finance Agencies ("CDFA"); Joint Response; Letter of Securities Industry Association ("SIA"); Letter of Morgan Stanley & Co., Inc. ("Morgan Stanley").

-[36]- See 1989 Release.

-[37]- Interpretive Release at Section III.B. The Interpretive Release is cited in the Preliminary Note to Rule 15c2-12 as a source of guidance as to the disclosure obligations of issuers of municipal securities, as well as the role of brokers, dealers, and municipal securities dealers.

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Government Finance Officers' Association, and the industry specific guidelines published by industry groups such as the National Federation of Municipal Analysts, are followed widely in the preparation of official statements.-[38]- The Commission anticipates that such sound practices will continue and develop beyond that mandated by the amendments. Although those guidelines are not mandatory, the Commission encourages market participants to continue to refer to those voluntary guidelines and the Commission's Interpretive Release in preparing disclosure documents. In addition, as noted in the Interpretive Release,-[39]- final official statements are subject to the prohibition against false or misleading statements of material facts, including the omission of material facts necessary to make the statements made, in light of the circumstances in which they are made, not misleading.

(2) Use of Cross References to Publicly Available Information

The Proposing Release requested comment on the appropriateness of satisfying disclosure needs through a reference to other externally prepared and located documents. In response, a number of commenters stated that the concept of incorporation of information should be explicitly included in the rule,-[40]- and that the ability to incorporate information should not be conditioned on a minimum dollar amount of securities in the hands of the public -- commonly known as "public float."-[41]- Some commenters also suggested that any limitation of this practice to "seasoned issuers" should include all investment grade issuers.-[42]- Some commenters further noted that the final official statement should not have to set

forth information that has been filed with the Commission in accordance with its periodic reporting requirements.-[43]- The commenters suggested one significant prerequisite for permitting cross referencing -- the availability of the information in some public repository.-[44]-

-[38]- See note 31, supra.

-[39]- See Interpretive Release at Section III.A.

-[40]- See Joint Response.

-[41]- See Letter of ABA Urban Law Section; Letter of Bose McKinney & Evans; Joint Response; Letter of Mudge Rose Guthrie Alexander & Ferdon ("Mudge Rose"); Letter of Dormitory Authority of the State of New York ("New York Dormitory Authority").

-[42]- See Letter of Mudge Rose; Letter of New York Dormitory Authority.

-[43]- See Letter of ABA Urban Law Section; Letter of Kutak Rock; Letter of Texas Public Finance Authority.

-[44]- See, e.g., Letter of Bose McKinney & Evans; Joint Response. One commenter also stated that if cross referencing was permitted, there should be a delay between the distribution of the official statement and the offering. The delay would enable potential purchasers and others to obtain any materials that were referenced in the official statement and make an informed investment decision. See Letter of Prudential Investment Corp.

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The definition of final official statement has been revised to make explicit-[45]- that a final official statement may include financial information and operating data either by setting forth the information in the document or set of documents composing the final official statement, or by including a specific reference to documents already prepared and previously made publicly available.-[46]- For purposes of the amendments, documents will be considered to be publicly available if they have been submitted to each NRMSIR and to the appropriate state information depository or, if the information concerns a reporting company, filed with the Commission. If the document is a final official statement, it must be available from the MSRB.

If cross referencing is used, for purposes of determining the appropriate scope of the ongoing information undertaking, the final official statement will be deemed to include all information and documents that have been cross referenced.-[47]- The amendment does not place limitations on the type of issuer that may use cross referencing. This approach is consistent with the goal of making the repositories the principal source of information concerning municipal securities. Once received by a repository, the referenced information should be readily available regardless of the nature of the issuer.

As commenters noted, permitting cross referencing to other externally prepared and available information should result in official statements that are clear and concise, yet provide information material to the Offering.-[48]- Moreover, the use of cross referencing also should ease some expressed apprehension about the ability of some issuers to obtain information about parties not within their control, to the extent that information

-[45]- See 1989 Release (discussing the definition of "final official statement" in Rule 15c2-12 as originally adopted, and stating that the definition recognizes that the issuer's final official statement may be composed of one or more documents).

-[46]- Rule 15c2-12(f)(3). To avoid confusion with the technical aspects of incorporation by reference for registrants under the Commission's registration rules, the amended rule does not use that term.

At least two states, New York and Texas, have prepared a standard disclosure document for state information.

-[47]- Participating Underwriters and other market participants must keep in mind their obligations under the rule with respect to the DFOS and final official statement, and under the antifraud provisions of the federal securities laws. To the extent that cross references are used, the DFOS should be disseminated in sufficient time for review by Participating Underwriters, and the POS should be made available in time to enable prospective purchasers to make informed investment decisions based upon the referenced materials. See Interpretive Release at Section III.C.6.

-[48]- See, e.g., Letter of New York Dormitory Authority; Letter of the Treasurer of the State of Connecticut.

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about these parties is made available to the repositories or, if a reporting company, filed with the Commission.-[49]-

(3) Description of Information Undertakings

The definition of final official statement also has been changed from the Proposed Amendments to include a requirement that the undertakings provided pursuant to the rule be described in the final official statement.-[50]- As the Commission recognized in the Interpretive Release-[51]- and a number of commenters echoed,-[52]- it is important for investors and the market to know the scope of any ongoing disclosure. By including a description of the undertaking in the final official statement, market participants will know the identity of the entities about which information will be provided, and the type of information to be provided. By reviewing the final official statement, investors in the secondary market will be able to ascertain the

scope of that undertaking and whether it has been satisfied.

Critical to any evaluation of a covenant is the likelihood that the issuer or obligated person will abide by the undertaking. The definition of final official statement thus has been modified to require disclosure of all instances in the previous five years in which any person providing an undertaking failed to comply in all material respects with any previous informational undertakings called for by the amendments.-[53]- This information is important to the market, and should, therefore, be disclosed in the final official statement. The requirement should provide an additional incentive for issuers and obligated persons to comply with their undertakings to provide secondary market disclosure, and will ensure that Participating Underwriters and others are able to assess the reliability of disclosure representations.-[54]-

The amendments do not prohibit Participating Underwriters from underwriting an Offering of municipal securities if an issuer or obligated person has failed to comply with previous undertakings to provide secondary market disclosure. However, if a failure to comply with such previous undertakings has not been remedied as of the start of the Offering, or if the party has a history of persistent and material breaches, it is doubtful whether a Participating Underwriter could form a reasonable basis for relying on the accuracy of the issuer's or obligated person's ongoing disclosure representations.

b. Entities About Which Information Must be Provided to the Secondary Market

It is critical that current financial information and operating data is provided to the secondary market about the

-[49]- See, e.g., Letter of Fieldman, Rolapp & Associates; Letter of State of Florida, Office of Auditor General; Letter of San Francisco International Airport; Letter of Texas Water Development Board; Letter of State of Washington, Office of the Treasurer.

-[50]- Rule 15c2-12(f)(3).

-[51]- See Interpretive Release at Section III.C.4.

-[52]- See, e.g., Letter of Chemical Securities, Inc. ("Chemical Securities"); Letter of Ferris Baker Watts; Letter of National Federation of Municipal Analysts ("NFMA").

-[53]- See Rule 15c2-12(f)(3).

-[54]- See Letter of PSA.

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persons that would be important to investors in evaluating the security. The Proposed Amendments would have required the Participating Underwriter to determine that the issuer had committed to provide, at least annually, current financial information concerning the issuer of the municipal securities and any significant obligor.-[55]- The identity of persons about which information should be provided to the secondary market was the subject of a substantial number of comment letters.-[56]- As

with the proposed definition of final official statement, a large number of commenters expressed particular concern about the provision of information on a continuing basis for conduit issuers who have no ongoing liability for repayment of municipal securities.-[57]- There also were a significant number of comments received critiquing the concept of significant obligor.-[58]-

Under the amendments as revised, the identity of the persons for which information must be provided on an annual basis is determined by the information included in the final official statement. If the final official statement includes financial information or operating data on a person, information about that person must continue to be provided to the secondary market if the person is committed by contract or other arrangement to support payment of the obligations on the municipal securities.-[59]- Thus, the obligation to provide ongoing information relates to those persons for which financial information or operating data is included in the final official statement and that have a contractual or other connection to repayment of the municipal obligations.

(1) The Obligated Person Concept

The Proposed Amendments defined a significant obligor as "any person who, directly or indirectly, is the source of 20 percent or more of the cash flow servicing the obligations on the

-[55]- Paragraph (b)(5)(i)(A) of the Proposed Amendments.

-[56]- See, e.g., Letter of Fidelity Management and Research Company; Letter of First Albany Corporation; Letter of Maine Municipal Bond Bank; Letter of NABL; Letter of National Council of Health Facilities Finance Authorities ("NCHFFA"); Letter of Realvest Capital Corporation; Letter of South Carolina Economic Developers Association, Inc.

-[57]- See, e.g., Letter of ABA Urban Law Section; Letter of Gilmore & Bell, P.C. ("Gilmore & Bell"); Letter of New York State Housing Finance Agency, State of New York Mortgage Agency, New York State Medical Care Facilities Finance Agency ("New York State Housing Finance Agency"); Letter of Orrick Herrington.

-[58]- See, e.g., Letter of Section of Business Law, American Bar Association ("ABA Business Law Section"); Letter of Treasurer of the State of California ("Treasurer of the State of California"); Letter of Goldman Sachs; Letter of IDS Financial Corporation; Joint Response; Letter of Kutak Rock; Letter of Morgan Stanley; Letter of National Association of State Treasurers ("NAST").

-[59]- Providers of bond insurance, letters of credit, and liquidity facilities have been excepted from the definition of obligated person to eliminate the need to separately obtain and disseminate annual information about such providers. See Section II.A.1.b.(1). infra.

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municipal security." The proposed definition generated a

significant amount of comment, including concerns that it could be interpreted to include significant taxpayers and customers,-[60]- credit enhancers (including banks that are letter of credit providers and insurers providing bond insurance),-[61]- providers of guaranteed investment contracts,-[62]- as well as state and federal governments that provide revenue sharing, grant, state and local aid and other cofinancing arrangements.-[63]- Commenters raised technical concerns as to the appropriate percentage of repayment obligation necessary to trigger inclusion in the definition of significant obligor,-[64]- and when the percentages were to be measured.-[65]- Some commenters also expressed concern that, in the bond pool context, the definition of significant obligor may not have permitted sufficient flexibility in determining which obligors in a pool would be the subject of the requirement to provide information on an ongoing basis.-[66]-

Commenters suggested a number of modifications to the significant obligor concept. First, a number of commenters indicated that the definition of significant obligor should include a requirement that a contractual relationship exist between the obligor and the repayment of the obligation before a continuing information obligation is imposed.-[67]- Second,

-[60]- See, e.g., Letter of American Municipal Power -- Ohio, Inc. ("AMP -- Ohio"); Letter of Gilmore & Bell; Letter of Treasurer of the State of California.

-[61]- See, e.g., Letter of Financial Guaranty Insurance Company ("FGIC"); Letter of Goldman Sachs; Letter of Hawkins Delafield & Wood; Letter of Thacher Proffitt & Wood.

-[62]- See, e.g., Letter of Kutak Rock.

-[63]- See, e.g., Letter of ABA Urban Law Section; Letter of Kutak Rock; Letter of State of Washington, Office of the Treasurer.

-[64]- See, e.g., Letter of APPA; Letter of George K. Baum & Co.; Letter of CDFA; Letter of Eaton Vance Management; Letter of NCHFFA.

-[65]- See, e.g., Letter of ABA Business Law Section; Letter of Electricities, Inc.; Letter of Hawkins Delafield & Wood; Letter of Kutak Rock; Letter of Mudge Rose; Letter of San Francisco International Airport.

-[66]- See, e.g., Letter of ABA Urban Law Section; Letter of A.G. Edwards & Sons, Inc.; Letter of Council of Infrastructure Financing Authorities ("CIFA"); Letter of Hawkins Delafield & Wood; Letter of Program Administration Services, Inc.

-[67]- See, e.g., Letter of ABA Business Law Section; Letter of APPA; Letter of City of Everett, Washington; Letter of Goldman Sachs; Letter of Hawkins Delafield & Wood; Letter of Merrill Lynch; Letter of Morgan Stanley; Letter of Mudge Rose; Letter of Orrick Herrington. Certain of these commenters noted that by including a

contractual or similar relationship between the entity making payments and the financing, customers and
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commenters recommended modifying the definition to include different percentages of cash flow, ranging from a low of no threshold to a high of 50% of cash flow.-[68]- Third, some commenters suggested replacing the entire definition of significant obligor with the concept of materiality, in which the issuer and the other offering participants would determine, on a continuing basis, whose information would be provided.-[69]-

As suggested by a number of commenters, the amendments eliminate the reference to significant obligor.-[70]- Instead, the amendments include a definition of "obligated person," which means a person (including an issuer of separate securities) that is committed by contract or other arrangement structured to support payment of all or part of the obligations on the municipal securities.-[71]- By including a nexus to the financing through a commitment that is structured to support the payment obligations, the amendments address concerns raised by many commenters that the term "source of cash flow" in the definition of significant obligor was overbroad and could encompass persons with no relationship to the financing.-[72]- The requirement for a contractual or other arrangement will assist Participating Underwriters in identifying the persons for which information should be provided pursuant to an undertaking.

Some commenters recommended that the commitment with respect to payment of the obligation on the securities consist of a contractual obligation to and enforceable by bondholders.-[73]- Instead, the definition includes a broader notion of a contract or arrangement that is structured to "support payment," without specifying that it run to bondholders. The definition is intended to include contracts or arrangements where payments are made either to bondholders, to issuers to be used to pay obligations on municipal securities, or through conduit structures.-[74]- Similarly, the reference to "obligations on

-[67]-(...continued)
taxpayers, having no connection to or responsibility in connection with the financing would not inadvertently be swept within the scope of the definition.

-[68]- See, e.g., Letter of APPA; Letter of George K. Baum & Co.; Letter of City of Everett, Washington; Letter of IDS Financial Corporation; Letter of Standish, Ayer & Wood, Inc.

-[69]- See, e.g., Letter of ABA Business Law Section; Letter of ALHFA; Letter of PSA.

-[70]- See, e.g., Letter of FGIC; Joint Response; Letter of NABL; Letter of PSA.

-[71]- See Rule 15c2-12(f)(10).

-[72]- See, e.g., Letter of Bose McKinney & Evans; Letter of Mudge Rose; Letter of New York Dormitory Authority;

Letter of Orrick Herrington.

-[73]- See, e.g., Letter of Bose McKinney & Evans; Letter of Goldman Sachs; Letter of Indiana Bond Bank; Letter of Hawkins Delafield & Wood.

-[74]- For example, if all or a portion of a project financed by bonds is used by a party that has committed, by contract or other arrangement (written or oral) to pay
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municipal securities" is intended to be broad enough to cover debt obligations, lease payments and any other repayment obligation on or resulting from the municipal securities.

As was the case with the proposed significant obligor concept, the term "obligated persons" includes, but is broader than, the concept of issuers of separate securities under Rule 131 pursuant to the Securities Act of 1933 ("Securities Act")-[75]- and Exchange Act Rule 3b-5.-[76]- Also, in response to comments raised that the terms "issuer" or "significant obligor" do not sufficiently address financings in which the source of repayment is not a separate person or entity, but a dedicated revenue stream from a specified project, segregated tax revenues or other enterprise, fund or account,-[77]- the definition includes persons which are obligated generally, such as with full recourse to the person, or, in a more limited manner, such as through an enterprise, fund or account of such person, including a dedicated revenue stream. As noted above, the obligation to provide information must cover all such enterprises, funds or accounts, whether or not there is a separate entity. In such a case, the information undertaking could be provided by the governmental unit or financing authority of which the enterprise, fund or account is a part.-[78]- For example, a Participating Underwriter could accept an information

-[74]-(...continued)
for such use, and such payments support payment of debt service on the bonds (as structured at the time of issuance), continuing information on the party would be appropriate. Accordingly, parties that support debt service through payments under a lease, loan, installment sale agreement, or other contract relating to use of a project are included in the definition, regardless of whether the financing is a conduit arrangement (such as a non-recourse loan to a manufacturer to finance acquisition of a new facility or to a hospital to acquire equipment) or system or project financing (such as a lease to a particular carrier of a terminal in an airport system or sale of the output of a facility pursuant to a take-or-pay (or take-and-pay) contract). Major customers purchasing power from a municipal light department that, in turn, is under a take-or-pay contract with a joint action public power agency would not be included in the definition, although the municipal light department would likely be included in the definition. Similarly, major taxpayers in a municipal general obligation issue

would not be included in the definition; however, an undertaking covering a developer that is the sole landowner in a development district assessment financing in which the future collection of assessments to service the borrowing is dependent upon the developer as part of the structure of the financing may be appropriate.

-[75]- 17 CFR 239.131.

-[76]- 17 CFR 240.3b-5

-[77]- See, e.g., Letter of Fidelity Management and Research Company; Letter of Mudge Rose; Letter of NABL; Letter of Texas Public Finance Authority.

-[78]- See Rule 15c2-12(b)(5)(i).

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undertaking from a state issuing bonds secured solely by funds collected under a special tax, to report financial information relating to the special tax; for issues supported both by contracts of assistance of separate authorities or funds in addition to the issuer's own revenues, undertakings from the separate authorities, as well as the issuer could be provided. Accordingly, although the definition of significant obligor has been eliminated, that modification does not reflect a change in the Commission's assessment of the importance of ongoing information concerning the ultimate sources of payment on the securities.

Unlike the significant obligor concept in the Proposed Amendments, there is no need to include a specified percentage of payment in the definition of obligated person, because the issuer and other participants will determine at the time of preparation of the final official statement which obligated persons are material to an Offering.-[79]- In making that materiality determination, the parties to a financing will evaluate the facts of the Offering.-[80]-

Determining the obligated persons in pooled financings requires more flexibility, because the composition of the pool may vary over time. Rather than identifying the specific persons for which information will be provided on a continuing basis, under the amendments, bond pools must describe in their official statements, and the undertaking, the objective criteria (presumably including percentage of payment support) they will apply consistently, both in the final official statement and on a continuing basis, in determining whether information concerning an obligated person will be provided.-[81]- The amendments permit, but do not require this approach for non-pooled issuers. The objective criteria approach ensures that financial

-[79]- Under the revised amendments, the concerns of some commenters that the definition of significant obligor failed to take into account short term arrangements (i.e. the arrangements with persons providing cash flow were shorter than the term of the securities) is also alleviated in two ways. First, the issuer determines at the outset if an obligated person is material to the

offering. Second, assuming an obligated person is included in the final official statement, the undertaking to continue to provide information on such obligated person may be terminated once it no longer has liability for any obligation on or relating to repayment of the municipal securities. See Rule 15c2-12(b)(5)(iii); Letter of APPA; Letter of Hawkins Delafield & Wood.

-[80]- Guidelines and practices that have developed in other contexts may be useful in analyzing both the materiality of an obligated person to the municipal financing and the appropriate level of disclosure relating to such obligated person. For example, in connection with securitization of non-recourse commercial mortgage loans, the 10 percent and 20 percent property assets concentration tests described in Staff Accounting Bulletins 71 and 71A are applied. These percentages are applied by analogy in other asset-backed financings.

-[81]- Although the amendments do not specify the scope of the objective criteria, the criteria description should be clear as to when and how they are applied.

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information and operating data will be provided about those persons that, at the time of disclosure, meet the objective standards described in the undertakings. Obligated persons could commit to the issuer, at the time of initial participation in a pooled financing, through an undertaking to provide information when and if they satisfy that criteria. Obligated persons that no longer meet the objective criteria will no longer need to provide ongoing information. In order to ensure that the selection method is incorporated into the undertaking, the amendments require that Participating Underwriters reasonably determine that the undertakings identify those persons for which the information will be provided, either by name or by the objective criteria to be used to select such persons.-[82]-

Commenters were divided on whether providers of bond insurance, letters of credit, and other liquidity facilities, should be excluded from the definition of significant obligor.-[83]- The concept of "obligated person" encompasses these entities because they are committed, at least conditionally, to support payment of principal and interest obligations. Moreover, these persons normally are material to an understanding of the security, and, therefore, official statements should contain financial information concerning such persons either directly or by reference to publicly available materials. A number of commenters stated, however, that it would be inappropriate to put the onus on the issuer to provide information on such providers on an annual basis, particularly where that information is otherwise available to investors either

-[82]- See Rule 15c2-12(b)(5)(ii).

-[83]- See, e.g., Letter of ABA Urban Law Section; Letter of Blackwell Industrial Authority, Blackwell, Oklahoma; Letter of Davis Polk & Wardwell; Letter of IDS Financial Corporation; Letter of Kutak Rock; Letter of Oregon Economic Development Department; Letter of Realvest Capital Corporation; Letter of Thacher Proffitt & Wood. Some commenters also were concerned as to whether the definition would encompass providers of guaranteed investment contracts and other investments. See, e.g., Letter of ABA Urban Law Section; Letter of Kutak Rock, on behalf of AMBAC Indemnity Corporation, Capital Markets Assurance Corporation, Capital Reinsurance Company, Enhance Reinsurance Company, Financial Guaranty Insurance Company, Financial Security Assurance, Inc., and Municipal Bond Investors Assurance Corporation ("Kutak Rock on behalf of Financial Guaranty Insurers"). A functional approach determines whether providers of investments should provide ongoing information. For example, if the proceeds of an Offering are invested in guaranteed investment contracts ("GICs"), and the income from the GICs is the predominant source of revenue to repay the obligations on the securities, information about the provider may be material to the Offering, including on an ongoing basis. If, however, other sources of revenue are committed to support payment of the obligations, the relative importance of the provider of the GIC to investors may be diminished.

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upon request or in public reports that have been submitted to appropriate regulatory authorities.-[84]-

Commenters indicated a willingness by providers of bond insurance, letters of credit, and other liquidity facilities to deposit publicly available reports in a repository, or otherwise note where such reports may be easily obtained.-[85]- The issuer or other obligated person providing the undertaking may then refer to such reports in their annual financial information and indicate the location where any such current annual reports can be obtained. Based upon such representations, providers of bond insurance, letters of credit, and liquidity facilities have been excepted from the definition of obligated person to eliminate the need to separately obtain and disseminate annual information about such providers.

The Commission encourages industry participants to work together to adopt appropriate disclosure practices, both with respect to information concerning the provider contained in primary offering materials and on an ongoing basis in the annual financial information. The Commission will monitor developments in this area regarding the nature and quality of information made available about credit enhancers and liquidity providers, and the manner in which information is made available to determine whether further steps are necessary to assure access to this important body of information.

-[84]- See, e.g., Letter of ABA Urban Law Section; Letter of Smith, Gambrell & Russell; Letter of Texas Water Development Board. Some commenters noted difficulty in obtaining information from credit enhancers. See Letter of Association of Bay Area Governments; Letter of New York State Housing Finance Agency; Letter of State of Washington, Office of the Treasurer.

-[85]- See, e.g., Memorandum of August 10, 1994 Meeting with Davis, Polk and Wardwell and Various Banks; Letter of Kutak Rock on Behalf of Financial Guaranty Insurers. One commenter recommended that bond insurers and banks providing letters of credit, who are not subject to periodic reporting requirements of the federal securities laws, send publicly available reports to the repositories. See Letter of ABA Urban Law Section.

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(2) Who Must Undertake

A related question to whose information must be given is who must provide the information undertaking; the person providing the undertaking may not necessarily be the person about which the information relates. The Proposed Amendments would have required that the continuing information undertaking be provided by the issuer. A significant number of commenters raised concerns about which of potentially several persons that could be considered an issuer of municipal securities-[86]- would be expected to provide the undertaking and who would make that determination.-[87]- This was a particular concern in light of the potential liability of the issuer providing the undertaking for the provision and the content of information regarding other issuers and significant obligors -- persons not necessarily under their control. Commenters made a number of suggestions to address these perceived ambiguities, including requiring that each issuer of a municipal security and each significant obligor undertake to provide the information only with respect to itself.-[88]-

In response to these concerns, and consistent with the general approach to affording underwriting participants significant flexibility, the undertaking provision has been revised to provide that the undertaking may be made by any issuer of the municipal securities being offered, or by any obligated person for which information is provided in the final official statement. An issuer of a municipal security may provide the undertaking, regardless of whether it is obligated on the municipal security. In addition, obligated persons may provide the undertaking regardless of whether they are deemed an issuer of municipal securities. These obligated persons may be the main, if not the only, credit source for repayment of the obligations on the municipal securities. This approach should allow the governmental issuer to shift to the obligated person the responsibility to provide information on a continuing basis.

Thus, a Participating Underwriter need only reasonably determine that an issuer of municipal securities or an obligated person for which financial information or operating data is presented in the final official statement has agreed to provide the information called for by the rule; it will not be necessary to obtain an undertaking from all possible issuers and obligated persons. Moreover, to respond to the expressed concern that separate undertakings should be permitted, the amendments have been revised to recognize that undertakings may be provided in combination with other issuers and other obligated persons. In all cases, however, the undertakings, either individually or collectively, must constitute a commitment to provide information with respect to all the persons about which information must be provided on an annual basis.

The amendments have been revised to clarify that dissemination responsibilities may be delegated to designated agents or to indenture trustees. As commenters pointed out,

-[86]- The term "issuer of municipal securities," as defined in Rule 15c2-12, includes issuers of separate securities as well.

-[87]- See, e.g., Letter of ALHFA; Letter of Hawkins Delafield & Wood; Letter of Kutak Rock; Letter of National State Auditors Association; Letter of the Treasurer of the State of North Carolina.

-[88]- See, e.g., Letter of ABA Urban Law Section; Letter of ALHFA; Letter of Kutak Rock; Letter of NABL.

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there are circumstances in which third parties may be effective in assisting issuers and obligated persons in disseminating the information.-[89]- Moreover, indenture trustees have expressed concerns about being considered "designated agents" in performing any dissemination role, based on the scope of, and standards affecting, their responsibilities as indenture trustees.-[90]- The language has been revised in response to clarify that, in addition to designated agents, issuers or obligated persons may contractually empower indenture trustees to disseminate information that an issuer or obligated person has agreed to provide. The parties may authorize an indenture trustee to provide certain information through specific instruction or on

its own initiative upon becoming aware of particular facts.

c. Scope of Financial Information and Operating Data to be Provided on an Annual Basis

(1) Definition of Annual Financial Information

The amendments provide a definition of the term "annual financial information,"-[91]- a concept that was used, without definition, in the Proposed Amendments. The definition of annual financial information specifies both the timing of the information -- that is, once a year -- and, by referring to the final official statement, the type of financial information and operating data that is to be provided to the repositories. If financial information or operating data concerning an obligated person (or category of obligated persons in the case of financings using the objective criteria approach) is included in the final official statement, then annual financial information would consist of the same type of financial information or operating data. For example, if anticipated cash flow information is provided in the final official statement for a revenue bond financing, cash flow data reflecting actual operations must continue to be provided on an annual basis. Only the annual financial information called for by the undertakings need be sent to the repositories; other types of financial information and reports that may be prepared by the issuer or obligated persons are not subject to the rule's dissemination provisions.

Many commenters addressed the issue of whether the rule should specify form and content of the information that should be provided on an annual basis, as well as for event specific information.-[92]- Some commenters argued that the rule should include specified formats for information to be provided, including financial statements and certain industry reporting

-[89]- See, e.g., Letter of Bond Investors Association; Letter of PSA; Letter of Texas Public Finance Authority.

-[90]- See, e.g., Letter of Bank One Corporation; Letter of Reliance Trust Company; Letter of State Street Bank and Trust Company.

-[91]- Rule 15c2-12(f)(9).

-[92]- See, e.g., Letter of Dean Witter Reynolds, Inc. ("Dean Witter"); Letter of National League of Cities; Letter of NFMA; Joint Response; Letter of PSA; Letter of Tillinghast, Collins & Graham; Letter of the Treasurer of the State of Connecticut.

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formats,-[93]- while other commenters contended that no form or content should be specified and that the parties should be permitted to make determinations based on materiality alone.-[94]- As discussed below, the flexibility afforded by the concept of annual financial information addresses these concerns

by providing a minimum standard for ongoing disclosure, but allowing the parties to define that standard with respect to each Offering of municipal securities.

(2) Financial Information

The proposal to mandate audited financial statements produced considerable comment. As with the proposed definition of final official statement, commenters expressed concern with the availability of audited financial statements on an annual basis, as well as the relevance of financial statements for certain types of financings.

Some commenters indicated that some municipalities were not required by law to have independently audited financial statements, and any such requirement would impose a significant new expense.-[95]- A number of commenters also expressed doubt as to whether audited financial information could be delivered on an annual basis, because audits may not be completed for a number of years following the close of the fiscal year.-[96]- Commenters noted that in some cases, financial statements for certain types of entities were audited every year, and in other cases every 2-3 years.-[97]- Therefore, some of these commenters argued that the requirement for annual audited financial statements would have an adverse impact on an issuer's ability to access the public securities markets or increase its costs of financing.-[98]-

A number of commenters also raised concerns regarding the availability of full financial statements for certain issuers, whether or not audited.-[99]- As examples, commenters noted that some issuing entities do not have their own financial statements and may be included in the financial statements of a larger

-[93]- See, e.g., Letter of Dain Bosworth, Inc.; Letter of First Albany Corporation; Letter of MSRB; Letter of NFMA; Letter of Standish, Ayer & Wood, Inc.

-[94]- See, e.g., Letter of CDFA; Letter of Chapman and Cutler; Letter of CIFA; Joint Response; Letter of H.M. Quackenbush; Letter of NABL.

-[95]- See, e.g. Letter of Texas Water Development Board; Letter of State of Washington, Office of the Treasurer.

-[96]- See, e.g., Letter of City of Barling; Letter of Dain Bosworth, Inc.; Letter of Friday, Eldridge & Clark.

-[97]- See, e.g., Letter of AMP -- Ohio; Letter of State of Indiana, State Board of Accounts; Letter of State of Montana, Department of Natural Resources and Conservation; Letter of Washington Finance Officers Association.

-[98]- See, e.g., Letter of AMP -- Ohio; Letter of Washington Finance Officers Association.

-[99]- See, e.g., Letter of ABA Business Law Section; Letter of Florida Division of Bond Finance; Letter of Gust & Rosenfeld; Letter of Office of the State Auditor, Texas ("Texas Office of the State Auditor").

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issuer or entity.-[100]- Commenters from two states indicated that governmental units of the states may be encompassed in the state's comprehensive annual financial report and that there may be only supplemental schedules that described the governmental units.-[101]-

Some commenters raised the point that financial statements of a general governmental unit may not necessarily be relevant in certain project and structured financings.-[102]- As an example, one commenter noted that in some asset backed financings, information about the governmental issuer may be relevant only with respect to its experience in managing programs of loan pools.-[103]-

Commenters proposed a number of alternatives to the requirement to provide annual audited financial statements. Among the alternatives was a suggestion that financial statements be required in the form customarily prepared by the issuer promptly upon becoming available and that audited financial statements be provided to the extent available.-[104]- Other suggestions included limiting the requirement to those entities required by state or federal law to have audited financial statements.-[105]-

In view of the comments received, the amendments do not adopt the proposal to mandate audited financial statements on an annual basis with respect to each issuer and significant obligor.

Instead, the amendments continue to require annual financial information, which may be unaudited, and may, where appropriate and consistent with the presentation in the final official statement, be other than full financial statements. While it is anticipated that full financial statements will be provided for entities with ongoing revenues and operating expenses, it is possible that in the case of dedicated revenue streams and certain types of structured financings, other types of special purpose financial statements, project operating statements or reports may be used to reflect the financial position of the credit source for the financing. However, if audited financial statements are prepared, then when and if available, such audited financial statements will be subject to the undertaking and must

-[100]- See, e.g., Letter of Treasurer of the State of North Carolina; Letter of Texas Office of the State Auditor.

-[101]- See, e.g., Letter of the Treasurer of the State of North Carolina; Letter of Texas Office of the State Auditor.

-[102]- See, e.g., Letter of ABA Urban Law Section; Letter of APPA; Letter of Goldman Sachs; Letter of Gust & Rosenfeld; Letter of The Hospital & Higher Education Facilities Authority of Philadelphia; Letter of Morgan Stanley; Letter of NABL; Letter of New York State Housing Finance Agency.

-[103]- See Letter of ABA Urban Law Section.

-[104]- See, e.g., Letter of ABA Business Law Section; Letter of Association of Bay Area Governments; Letter of North East Independent School District; Letter of PSA; Letter of Washington Finance Officers Association.

-[105]- See, e.g., Letter of the Treasurer of the State of North Carolina; Letter of Washington Finance Officers Association.

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be submitted to the repositories.-[106]- Thus, as suggested by a number of commenters, the undertaking must include audited financial statements only in those cases where they otherwise are prepared.

The amendments adopt the proposed requirement that the undertaking specify the accounting principles pursuant to which the financial information provided as part of the annual financial information will be prepared.-[107]- As discussed in the Proposing Release, it is important that financial information be prepared on a consistent basis to enable market participants to evaluate results and perform year to year comparisons.-[108]- The undertaking also must specify whether audited financial statements will be provided as part of the annual financial information.-[109]-

The amendments do not establish a standardized format for presentation of financial information, or any specification of the content of the information, other than by reference to the final official statement. The annual financial information may be presented through any disclosure document or set of documents, whatever their form or principal purpose, that include the necessary information. The amendments, as adopted, contemplate that sequential final official statements prepared by frequent issuers may meet the standards of the rule. As in the case of final official statements, annual financial information submitted to a repository also may reference other information already submitted to repositories or the MSRB, or filed with the Commission.-[110]-

(3) Operating Data

The Proposed Amendments-[111]- would have required that the undertaking call for pertinent operating information, and that the parties specify the pertinent operating information to be provided on an annual basis. The basic concern of commenters regarding this provision, in addition to issues of specification of form and content discussed above, was that the use of the term "pertinent" did not provide sufficient guidance as to who would determine what was pertinent and what independent obligations

-[106]- See Rule 15c2-12(b)(5)(i)(B).

-[107]- See Rule 15c2-12(b)(5)(ii)(B).

-[108]- See Proposing Release. A number of commenters responded to the request for comment on specification of the use of generally accepted accounting principles ("GAAP") and generally accepted auditing standards ("GAAS"). See, e.g., Letter of Comptroller of the

State of California; Letter of Government Accounting Standards Board ("GASB"); Letter of NAST; Letter of National State Auditors Association; Letter of Prudential Investment Corp. The amendments as adopted do not mandate the use of either GAAP or GAAS.

-[109]- See Rule 15c2-12(b)(5)(ii)(B).

-[110]- Of course, any required information must be the subject of an undertaking, and if the information cross referenced has not been submitted to a repository or the MSRB, or filed with the Commission, the undertaking will not have been complied with.

-[111]- Paragraph (b)(5)(i)(A) of the Proposed Amendments.

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Participating Underwriters would have with respect to such evaluation.-[112]-

The amendments have been modified to respond to these comments. The phrase "pertinent" has been deleted from the reference to operating information and the word "data" is used to emphasize the intended quantitative nature of the information. Operating data is included as a subset of annual financial information, and the operating data to be provided annually also is determined by reference to the type of operating data presented in the final official statement. Thus, the parties will determine at the outset, presumably with the assistance of applicable industry guidelines, what operating data will be provided both initially and on an ongoing basis. For example, in a conduit health care financing, under current industry practice, an official statement typically provides information relating to the obligated party -- the hospital -- in an appendix. In addition to a discussion describing the hospital, its administration and management, economic base and service area, and capital plan, operating statistics such as bed utilization, admissions and type, patient days, and payor utilization often is provided. Under the amendments, in this type of transaction, parties at the outset of a transaction will determine which operating data will be included in the hospital appendix; such information, in turn, will be the type of "operating data" to be provided annually.

Some commenters expressed concern that the Proposed Amendments were not sufficiently flexible to permit parties to address changing conditions because the undertaking would have to describe the financial and pertinent operating information to be provided in the future.-[113]- Nonetheless, the requirement that the undertaking specify in reasonable detail the type of data that will be provided on an ongoing basis, including the identity of the persons (or category of persons) about which the information will relate has been retained. As is the case with financial information, the intent of the amendments is to give investors and market participants the ability to evaluate the security through comparisons of the quantitative operating data provided. Contrary to the suggestion of some commenters, the undertaking would be meaningless if issuers and obligated persons could unilaterally determine that certain types of information were no longer necessary or meaningful to investors.

Because the amendments require that the undertaking specify

only the general type of information to be supplied, there should be sufficient flexibility to accommodate subsequent developments that may require adjustments in the financial information and operating data that should be provided annually. Of course, nothing in the undertaking will prevent a party from providing additional information, particularly where such disclosure may be necessary to avoid liability under the antifraud provisions of the federal securities laws. Similarly, the amendments make specific provision for adjusting the persons about which information is provided. As required in the case of pooled financings, parties may identify the persons covered by reference to objective selection criteria that will be applied on a consistent basis between the offering statements and with regard to annual financial information. Moreover, the party providing

-[112]- See, e.g., Letter of APPA; Letter of Fidelity Management and Research Company; Letter of Hawkins Delafield & Wood.

-[113]- See, e.g., Letter of Chapman and Cutler; Joint Response; Letter of Kutak Rock.

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the undertaking need not continue to provide information concerning persons that are no longer obligated persons with respect to the municipal securities.

A new provision has been added to the amendments which permits the written agreement or contract to have a termination provision with respect to any obligated person that is no longer directly or indirectly liable for repayment of any of the obligations on the municipal securities.-[114]- Once an obligated person no longer has any liability for repayment of the municipal securities, whether through termination or expiration of its commitment to support payment, or as a result of a defeasance of the municipal securities with no remaining liability, then the obligation to provide annual financial information and notices of events may terminate.

2. Notice of Material Events

Commenters generally agreed that issuers and obligors should be subject to an undertaking to provide event information to the market.-[115]- Brokers, dealers and municipal securities dealers supported these provisions of the Proposed Amendments, because the use of a list provides guidance as to what events should be covered.-[116]- Other commenters, however, felt that the list should be deleted from the rule and that the concept of materiality should be relied upon to determine what events should be the subject of notices.-[117]- Some commenters believed that the list of eleven events should be expanded to include a provision that would cover any other event that might reasonably be expected to have a material adverse effect on the holders of the bonds.-[118]-

The list of eleven events has been retained in the amendments.-[119]- As indicated in the Proposing Release, the list of eleven events was proposed in response to requests for guidance to issuers and other participants in the municipal securities markets as to those events that normally would reflect on the credit supporting the municipal securities, as well as on the terms of the securities that they issue, and thus normally

would be considered material. Under the amendments, only the

-[114]- See Rule 15c2-12(b)(5)(iii).

-[115]- See paragraph (b)(5)(i)(B) of the Proposed Amendments. See also, Letter of A.G. Edwards; Letter of Chemical Securities; Letter of J.J. Kenny Co., Inc. ("J.J. Kenny Co."); Letter of MSRB.

-[116]- See, e.g., Letter of Chemical Securities; Letter of Goldman Sachs; Letter of George K. Baum; Letter of PSA.

-[117]- See, e.g., Letter of CDFA; Letter of Gust & Rosenfeld; Joint Response; Letter of Municipal Treasurers Association; Letter of Rauscher Pierce Refsnes, Inc.; Letter of Standish Ayer & Wood, Inc.

-[118]- See, e.g., Letter of Chemical Securities; Letter of Edward D. Jones & Co.; Letter of Finance Authority of Maine; Letter of Ferris Baker Watts; Letter of Norwest Investment Services, Inc.; Letter of Prudential Investment Corp.

-[119]- The introduction to the list also has been clarified to indicate that the events relate specifically to the securities being offered. See Rule 15c2-12(b)(5)(i)(C).

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occurrence of one of the specified events will, if material, create an obligation to send a notice to the repository.

The determination of whether other events also should be the subject of notification pursuant to the information undertaking is left to the parties. For example, some commenters requested that the list of events be expanded to address circumstances when the notified events have been cured or rectified, as well as other favorable developments.-[120]- The parties would be free to add such matters to the undertaking. Issuers also may wish to send information regarding material developments to the repositories, to ensure equal access to that information by all investors and participants in the market, regardless of whether the particular development is subject to the undertaking.-[121]-

Some commenters were concerned that permitting issuers and obligors to send any notices or information they wished would flood the repositories. Given the fact that event notices generally are short, it appears that the repositories would be able to handle the flow of notices. The Commission will, however, monitor developments in this area.

Some commenters expressed concern that the event described as "matters affecting collateral" was too broad.-[122]- In response to such observations, that reference has been revised to reflect more clearly the types of events relating to collateral that could affect the creditworthiness of the security being offered. For instance, the item was not intended to require disclosure in the event of a drop in revenues or receipts securing payment. Rather, as more clearly indicated in the revised amendments, it is intended to encompass the release,

-[120]- See, e.g., Letter of NAST; Letter of the Treasurer of State of California.

-[121]- Several commenters have expressed concern that statements by various elected officials made in a political context relating to an issuer must now be included in information provided to a repository. The amendments contain no such requirement. Moreover, these concerns appear to be based upon a misunderstanding of the reminder to issuers in the Interpretive Release that investors may rely on a variety of formal and informal sources for continuing information on municipal issuers, including public statements and press releases concerning an entity's fiscal affairs made by municipal officials, particularly in the absence of a more standardized mechanism for disseminating information about the municipal issuer to the market as a whole. The caution contained in the Interpretive Release that the antifraud provisions may apply to releases of information to the public reasonably expected to reach investors and the trading market does not mean, as some commenters inferred, that such statements are per se material; nor do the amendments require that such statements, even where material, be provided to the repositories.

-[122]- See, e.g., Letter of ABA Business Law Section; Letter of ABA Urban Law Section; Letter of NABL; Letter of NCHFFA; Letter of New York State Housing Finance Agency; Letter of Orrick Herrington.

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substitution, or sale of property securing repayment of the securities being offered.-[123]-

Commenters also questioned whether the event relating to adverse tax opinions or events affecting the tax-exempt status of the security would include events not specific to an issuer, such as tax law changes which may affect a multitude of issuances and which are broadly reported.-[124]- They argued that there is no need for each issuer to make that disclosure, which may overwhelm the repositories. The amendments do not include a uniform requirement for notification of events having widespread impact that are widely reported. Frequently, individual issuer disclosure may not affect the total "mix" of information available to investors, for example where Congress amends tax rates or alternative minimum tax rules that could affect an investor's yield. On the other hand, it may not be clear, absent individual disclosure, which classes of outstanding securities are affected by the general events, for example, where the tax law change affects a particular type of municipal security or financing structure.

It is possible that an "event" affecting the tax-exempt status of the security may include the commencement of litigation

and other legal proceedings, including an audit by the Internal Revenue Service, when an issuer determines, based on the status of the proceedings and their likely impact on holders of the municipal securities, among other things, that such events may be material to investors.

Commenters expressed concern that the party providing the undertaking may not have knowledge of the occurrence of events affecting other parties that might be called for by the provisions of the rule.-[125]- This concern should be addressed by the revised approach of enabling the parties to the transaction to determine who will provide the undertakings. For example, in the conduit context, the covenant could be provided by the person that is committed by contract or other arrangement to support payment of debt service, rather than the conduit issuer.

The timing for providing the notification has not been changed from the Proposed Amendments, which required that the notice be provided on a "timely" basis. The amendments do not establish a specific time frame as "timely," because of the wide variety of events and issuer circumstances. In general, this determination must take into consideration the time needed to discover the occurrence of the event, assess its materiality, and prepare and disseminate the notice.

A new paragraph has been added to the amendments-[126]- that would require a Participating Underwriter to reasonably determine that the undertaking includes an agreement to notify the appropriate repository if the annual financial information is not provided in the stated time frame. Given the expressed concerns of some commenters regarding the difficulty that they would face in determining whether an issuer or other person was in

-[123]- See Rule 15c2-12(b)(5)(i)(C)(10).

-[124]- See, e.g., Letter of ABA Urban Law Section; Letter of Kutak Rock; Letter of Orrick Herrington.

-[125]- See, e.g., Letter of First Southwest Company; Letter of New York Dormitory Authority; Letter of the Treasurer of the State of North Carolina; Letter of City of Pullman, Washington.

-[126]- See Rule 15c2-12(b)(5)(i)(D).

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compliance with any of its undertakings,-[127]- this provision will help inform market participants if annual financial information for such persons has not been made available in the agreed upon time frame.

3. Location of Undertaking in a Written Agreement or Contract

The Proposed Amendments called for the undertaking to be contained in a written agreement or contract for the benefit of holders of municipal securities. Commenters provided a variety of views as to where the undertakings should be memorialized, who should be parties to such undertakings, and the need for flexibility to modify undertakings in the future. Commenters suggested, for instance, that the undertakings could be included in the trust indenture, bond resolution, ordinance, or other

legislation, a separate written agreement, or the underwriting agreement or bond purchase agreement.

As discussed in the Proposing Release, many offerings of municipal securities are issued pursuant to a trust indenture setting out the covenants of the issuer for the benefit of the holders of the municipal securities. If there is no trust indenture as part of an offering, as is the case with general obligation and certain other types of bonds, there may be a bond resolution, ordinance, or other legislation. Most commenters addressing this issue considered the trust indenture, bond resolution, ordinance, or other legislation to be appropriate for undertakings to provide secondary market disclosure, because they would create a direct obligation by issuers to bondholders.-[128]- Commenters also suggested the use of a separate written agreement between the issuer and the trustee as an appropriate method of memorializing undertakings.-[129]-

Several commenters suggested that the inclusion of the undertakings in an underwriting agreement or bond purchase agreement would be sufficient for purposes of Rule 15c2-12,-[130]- though another commenter suggested that a promise running to the benefit of the underwriter, whether in a bond purchase agreement or in a separate agreement, would be enforceable by existing and future bondholders only on the basis

-[127]- See, e.g., Letter of Gust & Rosenfeld.

-[128]- See, e.g., Letter of Merrill Lynch. Certain commenters considered that undertakings in a trust indenture could prove inflexible, as well as difficult to modify if they became inappropriate in the future. Letter of ABA Business Law Section. Other commenters considered that the issue of flexibility could be addressed through careful drafting. Letter of Morgan Stanley; Letter of Rauscher, Pierce, Refsnes, Inc.

-[129]- See Letter of Chapman and Cutler (suggesting that an agreement could be made between an issuer and a trustee or between the issuer and a NRMSIR); Letter of Rauscher, Pierce, Refsnes, Inc. These commenters noted that such agreements provide flexibility for the future modification of the type, timing, or presentation of secondary market disclosure, as well as remedies in the event of a breach of the agreement.

-[130]- See e.g., Letter of Mudge Rose.

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of a third party beneficiary theory, the availability of which may vary from state to state.-[131]-

Because commenters were supportive of leaving the determination of the location of the undertaking to the parties, the relevant language of the Proposed Amendments, requiring a Participating Underwriter to look to "undertakings in a written agreement or contract for the benefit of holders of such

securities" has been adopted as proposed. Therefore, undertakings may be included in a trust indenture, bond resolution or other legislation, or a separate written agreement.

Undertakings also may be included in the bond form itself. This general requirement will create a direct obligation to bondholders, yet will be flexible to address variations in state law, as well as the wide variety of types and structures of offerings in the municipal securities market.

The Commission also recognizes that an issuer's ability to contract may be limited under state law. To the extent that issuers are restricted by statute from entering into long-term contractual arrangements, the undertaking may include a qualifier to its obligation, such as that it is subject to appropriation.-[132]-

Commenters generally took the view that, while a statement in the final official statement describing any undertakings to provide secondary market disclosure would be an important addition to undertakings in a written agreement or contract, in order to make clear that the undertaking is an obligation of the issuer or obligated person that is enforceable on behalf of bondholders, the undertaking should be in a writing signed by the issuer or obligated person.-[133]- Statements regarding an issuer's or obligated person's provision of secondary market disclosure made exclusively in an official statement would not

-[131]- See Letter of Morgan Stanley. Morgan Stanley also suggested that an underwriting agreement was an unsatisfactory vehicle for undertakings to provide secondary market disclosure because an underwriter of a specific bond issue should not be the recipient of a long-term contract of this type. See Letter of Morgan Stanley. Other commenters agreed that undertakings should be for the benefit of holders of municipal securities, and that there should be no requirement that undertakings be made for the benefit of Participating Underwriters. See, e.g., Letter of Merrill Lynch (noting that "the holders of the securities have the greatest interest in enforcing the covenant to provide information and are in the best position to evaluate whether affirmative efforts to enforce the covenant should be undertaken").

-[132]- Some commenters were concerned that in some jurisdictions, an issuer's ability to agree to provide information beyond a one year period might be restricted by state law. To address such concerns, inclusion of a condition subsequent in the covenant, such as subject to appropriation, might be appropriate.

It is anticipated, however, that should funds that would enable the issuer to provide the agreed upon information not be appropriated, disclosure of such fact would be made by notice to the repositories pursuant to Rule 15c2-12(b)(5)(i)(D).

-[133]- See, e.g., Letter of Chemical Securities; Letter of Dain Bosworth, Inc.; Letter of Dillon, Read & Co., Inc.

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satisfy the terms of Rule 15c2-12(b)(5) because they would not create a contract enforceable on behalf of bondholders.

Commenters addressing the inclusion of undertakings in various documents were concerned that the failure to provide continuing disclosure pursuant to the undertakings could be deemed a potential event of default on the securities.-[134]- Though a failure to comply with the undertaking would be a breach of contract, the rule does not specify the consequences of an issuer's breach of its undertakings to provide secondary market disclosure. As called for by the Joint Response, as well as other commenters, remedies for breach of any undertaking under applicable state law are a subject for negotiation between the parties to the Offering. To avoid uncertainties of enforcement, the parties to a transaction are encouraged to enumerate the consequences in the undertaking, including the available remedies, for breach of the information undertaking.

B. Recommendation of Transactions in Municipal Securities

The Proposed Amendments would have prohibited any broker, dealer, or municipal securities dealer from recommending the purchase or sale of a municipal security unless it had specifically reviewed the information the issuer of such municipal security had undertaken to provide.-[135]- The purpose of this provision of the Proposed Amendments was to assist dealers in satisfying their obligation to have a reasonable basis to recommend municipal securities by requiring them to consider the most current information before making a recommendation.

In view of the importance of secondary market liquidity in municipal issues, the Commission requested comment on whether the Proposed Amendments would have a substantial or long-lasting effect on market liquidity. This request for comment was based on concerns raised about whether municipal securities dealers would be willing to effect secondary market transactions in a broad range of municipal securities if review was required on a recommendation by recommendation basis.

Many commenters strongly criticized this provision of the Proposed Amendments. The majority of commenters responded that requiring the review of information prior to making a recommendation on the purchase or sale of a municipal security would create substantial compliance burdens for dealers.-[136]- Commenters also noted that the specific requirement to review information either would impel dealers to hire larger research and analysis staffs,-[137]- or, more likely, would cause dealers to restrict the issuers whose municipal securities they would

-[134]- Commenters argued that an issuer's failure to comply with undertakings to provide secondary market disclosure should not result in an event of default. See, e.g., Letter of ABA Urban Law Section; Letter of State of Washington, Office of the Treasurer; Letter of Colorado Municipal Bond Supervision Advisory Board.

-[135]- See paragraph (c) of the Proposed Amendments.

-[136]- See Letter of PSA (noting that paragraph (c) would require dealers to create records showing that they had reviewed municipal securities).

-[137]- See, e.g., Letter of Chapman and Cutler (brokers with fewer analysts will be at a competitive disadvantage); Letter of Morgan Stanley (noting that in order to comply with paragraph (c) as proposed, reliance on third-party service providers for information analysis would be required).

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trade to a smaller number of large and frequent issuers.-[138]- Commenters predicted that, as a result, liquidity for all but the largest and most frequent issuers would be reduced.-[139]-

Commenters proposed alternatives to the recommendation prohibition, including basing the type of review of a municipal security, and disclosure about such review, on whether the investor was an institutional or retail investor,-[140]- or on the type of municipal security recommended.-[141]- Other commenters suggested the continued reliance on the reasonable basis standard inherent in the MSRB's suitability rule, G-19, and the antifraud provisions, as discussed by the Commission in the 1988 and 1989 Releases proposing and adopting Rule 15c2-12, as well as the Interpretive Release.-[142]-

As adopted, this provision has been modified in a number of respects to respond to concerns expressed by commenters. In particular, the amendments replace the proposed review standard with a requirement that dealers have procedures in place that provide reasonable assurance that they will receive promptly any notices of material events regarding the securities that they recommend. The events are any of the eleven events disclosed as described in Rule 15c2-12(b)(5)(i)(C), or the notice of failure to provide annual financial information in accordance with an undertaking as described in Rule 15c2-12 (b)(5)(i)(D) with respect to that security. Many dealers currently subscribe to electronic reporting systems that give notice of significant events made public by municipal issuers. To comply with the rule's requirement, these dealers should make certain that these systems receive, directly or indirectly, material event notices for issues the dealer recommends. In addition, dealers should develop procedures to ensure that notices of such events will be available to the staff responsible for making recommendations.

In the Commission's view, the recommendation provision, as modified, should substantially reduce the concerns of commenters with respect to compliance burdens and effects on liquidity. It also will help ensure that dealers will consider the material

-[138]- See, e.g., Joint Response; Letter of PSA; Letter of Gabriel, Hueglin & Cashman.

-[139]- See, e.g., Joint Response; Letter of PSA.

-[140]- Letter of Investment Company Institute ("ICI"). See also Letter of MSRB; Letter of NABL. NABL suggested disclosure by dealers as to whether a party has committed to provide secondary market disclosure, and if not, the consequences of investing in the securities.

-[141]- See, e.g., Letter of Edward D. Jones & Co. (suggesting application of the Proposed Amendments only to non-rated or special assessment bonds); Letter of NABL (suggesting exemptions from the amendments to Rule 15c2-12 for issuers that obtain and maintain an investment grade rating, and for general obligation bonds and revenue bonds issued to finance essential government purposes).

-[142]- See, e.g., Letter of PSA; Letter of A.G. Edwards & Sons, Inc. (reviewing issuer's disclosure is not the only way to form the basis for a recommendation).

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event notices that issuers produce, thus enabling them to have an adequate basis on which to recommend-[143]- municipal securities.

Moreover, even though the amendments do not require that dealers directly review an issuer's ongoing disclosure before making each recommendation, the Commission agrees with those commenters that said that additional information made available by issuers will be taken into account by dealers making recommendations regarding that security, under the MSRB's fair dealing and suitability rules, and the antifraud provisions.-[144]- In addition to the Commission's past interpretations of the responsibilities of dealers to have a reasonable basis for their recommendations, the MSRB repeatedly has emphasized that secondary market disclosure information publicized by issuers must be taken into account by dealers to meet the investor protection standards imposed by its investor protection rules. Specifically, MSRB rule G-17 requires dealers to disclose material facts of a transaction to the customer; MSRB rule G-19 requires dealers to ensure that any transaction recommended to the customer is suitable for that customer; and MSRB rule G-30 requires dealers to ensure that the prices set for customer transactions are fair and reasonable. In its comment letter, the MSRB noted that "[i]f a dealer is not aware of major financial and other material developments affecting an issuer's securities, it is difficult or impossible for the dealer to comply with these requirements."-[145]-

For example, if a dealer reviews an electronic reporting system for material events relating to a security, and finds that an issuer has submitted a notice that it has failed to provide annual financial information on or before the date specified in the written agreement or contract,-[146]- that fact would be a significant factor to be taken into account when the dealer formulates the basis for a recommendation of such securities. While the dealer would not be prohibited per se from recommending such municipal securities, notice that the issuer has failed to provide annual financial information would be the type of material information required to be disclosed to the customer pursuant to MSRB rule G-17.-[147]- Such a notice also would trigger a further inquiry by the dealer to assure itself that it is cognizant of the condition of the issuer or obligated persons,

-[143]- As noted in the Proposing Release, most situations in which a dealer brings a municipal security to the attention of a customer involve an implicit

recommendation of the security to the customer.

-[144]- See, e.g., Letter of MSRB (emphasizing that, in the Board's view, dealers would be responsible for continuing disclosure information available in NRMSIRs even without the specific "review" requirement); Letter of Paine Webber.

-[145]- Letter of MSRB (noting the requirements of the MSRB's rules in commenting that the Proposed Amendment's requirement to review periodic information is not a practical option for dealers).

-[146]- See Rule 15c2-12(b)(5)(i)(D).

-[147]- See MSRB Manual (CCH) 3581.30 (interpreting MSRB rule G-17 to require that a dealer disclose, at or prior to a sale, all material facts concerning the transaction, including a complete description of the security). See also 1988 Release at n. 50 and accompanying text.

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despite the absence of promised information. This also would be true if a dealer attempts to obtain an issuer's annual financial information, finds that it has not been submitted to any repository, and the dealer had no record of the issuer submitting a notice to this effect. In such cases, further research may be necessary or advisable prior to making a recommendation in the issuer's securities.

C. Information Repositories

1. Background

Under Rule 15c2-12, as adopted in 1989, NRMSIRs essentially serve the function of disseminators of official statements on behalf of Participating Underwriters.-[148]- The option of Participating Underwriters to transfer their final official statement delivery obligations to NRMSIRs has encouraged the development of NRMSIRs.-[149]- The three existing NRMSIRs are private vendors that gather and disseminate final official statements pursuant to Rule 15c2-12. In addition, although not required under existing provisions of the rule, they provide other current information about municipal issuers to the primary and secondary municipal securities markets.-[150]-

-[148]- Under Rule 15c2-12(b)(4), underwriters must deliver final official statements to potential customers for a 90 day period after the close of the underwriting period. The underwriters' 90 day delivery obligation is shortened to 25 days if the final official statement can be obtained from a NRMSIR.

-[149]- Since the Commission adopted Rule 15c2-12, the Division of Market Regulation issued three no-action letters recognizing national information vendors as NRMSIRS, based on the standards set out in the July 1989 Release. See Letters from Richard G. Ketchum, Director, Division of Market Regulation to: Joseph V. Riccobono, Executive Vice-President, American Banker-Bond Buyer (Jan. 4, 1990); J. Kevin Kenny, President,

Chief Executive Officer, J.J. Kenny Co. (Jan. 4, 1990); and Michael R. Bloomberg, President, Bloomberg, L.P. (Jan. 11, 1990). Recently, the Commission has received inquiries from additional information vendors desiring to be recognized as NRMSIRs.

-[150]- NRMSIRs are not the only source of information in the municipal market. The MSRB has developed its Municipal Securities Information Library ("MSIL") system, which presently collects information and disseminates it to market participants and information vendors. The Official Statement and Advance Refunding Document-Paper Submission System ("OS/ARD") of the MSIL collects and makes available on magnetic tape and on paper official statements and advance refunding notices. Securities Exchange Act Release No. 29298 (June 13, 1991), 56 FR 28194. As a part of the MSIL system, the MSRB commenced operation of its Continuing Disclosure Information ("CDI") pilot system in January, 1993. The CDI system is a central repository for voluntarily submitted official continuing disclosure documents relating to outstanding municipal securities issues. Securities Exchange Act Release No. 30556 (April 6, 1992) 57 FR 12534. Neither the MSIL OS/ARD system nor the CDI system is a NRMSIR; the Commission has previously indicated that it would consider the

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As a result of the amendments, NRMSIRs will play an expanded role in the collection and dissemination of secondary market information. In addition to the collection and dissemination of final official statements, they will collect and disseminate annual financial information, as well as notices of material events. The Commission is sensitive to the need of NRMSIRs for flexibility, especially with respect to the timing requirements for the dissemination of notices of material events. The Commission will monitor developments in the municipal securities market as participants adapt to the changes in Rule 15c2-12, and fully expects that the current and potential NRMSIRs are capable of adjusting to their expanded role. The Commission is of the view that NRMSIRs, as private information vendors, will have sufficient economic incentives to serve their expanded functions resulting from the amendments to Rule 15c2-12, even in the absence of the more specific review requirement of the recommendation prohibition of the Proposed Amendments.-[151]-

2. Definition of Nationally Recognized Municipal Securities Information Repository

The Commission requested comment on whether the term "NRMSIR" should be defined in Rule 15c2-12, and whether specific standards should be established for NRMSIRs. If standards were to be established in the rule, the Commission requested comment on whether proposed standards set forth in the release were adequate.-[152]- The majority of state-based information gatherers and disseminators, and other NRMSIRs that addressed the issue of defining the term "NRMSIR" supported maintaining the guidelines already established by the Commission in the 1989 Release.-[153]- After reviewing the comment letters, the

-[150]-(...continued)
competitive implications of a MSRB request for NRMSIR status. See Securities Exchange Act Release No. 28081 (June 1, 1990), 55 FR 23333, 23337 n.26.

-[151]- See, e.g., Letter of PSA (noting that the suggestion made by some market participants that municipal securities dealers will not utilize information they have long sought is implausible), Letter of Ferris Baker Watts (information will be used if it is available).

-[152]- The Commission suggested that NRMSIRs (a) maintain current, accurate information about municipal securities, including final official statements, the issuer's annual final information, and issuer's notices of material events; (b) have effective systems for the timely collection, indexing, storage and retrieval of these documents; and (c) be capable of national dissemination of final official statements, annual financial information, and notices of material events through electronic dissemination systems, in response to telephone inquiries, and hard copy delivery via facsimile, by mail and by messenger service. The Commission also stressed the importance of timely public availability upon receipt of information by a NRMSIR.

-[153]- See, e.g., Letter of Bloomberg L.P.; Letter of Cypress Capital Corp. (a dealer chosen by the Louisiana Municipal Association to assist it in developing a repository to collect and disseminate information on
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Commission has determined that the guidance established in the 1989 Release for NRMSIRs should be modified only as necessary to reflect the amendments to Rule 15c2-12. In determining whether a particular entity is a NRMSIR the Commission will now consider, among other things, whether the repository:

(1) is national in scope;
(2) maintains-[154]- current, accurate-[155]- information about municipal offerings in the form of official statements, and annual financial information, notices of material events, and notices of a failure to provide annual financial information undertaken to be provided in accordance with Rule 15c2-12;
(3) has effective retrieval and dissemination systems;
(4) places no limits on the persons from which it will accept official statements, and annual financial information, notices of material events, and notices of a failure to provide annual financial information undertaken to be provided in accordance with Rule 15c2-12;
(5) provides access to the documents deposited with it to anyone willing and able to pay the applicable fees; and
(6) charges reasonable fees.

-[153]-(...continued)
Louisiana issuers of municipal securities). In discussing NRMSIRs in the 1989 Release, the Commission noted that in determining whether a particular entity is a NRMSIR, it would look, among other things, at whether the repository: (1) is national in scope; (2) maintains current, accurate information about municipal offerings in the form of official statements; (3) has effective retrieval and dissemination systems; (4) places no limit on the issuers from which it will accept official statements or related information; (5) provides access to the documents deposited with it to anyone willing and able to pay the applicable fees; and (6) charges reasonable fees. See 1989 Release at n. 65.

-[154]- In the past, the Division of Market Regulation has required that each NRMSIR maintain copies of all disclosure documents. In view of recent requests from information collectors and disseminators, the Division of Market Regulation will review, on a case by case basis, NRMSIR proposals to satisfy the requirement to maintain copies of disclosure documents through a contract with another entity (including the MSRB) that will maintain copies. See Letters from Laurence M. Landau, Vice President, Dow Jones Telerate, to Elizabeth MacGregor, Division of Market Regulation, SEC, (July 18, 1994) and to Gautam S. Gujral, Division of Market Regulation, SEC (August 4, 1994). See also Letter of Storch & Brenner (on behalf of R.R. Donnelly Financial). This flexible approach, requested by industry participants, may allow NRMSIRs to reduce the cost at which they can collect and disseminate disclosure information to broker-dealers and investors.

-[155]- It should be noted that NRMSIRs are not being required to verify the accuracy of the information provided them. NRMSIRs are required to accurately convey the information provided to them.

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While NRMSIRs may charge reasonable fees-[156]- for the dissemination of information, they may not charge issuers for accepting information provided by issuers in accordance with Rule 15c2-12.-[157]- In response to concerns raised by commenters, the Commission also notes that giving preferential treatment to certain brokers, dealers, and municipal securities dealers by giving them market information before it is made available to all customers would be wholly inconsistent with recognition as a NRMSIR.-[158]-

Comment also was requested on the ability and willingness of both potential NRMSIRs, and those presently operating under no-action letters, to meet the dissemination standards discussed in the Proposing Release. NRMSIRs responded that they can meet these standards.-[159]- In order to implement these standards, the Commission has determined that existing NRMSIRs should reapply for recognition from the Commission under the revised

criteria to continue to function as NRMSIRs.

3. State Information Depositories

The Commission also requested comment on whether a state-based depository could serve as an effective means to disseminate information to the market for a nationally traded security, thus enabling the appropriate parties to fulfill their disclosure obligations using a state-based depository. Commenters expressed divergent views on this issue.-[160]- No state responded directly in response to the Commission's request for comment on whether states are willing to make the necessary financial commitment to create a state-based system. The Comptroller of the State of New York pointed out, however, that his office

-[156]- See 1989 Release.

-[157]- See, e.g., Letter of Maine Municipal Bond Bank; Letter of National Association of Independent Public Financial Advisers (NRMSIR users, not issuers, should pay the NRMSIR costs).

-[158]- See, e.g., Letter of Colonial Management Associates, Inc.

-[159]- Letter of Bloomberg L.P.; Letter of J.J. Kenny Co.; Letter of The Bond Buyer.

-[160]- With one notable exception, national information vendors generally did not see a need for state-based repositories and argued that state-based repositories would indeed add to the complexity of collecting and disseminating information. See, e.g., Letter of J.J. Kenny Co. Some state-based information gatherers and disseminators, however, argued that they already had created mechanisms for the collection and dissemination of information, and their systems are working well. The National Association of State Auditors, Comptrollers and Treasurers ("NASACT") pointed out that issuers and other obligors will probably file with state-based repositories, with whom they are accustomed to working and with whom they typically must file in any event for regulatory purposes unrelated to secondary market disclosure. NASACT argued that while the state repositories do not wish to compete with NRMSIRs, state-based repositories can serve an important role in enhancing the accessibility of disclosure information for repackaging by the NRMSIRs. See Letter of NASACT.

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already collects financial data from local governments, and that there "is an appropriate and important function which the states may perform in the secondary market disclosure process."-[161]- A number of third party state-based information collectors also stated that they were in the process of creating state-based repositories.-[162]- Other such third party state-based information collectors pointed out that they already had working depositories in place.-[163]-

Based on these comments, and in light of existing disclosure

mechanisms and recent legislation in several states designed to enhance secondary market disclosure,-[164]- it appears that states can play a beneficial role in enhancing disclosure in the municipal securities market.-[165]- State-based depositories will be in a special relationship with filers of disclosure information to provide for convenient and efficient dissemination. The Commission therefore encourages states to develop state-based depositories.

To encourage the development of state-based depositories, the Commission has amended Rule 15c2-12 to require that Participating Underwriters reasonably determine that the information undertaken to be provided, in addition to being submitted to the NRMSIRs, or, in some cases, to the MSRB, will be submitted to a state information depository ("SID"), if an appropriate SID has been established in that state. Further, as discussed below,-[166]- an exemption conditioned on making annual financial information available upon request or to a SID, and providing notices of material events to each NRMSIR or the MSRB, and to a SID, has been adopted. An appropriate SID would be a depository operated or designated-[167]- by the state that

-[161]- See Letter of the Office of the State Comptroller, State of New York.

-[162]- See, e.g., Letter of Cypress Capital Corporation (Louisiana Municipal Security Disclosure Board "intends to be in a position to comply with the standards developed by the Commission for NRMSIRs").

-[163]- See Letter of Municipal Advisory Council of Texas; Letter of Ohio Municipal Advisory Council.

-[164]- South Carolina recently enacted legislation requiring issuers to agree in a bond indenture to file an annual independent audit within a specified number of days of the issuer's receipt thereof and certain event information with a central repository. South Carolina Senate Bill 1182, (effective September 1, 1994) to be codified in S.C. Code Ann. Chapter 1, Title 11, Section 11-1-85 (1976). Similarly, Tennessee recently adopted legislation authorizing the adoption of rules to facilitate secondary market disclosure by any public entity, including the form and content of that disclosure. Tenn. Code Ann. Sec. 9-21-151 (a) and (b)(2).

-[165]- See, e.g., Letter of the Office of the State Comptroller, State of New York.

-[166]- See Section II.D.1. infra.

-[167]- There is no requirement that SIDs be instrumentalities of a state. A number of private organizations already

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receives information from all issuers within the state, and makes this information available promptly to the public on a

contemporaneous basis.-[168]- The Commission staff is prepared to provide guidance in particular instances regarding a SID's qualification for purposes of the rule.

4. Information Delivery Requirements

The Proposing Release asked to whom the required information should be delivered. It also requested comment on the feasibility of requiring NRMSIRs to inform the MSRB when they receive disclosure information from issuers, and whether such information also should be required to be placed with the MSRB, in addition to or in lieu of a NRMSIR. The NRMSIRs did not address the issue of requiring them to inform the MSRB whenever they received disclosure information from an issuer, although one commenter argued that designating the MSRB as a repository only would add an unnecessary layer to the dissemination process.-[169]- Other commenters suggested designating a single central repository.-[170]- Similarly, some commenters suggested imposing a requirement that disclosure information be delivered to all NRMSIRs,-[171]- while others suggested that NRMSIRs be required to share the information received with other NRMSIRs,-[172]- and a third group preferred the establishment of a central index.-[173]- State-based information gatherers and disemminators had diverging views on this issue.-[174]-

-[167]-(...continued)
function as state-based repositories, at times at no cost to the taxpayer. The Commission defers to each state's determination whether to have a private or public entity be its SID.

-[168]- As with NRMSIRs, for a SID to give preferential treatment to a NRMSIR by giving it market information before it is made available to other NRMSIRs would be wholly inconsistent with functioning as a SID.

-[169]- Letter of Bloomberg L.P.

-[170]- See, e.g., Artemis Capital Group, Ltd. (proposing that the Commission designate the MSRB's MSIL system as the single central repository); Letter of Chapman and Cutler (there should be one central source of information).

-[171]- See, e.g., Letter of J.J. Kenny Co.; Letter of National Association of Independent Public Financial Advisers.

-[172]- See, e.g., Letter of MSRB; Letter of Richard A. Ciccarone.

-[173]- Letter of Storch & Brenner (on behalf of R.R. Donnelly Financial); Letter of The Bond Buyer.

-[174]- The Ohio Municipal Advisory Council stated that it is feasible to require repositories to inform the MSRB as to which issuers have released information to it. Under Cypress Capital Corporation's proposal, the indexing party would receive descriptions of all materials received by the Louisiana Repository. But see, Letter of NASACT (requirement that a repository be required to notify a central index each time an item of

information is received by the repository is unduly burdensome and unnecessary).

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Based on these comments, the Commission has determined to require that annual financial information undertaken to be provided be deposited with each NRMSIR and the appropriate SID in the issuer's state. Any audited financial statements submitted in accordance with the undertakings also must be delivered to each NRMSIR and to the SID in the issuer's state, if such a depository has been established. The requirement to have annual financial information and audited financial statements delivered to all NRMSIRs and the appropriate SID is a modification of the Proposed Amendments. This modification will ensure that all NRMSIRs receive disclosure information directly. It also permits the Commission to adopt the amendments without a delay for the creation of a central index or a system of information sharing among NRMSIRs.-[175]- The requirement to send information to all NRMSIRs rather than a single NRMSIR of the issuer's or obligated person's choice, should not impose significant burdens or costs, other than duplication and mailing costs. Furthermore, this requirement to deliver disclosure to the NRMSIRs and the appropriate SID also allays the anti-competitive concerns raised by the creation of a single NRMSIR.

In contrast to annual financial information, under the amendments, notices of material events, as well as notices of a failure by an issuer or other obligated person to provide annual financial information must be delivered to each NRMSIR or the MSRB, and the appropriate SID. The Commission is of the view that permitting issuers and obligated persons to file such notices either with each NRMSIR or with the MSRB (as well as the appropriate SID) will facilitate prompt and wide disclosure. The amendments reflect the preference of some commenters for filing such notices in one central place, such as the MSRB, rather than having to file with multiple NRMSIRs. The Commission expects that if notices are filed with the MSRB, the MSRB will make these notices available to all NRMSIRs on a prompt and contemporaneous basis.

5. Timing of Dissemination

Due to the time sensitive nature of notices of material event and failures to provide annual financial statements, it is important that such notices are disseminated quickly. These market requirements will dictate that disseminators have a system in place by which information vendors can make such notices available to broker-dealers and investors quickly and contemporaneously.

NRMSIRs and other information vendors have indicated in their comment letters that under certain circumstances a 15 minute turnaround-[176]- time for notices of material events, and a 24 hour turnaround period for annual financial information may

-[175]- Some commenters expressed an interest in creating a central index and an information sharing system. Letter of Storch & Brenner (on behalf of R.R. Donnelly Financial); Letter of Dow Jones Telerate, Inc. The Commission is prepared to review such mechanisms for centralized collection and dissemination if requested to do so.

-[176]- The Commission considers "turnaround time" or "turnaround period" to mean the time between which a NRMSIR initially receives information, and the time when such information is made available to the public. NRMSIRs will be required to make available the full text of notices of material events, and post the receipt and availability of other documents within the designated turnaround time period.

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be feasible, and, in some instances, already is in place.-[177]- Nonetheless, because the ultimate scope of the information undertakings was not known to the existing and potential NRMSIRs at the time they submitted their comments, the Commission intends to discuss with the NRMSIRs during the recognition process appropriate and practicable turnaround standards for information re-dissemination. Because SIDs are alternative sources of information for every type of disclosure, the Commission does not intend to impose strict turnaround times for SIDs. Instead, SIDs should provide the Commission and users with a clear statement of turnaround times that they will meet consistently.

6. Technological Considerations

The Commission also received many suggestions from information gatherers and vendors on streamlining the filing of disclosure information. These suggestions included requiring electronic filing of disclosure information, providing filings on computer disks and providing information to NRMSIRs as images of original source documents rather than exclusively as coded text.-[178]- Rather than dictate standards, the Commission encourages municipal securities market participants to coordinate their requirements and preferences on an industry-wide basis.

D. Exemptions

The Proposed Amendments contained two new exemptions, which are being adopted with certain modifications. A third new exemption from the annual financial information requirement, for short-term securities, also is being adopted. In addition, Rule 15c2-12's limitation to primary offerings of municipal securities with an aggregate principal amount of $1,000,000 or more, and its existing exemptions, also apply to the amendments.-[179]-

-[177]- The Bond Buyer stated that it broadcasts, through its Munifacts News product, material events and time critical announcements within 15 minutes of their receipt to municipal market participants throughout the country. It stated that it also posts documents within 24 hours of a document's receipt to the Bond Buyer's On-line Index which is updated throughout the day. Letter of The Bond Buyer. Similarly, Dow Jones Telerate stated that electronic dissemination will allow the turnaround time of 24 hours for an official statement and 15 minutes for secondary disclosure documents on material events to be feasible. Letter of Dow Jones Telerate. Material information is electronically disseminated on a "real time" basis by Bloomberg L.P. Letter of Bloomberg L.P.

-[178]- J.J. Kenny Co. requested that documents be required to

be filed as images of original source documents rather than exclusively as coded text. Dow Jones Telerate requested that Official statements be filed along with one electronic disk copy of the original Word Processing\Desktop publishing file with the label marked as to which software and version was used. For secondary market disclosure documents, Telerate advises using the NFMA proposed worksheets. The Bond Buyer stated that "collection would be most efficient if documents were in ASCII and a common word processing or publishing format".

-[179]- Former paragraph (c) of Rule 15c2-12 was proposed to be, and has been redesignated as paragraph (d)(1). This paragraph exempts primary offerings of municipal

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1. Small Issuer Exemption

The Proposed Amendments would have exempted from the provisions of the undertaking and recommendation prohibitions of the rule municipal securities issued in Offerings by issuers that had (i) less than $10,000,000 in principal amount of securities outstanding, including the offered securities and (ii) issued less than $3,000,000 in aggregate amount of municipal securities in the most recent 48 months preceding the offering.

A number of commenters discussed the appropriateness of the proposed dollar exemption, with comments ranging from a call for increased thresholds to no thresholds at all.-[180]- Some commenters believed that the thresholds should be increased, because many small municipalities would exceed these thresholds if they delay their financings in order to issue a greater amount of bonds at one time. The commenters argued that these are small, infrequent issuers with limited trading in the secondary market and the cost of compliance would outweigh the benefits received from improved secondary market disclosure.-[181]-

Other commenters took exception to the proposed thresholds because they were too high. These commenters argued that the exemption as proposed would exclude from coverage of the rule the types of issuers who have historically had deficient disclosure practices and disproportionate numbers of defaults.-[182]- A number of commenters also argued that the $3 million/48 month component of the threshold was too complex.-[183]-

As adopted,-[184]- the exemption retains the aggregate $10,000,000 limitation, but eliminates the $3,000,000 threshold. Instead, in addition to falling under the $10,000,000 in outstanding securities threshold, the exemption is conditioned upon an issuer or obligated person providing a limited disclosure undertaking. Under this undertaking, financial information and operating data concerning each obligor for which financial information or operating data is presented in the final official statement, must be provided upon request to any person, or be

-[179]-(...continued)

securities in authorized denominations of $100,000 or more, if such securities: (1) are sold to no more than 35 investors, each of whom the underwriter reasonably believes is capable of evaluating the investment and

who is not purchasing with a view to distribution; (2) have a maturity of nine months or less or; (3) at the option of the holder may be tendered to an issuer at least as frequently as every nine months.

-[180]- See, e.g. Letter of ALHFA; Letter of CDFA; Letter of NFMA; Letter of National Association of Independent Public Finance Advisors; Letter of Prudential Investment Corp.; Letter of PSA; Letter of Washington State Auditor.

-[181]- See, e.g., Letter of NAST; Letter of SIA.

-[182]- See, e.g. Letter of Chemical Securities; Letter of Eaton Vance Management; Letter of Edward D. Jones & Co.; Letter of Morgan Stanley; Letter of National Association of Independent Public Finance Advisors; Letter of Norwest Investment Services.

-[183]- See, e.g., Letter of APPA; Letter of The Bank of New York; Joint Response.

-[184]- See Rule 15c2-12(d)(2).

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provided at least annually to the appropriate SID. The undertaking would specify the type of financial information and operating data that will be made available annually, which must include financial information and operating data that is customarily prepared by the obligated person and is publicly available. The final official statement must describe where and how the financial information and operating data can be obtained.

Financial information and operating data of governmental issuers generally are subject to freedom of information laws, and thus would be publicly available for purposes of this condition of the exemption. Conduit borrowers generally provide annual financial information to trustees, credit enhancers, or the financing agency that issued the municipal securities, and thus would have no difficulty complying with this standard if that information is made publicly available. To the extent that an obligated person does not currently publicly disclose that information, they are free to specify the type of information they are undertaking to provide on an ongoing basis, but they must agree to provide some information. That information need not be the same type of information presented in the official statement. Nor would these exempt persons have to release their audited financial statements, unless they otherwise customarily prepare and make their audited financial statements publicly available. Moreover, the limited disclosure undertaking need only cover those obligors for which financial information or operating data is provided in the official statement.

In addition to providing financial information and operating data annually, notices of material events must be sent to each NRMSIR or to the MSRB, and the appropriate SID. This public information condition has been adopted in response to comments highlighting the need for information regarding small issuers accessing the public debt market.-[185]-

The threshold of $10,000,000 has been retained, notwithstanding comments that it was too high or too low.

According to statistics provided by one commenter,-[186]- in 1993, 71% of the approximately 52,000 municipal issuers had under $10,000,000 in outstanding municipal securities. Accordingly, the amendments as proposed already provided significant exemptive relief for small issuers. Indeed, the fact that a majority of issuers fall below that threshold supports conditioning the exemption on a commitment to provide a limited amount of secondary market information from exempt issuers. Even with that condition, a significant percentage of offerings would remain totally exempt from the amendments as adopted, because over 20% of the total issuances in 1993 were under $1,000,000.-[187]- As

-[185]- See Joint Response. A number of other commenters expressed concern about the lack of information on issuers in market segments in which the higher proportion of defaults have occurred. See note 182, supra and accompanying text. The effective date for this information undertaking condition on the small issuer exemption will be delayed until January 1, 1996.

See Section II.E., infra.

-[186]- See Letter of The Bond Buyer.

-[187]- See Letter of The Bond Buyer. The requirements of Rule 15c2-12, as amended, may not be avoided by breaking up an offering into several offerings of less than $1,000,000, where the offerings are of the same class of securities and are for the same purpose.

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these statistics demonstrate, the exemption should exclude a large percentage of small infrequent issuers.

Commenters also questioned how the aggregate thresholds were measured, including whose securities would be included and whether the exemption applied only to outstanding securities that were sold in Offerings subject to the rule.-[188]- Many commenters indicated that the thresholds should be separately applied to each issuer of municipal securities and each underlying obligor.-[189]- Thus, in the case of conduit issuers that have no liability on the municipal securities, commenters argued that the thresholds should be determined by reference to the persons who are the beneficiaries of the financing.-[190]- Some commenters argued that those issuers that had different types of financings that relied on separate revenue streams for repayment, such as dedicated tax revenues, should not be foreclosed from relying on the small issuer exemption for each financing.-[191]-

To address the first of these concerns, the amendments have been revised to clarify that the availability of the exemption turns on the amount of outstanding municipal securities for which an issuer or obligated person also is an obligated person. An issuer of municipal securities would need to satisfy the threshold only if it were an obligated person with respect to the security being offered. Under this approach, if a financing agency that is offering obligations that have some recourse to the agency, only those outstanding securities of the agency that

likewise are recourse would count toward the threshold. If the financing agency does not issue recourse securities, the exemption will be unavailable only if a conduit borrower obligated on the municipal securities being offered is an obligated person with respect to more than $10,000,000 in outstanding municipal securities. If any one obligated person in an Offering exceeds the threshold, then the entire Offering, including all obligated persons, will be subject to the rule. Subsequent non-recourse offerings by the financing agency would not be affected, but would be subject to a similar test.

With respect to the second concern, however, the amendments require that an obligated person aggregate all its outstanding obligations, even if some are payable from separate dedicated revenue sources. For example, a city or county that issues securities for a number of different purposes could not qualify as a small and infrequent issuer merely because its outstanding securities are payable from separate revenue streams. Thus, while a governmental issuer's outstanding obligations need not be aggregated with that of non-governmental obligated persons, a

-[188]- See, e.g., Letter of ABA Urban Law Section; Letter of CIFA; Letter of Colorado Municipal Bond Supervision Advisory Board.

-[189]- See, e.g., Letter of ALHFA; Letter of CDFA; Letter of Hawkins Delafield & Wood.

-[190]- See, e.g., Letter of Alaska Municipal Bond Bank; Letter of Bose, McKinney & Evans; Letter of CDFA; Letter of Oregon Economic Development Department.

-[191]- See, e.g., Letter of ABA Business Law Section; Letter of Chapman and Cutler; Letter of NABL.

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governmental issuer could not avoid aggregation of its securities by restricting repayment to separate revenue streams.-[192]-

Commenters also discussed a related issue of what securities would be included in the calculation. Commenters contended that only publicly offered securities should be included in the calculation. Other commenters questioned how short term obligations such as bond anticipation notes, refunded bonds and installment/lease purchase agreements would be treated. Several commenters suggested that the threshold should be measured only against publicly offered, long-term bonds.-[193]-

The amendments have been clarified in this respect to exclude from the threshold calculation securities that were offered in transactions exempt from Rule 15c2-12 because they were otherwise exempt as private placements and short term financings. In addition, to the extent that an issuer or obligated person is no longer liable for repayment on bonds, as with certain defeased bonds, then such bonds would not be included in the calculation of the threshold for such issuer or obligated person.

A number of commenters indicated that an exemption should be available based on the number of holders of the municipal securities.-[194]- However, in accordance with concerns voiced by other commenters regarding the difficulty in ascertaining the number of holders due to the fact that most municipal securities are held in street name through a very limited number of depositories,-[195]- the amendments do not adopt any exemption based on the number of holders of the municipal securities.

A variety of other comments were raised relating to exemptions, and a number of alternative exemptions were proposed, including exemptions based on the type of issuer or the existence of an investment grade rating.-[196]- Commenters also believed that an exemption should be available for securities covered by bond insurance or other credit enhancement, such as bank letters

-[192]- Significant indicia of whether an issuer in a revenue-type financing is in fact a part of a larger municipality would be whether the issuer's accounts are reflected in the municipality's financial statements and whether the municipality's officials or personnel manage the separate financing programs.

-[193]- See, e.g., Letter of ABA Business Law Section; Letter of Day Berry & Howard; Joint Response; Letter of Kutak Rock; Letter of the Treasurer of the State of North Carolina.

-[194]- See, e.g., Letter of ABA Business Law Section; Letter of Kutak Rock; Letter of Mudge Rose; Letter of National League of Cities.

-[195]- See, e.g., Letter of Bank One Corporation; Letter of Reliance Trust Company.

-[196]- See, e.g., Letter of ICI; Letter of McDonald & Company Securities; Letter of NABL; Letter of National League of Cities; Letter of NFMA; Letter of New York Dormitory Authority; Letter of Putnam Investment Management; Letter of State of Utah, Office of the State Treasurer; Letter of State of Washington, Office of the State Treasurer.

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of credit.-[197]- Except as described above, the exemptions have not been revised to adopt these suggestions. Commenters, including some bond insurance providers,-[198]- expressed the view that the existence of credit enhancement does not necessarily eliminate the need for information regarding the underlying credit.

A number of commenters also argued that new exemptions should be added that would mirror exemptions under the Securities Act.-[199]- Some commenters argued that exemptions should be included for non-profit entities that would have their own exemption from registration under the Securities Act.-[200]- The Commission is not including any exclusion in the amendments for

any such issuers. Issuers accessing the tax-exempt public securities markets have obligations to promote the integrity and efficiency of those markets. As the Commission noted in the Interpretive Release, the high level of defaults in sectors such as healthcare, lifecare, retirement homes and multifamily housing, relative to other market sectors,-[201]- and the past problems with the sufficiency of information in many of these sectors, weighs heavily against adopting such exclusions.

2. Exemption from the Annual Financial Information Requirement for Short-term Securities

A new exemption has been added to exempt from the requirement for an undertaking calling for annual financial information, Offerings of securities with an 18 month or shorter maturity.-[202]- The new exemption is in response to comments suggesting that the rule not require annual financial information in situations where the securities would mature shortly after, or possibly even before, the annual financial information would be

-[197]- See, e.g., Letter of Delaware County Industrial Development Authority; Letter of Financial Security Assurance; Letter of McNair & Sanford; Letter of Smith, Gambrell & Russell.

-[198]- As some commenters indicated, the existence of credit enhancement or other programmatic enhancement features does not eliminate the need for information on underlying obligated persons, particularly where there is a long term guarantee, because of the potential impact of a default on the pricing of the securities. See Letter of Kutak Rock on behalf of Financial Guaranty Insurers; Letter of FGIC; Letter of Prudential Investment Corp. See also Securities and Exchange Commission, Report by the Securities and Exchange Commission on the Financial Guaranty Market: The Use of the Exemption In Section 3(a)(2) of the Securities Act for Securities Guaranteed by Banks and the Use of Insurance Policies to Guarantee Debt Securities (August 28, 1987).

-[199]- See, e.g., Letter of ABA Business Law Section; Letter of Goldman Sachs; Letter of Morgan Stanley; Letter of Mudge Rose; Letter of Thacher Proffitt & Wood.

-[200]- See, e.g., Letter of Morgan Stanley; Letter of Mudge Rose; Letter of New York Dormitory Authority.

-[201]- Interpretive Release at Section III.D. See also Letter of The Bond Buyer.

-[202]- Rule 15c2-12(d)(3).

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due.-[203]- The provisions of the amended rule relating to notices of material events, however, would apply to these Offerings absent some other Rule 15c2-12 exemption.

3. Exemptions from the Recommendation Prohibition

The Proposed Amendments also included a new

exemption,-[204]- which would have permitted the recommendation in the secondary market of securities that were not subject to the underwriting prohibition, either because they were sold in a primary offering-[205]- of municipal securities with an aggregate principal amount of less than $1,000,000, or came within the existing exemptions for limited placements, short-term securities, and securities with demand features,-[206]- or within the new exemption for small, infrequent issuers.-[207]- This exemption has been adopted as proposed,-[208]- with the exception that securities sold in an exempt Offering that is subject to the limited undertaking condition,-[209]- are not exempt from the application of the recommendation prohibition. Pursuant to this element of the small issuer exemption, dealers must have in place procedures to receive notices of material events.-[210]-

4. Transactional Exemption

The existing Rule 15c2-12 transactional exemption-[211]- permits the Commission to exempt any Participating Underwriter from any requirement of the rule. Because Rule 15c2-12, as amended, places requirements on brokers, dealers, and municipal securities dealers in the secondary market, the transactional exemption has been amended to clarify that the Commission has exemptive authority with respect to both Participating Underwriters, in connection with Offerings, and with respect to

-[203]- See, e.g., Letter of ABA Urban Law Section; Letter of Chemical Securities; Letter of Day, Berry & Howard; Letter of Kutak Rock; Letter of Maryland Department of Economic and Employment Development.

-[204]- See paragraph (d)(3) of the Proposed Amendments.

-[205]- This exemption has been modified to clarify that the recommendation prohibition will not apply to primary or secondary market trading where municipal securities are exempt at the time of their original issuance. Several commenters noted that the inclusion of the term "a primary offering of" created confusion, based on the stated purpose of the exemption in the Proposing Release. See, e.g., Letter of Kutak Rock; Letter of ABA Urban Law Section; Letter of Colorado Municipal Bond Supervision Advisory Board; Letter of Day, Berry & Howard. The exemption has been modified to delete that term, thus giving the exemption its intended meaning.

-[206]- See paragraph (d)(1) of the Proposed Amendments.

-[207]- See paragraph (d)(2) of the Proposed Amendments.

-[208]- Rule 15c2-12(d)(4).

-[209]- See Rule 15c2-12(d)(2)(ii).

-[210]- See Rule 15c2-12(b)(5)(i)(C).

-[211]- Former paragraph (d) of Rule 15c2-12.

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brokers, dealers, and municipal securities dealers recommending transactions in the secondary market.-[212]-

E. Transitional Provision

The rule as amended contains a transitional provision for the amendments to Rule 15c2-12.-[213]- The underwriting prohibition applies to a Participating Underwriter that has contractually committed to act as an underwriter in an Offering on or after the effective date of the rule, July 3, 1995; provided that issuers need not undertake to provide annual financial information for fiscal years ending prior to January 1, 1996. The recommendation prohibition will become effective on January 1, 1996. The Commission is of the view that this delay of six months beyond the effective date of the amendment relating to the underwriting of municipal securities is sufficient to permit participants in the municipal securities market to design procedures for compliance with the provisions of Rule 15c2-12. Brokers, dealers and municipal securities dealers must, therefore, have procedures in place to comply with the recommendation prohibition on or before January 1, 1996. Finally, the limited undertaking condition to the small issuer exemption need not be satisfied for offerings commencing prior to January 1, 1996.

III. Effects on Competition and Regulatory Flexibility Act Considerations

Section 23(a)(2) of the Exchange Act-[214]- requires the Commission, in adopting rules under the Act, to consider the anticompetitive effects of those rules, if any, and to balance that impact against the regulatory benefits gained in terms of furthering the purposes of the Exchange Act. The Commission has considered the amendments to Rule 15c2-12 in light of the standard cited in Section 23(a)(2) and believes the adoption of the amendments will not impose any burden on competition not necessary or appropriate in furtherance of the Exchange Act.

In addition, the Commission has prepared a final regulatory flexibility analysis ("FRFA"), pursuant to the requirements of the Regulatory Flexibility Act-[215]- regarding the proposed amendments to Rule 15c2-12. The Commission requested comment on the extent to which current practice deviates from the requirements of the proposed amendments, and the extent to which additional costs may be imposed on small issuers, brokers, dealers, and municipal securities dealers if the amendments are adopted as proposed. The FRFA indicates that the amendments to the rule could impose some additional costs on small broker-dealers and municipal issuers. Nonetheless, the Commission is of the view that many of the substantive requirements of the amendments already are observed, absent access to the continuing information provided by the amendments, by issuers, brokers, dealers, and municipal securities dealers as a matter of business practice, or to fulfill their existing obligations under the antifraud provisions of the federal securities laws. To the extent that the Proposed Amendments would have imposed additional costs on small issuers, brokers, dealers, and municipal securities dealers, in response to commenters' concerns, the Commission has modified the amendments as described.

-[212]- The transactional exemption also has been redesignated as paragraph (e) of Rule 15c2-12.

-[213]- See Rule 15c2-12(g).

-[214]- 15 U.S.C. 78w(a)(2).

-[215]- 5 U.S.C. 604.

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A copy of the FRFA may be obtained from Janet W. Russell-Hunter, Attorney, Office of Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 7-10, Washington, D.C. 20549, (202) 942-0073.

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List of Subjects in 17 CFR Part 240
Reporting and recordkeeping requirements, securities.
Text of Amendments to Rule 15c2-12
In accordance with the foregoing, Title 17, Chapter II of Title 17 of the Code of Federal Regulations is amended as follows:
PART 240--GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT
OF 1934
1. The authority citation for Part 240 continues to read in part as follows:
Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78i, 78j, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78w, 78x, 78ll(d), 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.
* * * * *
2. Section 240.15c2-12 is amended by adding a Preliminary Note preceding paragraph (a); revising paragraph (a); adding paragraph (b)(5); redesignating paragraph (c) through paragraph (f) as paragraph (d) through paragraph (g); adding paragraph (c); revising newly designated paragraph (d), paragraph (e), and paragraph (f)(3); adding paragraph (f)(9) and paragraph (f)(10); and adding four sentences to the end of newly designated paragraph (g) to read as follows:
240.15c2-12 Municipal securities disclosure.
Preliminary Note: For a discussion of disclosure obligations relating to municipal securities, issuers, brokers, dealers, and municipal securities dealers should refer to Securities Act Release No. 7049, Securities Exchange Act Release No. 33741, FR-42 (March 9, 1994). For a discussion of the obligations of underwriters to have a reasonable basis for recommending municipal securities, brokers, dealers, and municipal securities dealers should refer to Securities Exchange Act Release No. 26100 (Sept. 22, 1988) and Securities Exchange Act Release No. 26985 (June 28, 1989).

(a) General. As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any broker, dealer, or municipal securities dealer (a "Participating Underwriter" when used in connection with an Offering) to act as an underwriter in a primary offering of municipal securities with an aggregate principal amount of $1,000,000 or more (an "Offering") unless the Participating Underwriter complies with the requirements of this section or is

exempted from the provisions of this section.

* * * * *

(b) Requirements. * * *

(5)(i) A Participating Underwriter shall not purchase or sell municipal securities in connection with an Offering unless the Participating Underwriter has reasonably determined that an issuer of municipal securities, or an obligated person for whom financial or operating data is presented in the final official statement has undertaken, either individually or in combination with other issuers of such municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such securities, to provide, either directly or indirectly through an indenture trustee or a designated agent:

(A) To each nationally recognized municipal securities information repository and to the appropriate state information depository, if any, annual financial information for each obligated person for whom financial information or operating data is presented in the final official statement, or, for each obligated person meeting the objective criteria specified in the undertaking and used to select the obligated persons for whom financial information or operating data is presented in the final

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official statement, except that, in the case of pooled obligations, the undertaking shall specify such objective criteria;

(B) If not submitted as part of the annual financial information, then when and if available, to each nationally recognized municipal securities information repository and to the appropriate state information depository, audited financial statements for each obligated person covered by paragraph (b)(5)(i)(A) of this section;

(C) In a timely manner, to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of any of the following events with respect to the securities being offered in the Offering, if material:

(1) Principal and interest payment delinquencies;

(2) Non-payment related defaults;

(3) Unscheduled draws on debt service reserves reflecting financial difficulties;

(4) Unscheduled draws on credit enhancements reflecting financial difficulties;

(5) Substitution of credit or liquidity providers, or their failure to perform;

(6) Adverse tax opinions or events affecting the tax-exempt status of the security;

(7) Modifications to rights of security holders;

(8) Bond calls;

(9) Defeasances;

(10) Release, substitution, or sale of property securing repayment of the securities;

(11) Rating changes; and

(D) In a timely manner, to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of a failure of any person specified in paragraph (b)(5)(i)(A) of this section to provide

required annual financial information, on or before the date specified in the written agreement or contract.

(ii) The written agreement or contract for the benefit of holders of such securities also shall identify each person for whom annual financial information and notices of material events will be provided, either by name or by the objective criteria used to select such persons, and, for each such person shall:

(A) Specify, in reasonable detail, the type of financial information and operating data to be provided as part of annual financial information;

(B) Specify, in reasonable detail, the accounting principles pursuant to which financial statements will be prepared, and whether the financial statements will be audited; and

(C) Specify the date on which the annual financial information for the preceding fiscal year will be provided, and to whom it will be provided.

(iii) Such written agreement or contract for the benefit of holders of such securities also may provide that the continuing obligation to provide annual financial information and notices of events may be terminated with respect to any obligated person, if and when such obligated person no longer remains an obligated person with respect to such municipal securities.

(c) Recommendations. As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any broker, dealer, or municipal securities dealer to recommend the purchase or sale of a municipal security unless such broker, dealer, or municipal securities dealer has procedures in place that provide reasonable

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assurance that it will receive prompt notice of any event disclosed pursuant to paragraph (b)(5)(i)(C), paragraph (b)(5)(i)(D), and paragraph (d)(2)(ii)(B) of this section with respect to that security.

(d) Exemptions. (1) This section shall not apply to a primary offering of municipal securities in authorized denominations of $100,000 or more, if such securities:

(i) Are sold to no more than thirty-five persons each of whom the Participating Underwriter reasonably believes:

(A) Has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the prospective investment; and

(B) Is not purchasing for more than one account or with a view to distributing the securities; or

(ii) Have a maturity of nine months or less; or

(iii) At the option of the holder thereof may be tendered to an issuer of such securities or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months until maturity, earlier redemption, or purchase by an issuer or its designated agent.

(2) Paragraph (b)(5) of this section shall not apply to an Offering of municipal securities if, at such time as an issuer of such municipal securities delivers the securities to the Participating Underwriters:

(i) No obligated person will be an obligated person with respect to more than $10,000,000 in aggregate amount of outstanding municipal securities, including the offered securities and excluding municipal securities that were offered in a transaction exempt from this section pursuant to paragraph

(d)(1) of this section;

(ii) An issuer of municipal securities or obligated person has undertaken, either individually or in combination with other issuers of municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such municipal securities, to provide:

(A) Upon request to any person or at least annually to the appropriate state information depository, if any, financial information or operating data regarding each obligated person for which financial information or operating data is presented in the final official statement, as specified in the undertaking, which financial information and operating data shall include, at a minimum, that financial information and operating data which is customarily prepared by such obligated person and is publicly available; and

(B) In a timely manner, to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of events specified in paragraph (b)(5)(i)(C) of this section with respect to the securities that are the subject of the Offering, if material; and

(iii) the final official statement identifies by name, address, and telephone number the persons from which the foregoing information, data, and notices can be obtained.

(3) The provisions of paragraph (b)(5) of this section, other than paragraph (b)(5)(i)(C) of this section, shall not apply to an Offering of municipal securities, if such municipal securities have a stated maturity of 18 months or less.

(4) The provisions of paragraph (c) of this section shall not apply to municipal securities:

(i) Sold in an Offering to which paragraph (b)(5) of this section did not apply, other than Offerings exempt under paragraph (d)(2)(ii) of this section; or

(ii) Sold in an Offering exempt from this section under paragraph (d)(1) of this section.

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(e) Exemptive Authority. The Commission, upon written request, or upon its own motion, may exempt any broker, dealer, or municipal securities dealer, whether acting in the capacity of a Participating Underwriter or otherwise, that is a participant in a transaction or class of transactions from any requirement of this section, either unconditionally or on specified terms and conditions, if the Commission determines that such an exemption is consistent with the public interest and the protection of investors.

(f) Definitions. * * *

(3) The term final official statement means a document or set of documents prepared by an issuer of municipal securities or its representatives that is complete as of the date delivered to the Participating Underwriter(s) and that sets forth information concerning the terms of the proposed issue of securities; information, including financial information or operating data, concerning such issuers of municipal securities and those other entities, enterprises, funds, accounts, and other persons material to an evaluation of the Offering; and a description of the undertakings to be provided pursuant to paragraph (b)(5)(i), paragraph (d)(2)(ii), and paragraph (d)(2)(iii) of this section, if applicable, and of any instances in the previous five years in

which each person specified pursuant to paragraph (b)(5)(ii) of this section failed to comply, in all material respects, with any previous undertakings in a written contract or agreement specified in paragraph (b)(5)(i) of this section. Financial information or operating data may be set forth in the document or set of documents, or may be included by specific reference to documents previously provided to each nationally recognized municipal securities information repository, and to a state information depository, if any, or filed with the Commission. If the document is a final official statement, it must be available from the Municipal Securities Rulemaking Board.

* * * * *

(9) The term annual financial information means financial information or operating data, provided at least annually, of the type included in the final official statement with respect to an obligated person, or in the case where no financial information or operating data was provided in the final official statement with respect to such obligated person, of the type included in the final official statement with respect to those obligated persons that meet the objective criteria applied to select the persons for which financial information or operating data will be provided on an annual basis. Financial information or operating data may be set forth in the document or set of documents, or may be included by specific reference to documents previously provided to each nationally recognized municipal securities information repository, and to a state information depository, if any, or filed with the Commission. If the document is a final official statement, it must be available from the Municipal Securities Rulemaking Board.

(10) The term obligated person means any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations on the municipal securities to be sold in the Offering (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities).

* * * * *

(g) Transitional Provision. * * * Paragraph (b)(5) of this section shall not apply to a Participating Underwriter that has contractually committed to act as an underwriter in an Offering of municipal securities before July 3, 1995; except that paragraph (b)(5)(i)(A) and paragraph (b)(5)(i)(B) shall not apply

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with respect to fiscal years ending prior to January 1, 1996. Paragraph (c) shall become effective on January 1, 1996. Paragraph (d)(2)(ii) and paragraph (d)(2)(iii) of this section shall not apply to an Offering of municipal securities commencing prior to January 1, 1996.

By the Commission.

Jonathan G. Katz
Secretary

Dated: November 10, 1994

# EXHIBIT NO. 37

# The Securities Law of Public Finance

SECOND EDITION

ROBERT A. FIPPINGER

VOLUME 1

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with SEC rules imposing requirements on broker-dealers acting as participating underwriters.[104]

The 1994 amendments require participating underwriters to determine, as of the sale date, that the issuer of the municipal securities or an obligated person[105] will have undertaken, in a written agreement or contract for the benefit of holders of the securities, at or prior to closing, to provide specified categories of ongoing information. Municipal securities are debt securities, and if the source of repayment of the debt is one or more persons (each referred to as an obligated person), the undertaking may be made by one or more of

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104. The jurisdiction of the SEC for adopting Rule 15c2-12 is described above at section 6:4. In proposing the 1994 amendments, the SEC sought to deter fraud by prohibiting the underwriting and subsequent recommendation of securities for which adequate continuing information is not available. The absence of current information in the secondary market is viewed by the SEC as creating a likelihood that trading in the securities on the basis of misinformation will take place.

105. The drafters of the 1994 amendments recognized that in public finance the person obligated to repay the debt is not necessarily the state or political subdivision issuing the debt. A hospital or university financing is illustrative. It is the nonprofit corporation, not the issuer, that is the primary source of key information for investors. If the final official statement contains financial information or operating data about the hospital or university, Rule 15c2-12 requires such information to be updated annually. The 1994 amendments leave to negotiation among the parties the determination of the person who is to be contractually obligated to provide annual updating. However, the participating underwriter must determine that either the issuer or an obligated person has undertaken contractually to update all information identifiable in the final official statement as financial information or operating data of an issuer or an obligated person. An obligated person is defined by two tests. First, an obligated person is a person committed by contract or other arrangement to support payment of all or a part of the debt service obligation on the municipal securities. The SEC concluded that for a person to be an obligated person, there must be a nexus to debt service through a commitment to support the payment obligations. The concept is intended to be less inclusive than all sources of cash flow providing revenues for the payment of debt service but more inclusive than sources who have agreements to make payments that are specifically enforceable by bondholders. The SEC in the Adopting Release summarizes the first test as whether the person is "committed by contract or other arrangement to support payment of the obligations on the municipal securities." The second test limits ongoing disclosure to those persons for which the issuer and underwriters determine it is necessary to provide financial information or operating data under the antifraud standards applicable to the final official statement. If there is no information in the official statement about a person (unless the financing is for an undetermined pool for which a special rule applies), no updating is required. The presumption is that if there is an obligation by a person, who represents a source of repayment of the debt, that is not viewed as sufficiently material to require financial information or operating data about the person in the official statement, continuing disclosure about that person would also not be material.

# EXHIBIT NO. 38

# The Securities Law of Public Finance

SECOND EDITION

ROBERT A. FIPPINGER

VOLUME 1

Incorporating Release No. 14
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New York City

**B1-1340**

silent as to other information regardless of its materiality unless there exists a separate basis for a duty of disclosure apart from Rule 15c2-12. It is useful to consider the required financial information and operating data as structured line item disclosure comparable to the disclosure set forth on form 10-K or 10-Q for a 1934 Act reporting company. Unless the antifraud rules require more in a particular circumstance, all that is necessary is to respond to the line item.

: fact is, Rule 15c2-12 significantly limits the required ongoing :losure to specific items despite the use of an official statement ı point of reference. Clearly, the Rule 15c2-12 line item discloes must be accurate. The question is whether federal securities /, most notably Rule 10b-5, requires amplification of a response the line item disclosure in order for the statement not to be misıding in light of the circumstances in which it is made.

Since the 1968 decision in *SEC v. Texas Gulf Sulphur Co.*,[108] it ıs been recognized that all company statements reasonably calcuted or expected to reach investors and the trading markets are sub-

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the operating data set forth in the official statement. The Adopting Release uses a hospital financing to illustrate the intended requirements. An official statement for a hospital financing describes the hospital, its administration and management, economic base, service area, and capital plans. This information is not operating data. Operating data does include such statistics as bed utilization, admissions, categories of admissions (such as coronary care, pediatrics, etc.) and payor information (such as percentages of Medicare, Medicaid, and private insurance). It is useful to consider operating data as quantitative data related to the operations of the issuer or an obligated person. Therefore, demographic data about the geographical territory of a governmental issuer and related information about the economic base may not constitute operating data about the issuer. Economic information may, however, be necessary in limited circumstances to place in context the financial information and operating data that are disclosed.

108. SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). The court reached the following conclusion:

> The dominant congressional purposes underlying the Securities Exchange Act of 1934 were to promote free and open public securities markets and to protect the investing public from suffering inequities in trading, including, specifically, inequities that follow from trading that has been stimulated by the publication of false or misleading corporate information releases. . . . Accordingly, we hold that Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public, *e.g.*, by means of the financial media, . . . if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes.

*Id.* at 858, 862.

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ject to the antifraud provisions of the federal securities laws.[109] The phrase "all company statements" would include statements made in line item disclosure in reports required to be filed with the SEC under the 1934 Act. It follows that the antifraud provisions should be viewed as the standard of care appropriate to the preparation of the annual disclosures required by Rule 15c2-12.[110] This view was summarized by the SEC in the 1994 Interpretative Release as follows:

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109. The principle was stated by the SEC as follows:

> The antifraud provisions of the federal securities laws apply to all company statements that can reasonably be expected to reach investors and the trading markets. . . . To the extent that the standard for accuracy and completeness embodied in the antifraud provisions is not met, the company and any person responsible for the statements may be held liable under the federal securities laws.

Public Statements by Corporate Representatives, Exchange Act Release No. 20,560 (Jan. 13, 1984).

110. Shortly after the *Texas Gulf Sulphur* decision, the Second Circuit made the following observation in Heit v. Weitzen, 402 F.2d 909, 913 (2d Cir. 1968):

> It is reasonable to assume that investors may very well rely on the material contained in false corporate financial statements which have been disseminated in the market place, and in so relying may subsequently purchase securities of the corporation.

In Ross v. A.H. Robins Co., Inc., 607 F.2d 545 (2d Cir. 1979), the court specifically considered whether an action could be brought under Rule 10b-5 for misstatements made in the company's 10-K. The company raised in defense that section 18 of the 1934 Act creates a private remedy for "false or misleading" statements contained in "any application, report or document" filed with the SEC. The defendant argued that section 18 supersedes Rule 10b-5 as to line item disclosure. The court held "that even as to those documents filed with the SEC, plaintiffs may seek to prosecute their claim under section 10(b) and Rule 10b-5." 607 F.2d at 556.

A Rule 10b-5 action based on line item disclosure also raises the issue whether 10-K or 10-Q misstatements or omissions are made "in connection with" the purchase or sale of securities. *In re* Ames Dep't Stores Inc. Stock Litig., 991 F.2d 953 (2d Cir. 1993), answered that issued affirmatively:

> It appears that the district court construed the "in connection with" requirement as requiring that the statements be made in the registration statements for the particular stock at issue—in short, as if it were identical with the requirement for claims involving sections 11 and 12 of the 1933 Act. . . . We have already indicated that, in ruling against the common stockholders, the district court misread the facts as well as the law. The stockholders' complaint is not based solely upon misrepresentations in and omissions from the reset note and debenture prospectuses, but alleges a common course of false and misleading statements, including press releases, news articles, and quarterly and annual public filings, in connection with which the common stockholders made their purchases. In addition to the debt prospectuses, the defendants are alleged to have

# SEC RELEASE No. 33-7049; 34-33741 (March 9, 1994): Interpretive Guidance on the Antifraud Provisions

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Parts 211, 231, and 241**

**(Release No. 33-7049; 34-33741; FR-42; FILE NO. S7-4-94)**

**Statement of the Commission Regarding Disclosure Obligations of Municipal**

**Securities Issuers and Others**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Interpretation; Solicitation of comments.

**SUMMARY:** The Securities and Exchange Commission ("Commission") is publishing its views with respect to the disclosure obligations of participants in the municipal securities markets under the antifraud provisions of the federal securities laws, both in connection with primary offerings and on a continuing basis with respect to the secondary market. This interpretive guidance is intended to assist municipal securities issuers, brokers, dealers and municipal securities dealers in meeting their obligations under the antifraud provisions. The Commission is seeking comment on issues discussed in this release and possible future agency action.

**DATES:** This Interpretation is effective March 9, 1994.

Comments should be received on or before July 15, 1994.

**ADDRESSES:** Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Stop 6-9, Washington, DC 20549. Comment letters should refer to File No. S7-4-94. All comments received will be available for public inspection and copying at the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549.

**FOR FURTHER INFORMATION CONTACT:** Ann D. Wallace ((202) 272-7282), Amy Meltzer Starr ((202) 272-3654), Vincent W. Mathis ((202) 272-3968), Division of Corporation Finance; Janet W. Russell-Hunter (with respect to Sections III.C.6. and V.) ((202) 504-2418), Division of Market Regulation, U.S. Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549.

**SUPPLEMENTARY INFORMATION:** In a companion release, the Commission is proposing rule amendments that prohibit a broker, dealer or municipal securities dealer from underwriting a municipal issue unless the issuer agrees to disseminate information to the secondary market and from recommending the purchase of a municipal security without reviewing such information.

## I. Executive Summary

The recent high volume of municipal securities offerings, as well as the growing ownership of municipal securities by individual investors, has highlighted the need for improved disclosure practices in the municipal securities market, particularly in the secondary market. To encourage and expedite the ongoing efforts by market participants to improve disclosure practices, and to assist market participants in meeting their obligations under the antifraud provisions, the Commission is publishing its views with respect to disclosures under the federal securities laws in the municipal market.

This interpretive release addresses the following:

(1) With respect to primary offering disclosure, despite the significant improvement in disclosure practices in recent years as a result of voluntary initiatives, increased attention needs to be directed at

- Disclosure of potential conflicts of interest and material financial relationships among issuers, advisers and underwriters, including those arising from political contributions;
- Disclosure regarding the terms and risks of securities being offered;
- Disclosure of the issuer's or obligor's financial condition, results of operations, and cash flows. This information should include audited financial statements (or disclosure that the financial statements were not subject to audit) and an explanation of the accounting principles followed in the preparation of the financial statements, unless the statements were prepared in accordance with generally accepted accounting principles ("GAAP") or accompanied by a quantified explanation of any deviation from GAAP;
- Disclosure of the issuer's plans regarding the provision of information to the secondary market; and
- Timely delivery of preliminary official statements to underwriters and potential investors.

(2) The Commission is renewing its recommendation for legislation to repeal the exemption for corporate obligations underlying certain conduit securities from the registration and reporting requirements of the federal securities laws.

(3) Particularly because of their public nature, issuers in the municipal market routinely make public statements and issue reports that can affect the market for their securities; without a mechanism for providing ongoing disclosures to investors, these disclosures may cause the issuer to violate the antifraud provisions.

Basic mechanisms to address potential antifraud liability include:

• Publication of financial information, including audited financial statements and other financial and operating information, on at least an annual basis;

• Timely reporting of material events reflecting upon the creditworthiness of the issuer or the obligor and the terms of its securities, including material defaults, draws on reserves, adverse rating changes and receipt of an adverse tax opinion; and

• Submission of such information to an information repository.

(4) Underwriters and municipal securities dealers are key players in maintaining the quality of disclosure in the municipal securities markets. The underwriter has a duty to review the issuer's disclosure documents before offering, selling or bidding for the securities and to have a reasonable basis for its belief as to the accuracy and completeness of the representations in the documents. Municipal dealers must have a reasonable basis for recommending the purchase of securities.

In a companion release,[1] the Commission is proposing for comment two related rule amendments, the first proposing to prohibit a broker, dealer or municipal securities dealer from underwriting a municipal issue unless the issuer makes a commitment to provide annual and event-related secondary market information to a designated repository; and the second proposing to prohibit a broker, dealer, or municipal securities dealer from recommending purchases of such issues in the secondary market if it does not review such information.

**II. Introduction**

*A. The Municipal Securities Market*

As detailed in the recent Staff Report on the Municipal Securities Market, the market for municipal securities is characterized by great diversity and high volume. Issuers, estimated to number approximately 50,000, include state governments, cities, towns, counties, and special subdivisions, such as special purpose districts and public authorities. It is estimated that there currently are 1.3 million municipal issues outstanding, representing approximately $1.2 trillion in securities.[2] In 1993, a record level of over $335 billion in municipal securities was sold, representing over 17,000 issues. This record financing was heavily influenced by refundings. Nevertheless, the level of long term new money financings, representing 49% of financings for the year, reflected continued growth. In 1993, there were $142 billion of new money long term financings, compared to $81 billion in 1988, a 75% increase.[3]

In recent years, the forms of securities used to meet the financing needs of these issuers have become increasingly diverse and complex. For example, conduit bonds, certificates of participation, and a variety of derivative products have joined traditional general obligation and revenue bonds as prevalent forms of municipal financing.[4]

In addition, there has been a change in the investor profile in the municipal securities market. By 1992, individual investors, including those holding through mutual funds, held 75% of the municipal debt outstanding, compared to 44% in 1983.[5]

Along with the changing investor profile, there has been a change in investor strategy. Traditionally, municipal bondholders have been buy and hold investors; however, this strategy has changed significantly with the growth and development of municipal bond funds. Many of these funds actively trade their portfolio securities to take advantage of market conditions or to meet redemption needs.

*B. SEC Oversight of the Municipal Securities Market*

As the agency charged with administering the federal securities laws and overseeing this nation's securities markets, the Commission has an obligation to protect investors in the municipal markets from fraud, including misleading disclosures. As the New York City report stated nearly two decades ago:

By virtue of the large dollar volume of municipal securities issued and outstanding each year, such securities are a major factor in the Nation's economy and the national securities markets. In light of the national scope of the municipal securities markets, there is an overriding federal interest in assuring that there is adequate disclosure of all material information by issuers of municipal securities.

Although municipalities have certain unique attributes by virtue of their political nature, insofar as they are issuers of securities, they are subject to the proscription against false and misleading disclosures.[6]

The burgeoning volume and complexity of municipal securities offerings, as well as the retail nature of the market, heighten the need for market participants to seek to prevent fraud through the timely provision of material information concerning municipal issuers and securities.

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[1] Exchange Act Release No. 33742 (March 9, 1994) ("Companion Release").

[2] See Division of Market Regulation, Securities and Exchange Commission, Staff Report on the Municipal Securities Market ("Staff Report") (Sept. 1993) at 1.

[3] "A Decade of Municipal Finance," The Bond Buyer (Jan. 6, 1994) at 24.

[4] Staff Report at 1-2.

[5] The Bond Buyer 1993 Yearbook ("Bond Buyer 1993 Yearbook") at 61-63.

[6] Staff Report on Transactions in Securities of the City of New York ("NY City Report") (Aug. 1977) Chapter III, at 1-2.

While Congress exempted offerings of municipal securities from the registration requirements and civil liability provisions of the Securities Act of 1933,[7] and a mandated system of periodic reporting under the Securities Exchange Act of 1934,[8] it did not exempt transactions in municipal securities from the coverage of the antifraud provisions of section 17(a) of the Securities Act,[9] [FN9] section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder.[10] These antifraud provisions prohibit any person, including municipal issuers and brokers, dealers and municipal securities dealers, from making a false or misleading statement of material fact, or omitting any material facts necessary to make statements made by that person not misleading, in connection with the offer, purchase or sale of any security. In addition, brokers, dealers and municipal securities dealers are subject to regulations adopted by the Commission, including those regulations adopted to define and prevent fraud.[11] [FN11] Municipal securities dealers are also subject to rules promulgated by the Municipal Securities Rulemaking Board ("MSRB").[12]

*C. Disclosure Practices and Calls for Enhanced Disclosure*

In the absence of a statutory scheme for municipal securities registration and reporting, disclosure by municipal issuers has been governed by the demands of market participants and antifraud strictures. Spurred by the New York City fiscal crisis in 1975 and the Washington Public Power Supply System defaults,[13] participants in the municipal securities market have developed extensive guidance to improve the level and quality of disclosure in primary offerings of municipal securities, and to a more limited extent, continuing disclosure in the secondary market.

In 1989, the Commission adopted Rule 15c2-12 under the Exchange Act[14] to enhance the quality and timeliness of disclosure to investors in municipal securities.[15] The rule requires that underwriters (both bank and non-bank) of primary offerings of municipal securities with an aggregate principal amount of $1,000,000 or more obtain and distribute to their customers the issuers' official statements for the offerings. This mechanism provides underwriters an opportunity to review the issuer's disclosure documents before commencing sales to investors.[16]

There is a consensus that, over the last two decades, these market and regulatory efforts have improved significantly the quality of primary offering disclosure in the municipal securities markets.[17] Nonetheless, there continue to be concerns with the adequacy of municipal offering disclosure, particularly with respect to offerings of non-general obligation bonds and smaller issues.[18]

Secondary market disclosure practices present greater concerns. Recent highly publicized defaults[19] and refundings,[20] as well as the tremendous level of issuances during the past two years, have

[7] See section 3(a)(2) of the Securities Act (15 U.S.C. 77c(a)(2)).

[8] See section 3(a)(29) of the Exchange Act (15 U.S.C. 78c(a)(29)).

[9] 15 U.S.C. 77q(a).

[10] 15 U.S.C. 78j(b); 17 CFR 240.10b-5.

[11] Sections 15(c) (1) and (2) of the Exchange Act (15 U.S.C. 78o(c) (1) and (2)).

[12] See MSRB Manual (CCH).

[13] See Securities and Exchange Commission, Report of the Securities and Exchange Commission on Regulation of Municipal Securities (1988); Securities and Exchange Commission, Staff Report on the Investigation in the Matter of Transactions in the Washington Public Power Supply System Securities (1988); Securities Act Release No. 6021, Final Report in the Matter of Transactions in the Securities of the City of New York (Feb. 5, 1979); NY City Report.

[14] 17 CFR 240.15c2-12; see Municipal Securities Disclosure, Securities Exchange Act Release No. 26100 (Sept. 28, 1988), 53 FR 37778 ("Proposing Release"); Municipal Securities Disclosure, Securities Exchange Act Release No. 26985 (July 10, 1989), 54 FR 28799 ("Adopting Release").

[15] Proposing Release, 53 FR at 37779-37782; Staff Report at 25.

[16] Adopting Release, 54 FR at 28800.

[17] National Federation of Municipal Analysts, Membership Survey Results Fall 1992 Disclosure Survey ("NFMA Survey"); Public Securities Association, Municipal Securities Disclosure Task Force, Report: Initial Analysis of Current Disclosure Practices in the Municipal Securities Market (June 1988) ("PSA Survey") (content and completeness of primary disclosure documents and sufficiency of financial information rated satisfactory to excellent by 94% and 93% of firms responding, respectively).

[18] See Letter to Chairman Levitt from Charles Mires, Allstate Insurance Company (Nov. 4, 1993, as updated Jan. 19, 1994) ("Allstate Letter") (primary market disclosure by conduits found inadequate in 43.8% of rated issues reviewed); NFMA Survey (local housing, special district, hospitals, long term healthcare and industrial development issues were found to provide the least disclosure); PSA Survey (small issue industrial development bonds received a low rating; issues of $10 million or less received a low rating).

[19] Examples include the defaults engendered by the failures of Mutual Benefit Life, Executive Life and Tucson Electric Power, and the bankruptcies arising out of the Colorado Special Districts. See, e.g., Hinden, "Mutual Benefit Life's Collapse Shows Fragility of Bond Guarantees," The Washington Post (Jul. 22, 1991) at F 27; Levinson, "No Coverage Against Junk," Newsweek (Apr. 22, 1991) at 46; Stamas, "Rep. Dingell Asks SEC to Investigate Defaults by Special Assessment Districts in Colorado," The Bond Buyer (Jan. 25, 1991) at 1.

[20] See Gasparino, "Balancing Budgets Through Lease Deals May Pose Credit Risks, Rating Agency Warns," The Bond Buyer (Jan. 25, 1993) at 1; Herman, "Municipal-Bond Holders: Watch Out for 'Call' Shock," The Wall Street Journal (Aug. 29, 1992) at C1; Hume, "Dealer Threatens Suit Over Proposed Call for Escrowed Bonds," The Bond Buyer (Nov. 8, 1993) at 4; Hume, "Issuer in Louisiana May Run Afoul of Law if Escrowed Bonds Are Called Next Month," The Bond Buyer (Apr. 22, 1993) at 1; Hume, "Rise in Re-Refundings of Escrowed Bonds Likely to Gain Attention at Treasury, SEC," The Bond Buyer (May 12, 1992) )at 1.

heightened interest in municipal secondary market disclosure.[21] The PSA has testified that today "secondary market information is difficult to come by even for professional municipal credit analysts, to say nothing of retail investors."[22] ] Substantial issuer information, in the form of official statements, state-required reports, and other public documents, is available from the approximately 20% of municipal issuers that come to market frequently, accounting for 80% of the dollar volume of municipal securities issued.[23] However, the remaining issuers, representing 20% in dollar volume but 80% in number, which come to the market much less frequently, provide substantially less continuing information. Many of these issues are health care issues, housing issues, industrial development bonds, and other conduit financings,[24] financing sectors which have had the greatest incidence of defaults, both monetary and technical.[25] In addition, information often is unavailable for smaller issues of securities of general purpose units of government and the securities of special purpose districts and authorities.[26]

In response to a request by Commission Chairman Arthur Levitt for a recommended "market-participant sponsored solution" to the disclosure issues in the municipal securities market, on December 20, 1993, 12 groups and associations representing a broad range of market participants submitted to the Commission a Joint Statement on Improvements in Municipal Securities Market Disclosure (the "Joint Statement").[27] The Joint Statement sets forth "a framework for improving the availability of information in the marketplace" that calls for both continued market initiatives to improve issuer disclosure and "support from the SEC and the Municipal Securities Rulemaking Board (MSRB)."[28] Among other things, its participants recommend the adoption of a rule or interpretive guidance restricting underwriting of municipal issues unless continuing information covenants are provided by the issuer.

## III. Primary Offering Disclosure

### *A. Application of the Antifraud Provisions*

The antifraud provisions of the federal securities laws prohibit fraudulent or deceptive practices in the offer and sale of municipal securities.[29] Disclosure documents used by municipal issuers, such as official statements, are subject to the prohibition against false or misleading statements of material facts, including the omission of material facts necessary to make the statements made, in light of the circumstances in which they are made, not misleading. The adequacy of the disclosure provided in municipal security offering materials is tested against an objective standard: an omitted fact is material if there is a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual

[21] See generally, Testimony of Jeffrey S. Green, General Counsel, Port Authority of New York and New Jersey on behalf of Government Finance Officers Association, before the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce, Oct. 7, 1993 ("GFOA Testimony") at 7-9; Remarks by C. Richard Lehmann, President, Bond Investors Association Before the U.S. House of Representatives Subcommittee on Telecommunications and Finance Concerning the Municipal Securities Market, Oct. 7, 1993 ("Lehmann Testimony") at 4-5; Testimony of Andrew R. Kintzinger, President-Elect, National Association of Bond Lawyers, Before the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce, Oct. 7, 1993 ("NABL Testimony") at 8-23; Testimony of Harvey Eckert, Chairman of the Blue Ribbon Committee on Secondary Market Disclosure on Behalf of the National Association of State Auditors, Comptrollers and Treasurers Before the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce, Oct. 7, 1993 ("NASACT Testimony") at 3-6; Testimony Relating to the Municipal Securities Market given by the National Federation of Municipal Analysts, Katherine Bateman, Chairperson, to the Subcommittee on Telecommunications and Finance, Oct. 7, 1993 ("NFMA Testimony") at 1-7; Statement of Gerald McBride, Chairman, Municipal Securities Division, Public Securities Association, Before the House Committee on Energy and Commerce, Telecommunications and Finance Subcommittee, Oct. 7, 1993 ("PSA Testimony") at 5-7; NASACT, State and Local Government Securities Markets and Secondary Market Disclosure (Oct. 1993) at 5; Stamas, "Issuers' Intentions on Secondary Market Disclosure are Starting to Appear in Official Statements," The Bond Buyer (Dec. 14, 1992) at 1; Standard & Poor's, "In Support of Secondary Market Disclosure," CreditWeek Municipal (Mar. 16, 1992).

[22] PSA Testimony at 5. See also Lehmann Testimony at 4; NASACT Testimony at 3; Nemes, "Investors' Service Steps in to Fill Void in Hospital Data Disclosure," Modern Healthcare (Feb. 3, 1992) at 46; Quint, "Credit Markets; Aiming for More Data About Municipal Bonds," The New York Times (June 28, 1993) at D5; Schifrin, "Hello, Sucker," Forbes (Feb. 1, 1993) at 40.

[23] NASACT, Report of the Blue Ribbon Committee on Secondary Market Disclosure--Improving Secondary Market Disclosure (Aug. 1993) ("NASACT Blue Ribbon Committee Report") at 1-2.

[24] See id. at 1. See also Allstate Letter.

[25] See Bond Buyer 1993 Yearbook at 3-5; Municipal Bond Defaults--The 1980's; a Decade in Review (J.J. Kenny Co., Inc. 1993)("Kenny Default Report"); Public Securities Association, An Examination of Non-Rated Municipal Defaults 1986-1991 (Jan. 8, 1993)("PSA Default Report"); Staff Report, Appendix B.

[26] See NASACT Blue Ribbon Committee Report at 1-2.

[27] Joint Statement on Improvements in Municipal Securities Market Disclosure ("Joint Statement") (Dec. 20, 1993) at 1. The Joint Statement was submitted by the American Bankers Association's Corporate Trust Committee, American Public Power Association, Association of Local Housing Finance Agencies, Council of Infrastructure Financing Authorities, Government Finance Officers Association, National Association of Bond Lawyers, National Association of Counties, National Association of State Auditors, Comptrollers and Treasurers, National Association of State Treasurers, National Council of State Housing Agencies, National Federation of Municipal Analysts, and Public Securities Association.

[28] Id.

[29] See In re Washington Public Power Supply System Securities Litigation, 623 F. Supp. 1466, 1478 (W.D. Wash. 1985). See also Brown v. City of Covington, 805 F.2d 1266, 1270 (6th Cir. 1986).

significance in the deliberations of the reasonable (investor). Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[30]

*B. Voluntary Guidelines*

In the primary offering of municipal securities, the extensive voluntary guidelines issued by the Government Finance Officers Association ("GFOA") have received widespread acceptance and, among a number of larger issuers, have been viewed as "in essence obligatory rules."[31] Other groups, including the National Federation of Municipal Analysts ("NFMA"), have published voluntary disclosure guidelines covering industry specific sectors, including among others, housing, student loans, transportation and health care.[32] In connection with the offering of municipal securities, the GFOA Guidelines call for:[33]

- An introduction to serve as the guide to the official statement;
- A description of the securities being offered, including complete information regarding the purposes of the offering, the plan of financing, the security and sources of repayment, and the priority of the securities, as well as structural characteristics, such as call provisions, tender options, original issue or deep discount, variable rates, and lease purchase agreements;
- Information regarding the nature and extent of any credit enhancement and financial and business information about the issuer of the enhancement;
- A description of the government issuer or enterprise, including information about the issuer's range or level of service, capacity and demographic factors and, in the case of revenue supported offerings, information on the enterprise's organization, management, revenue structure, results of operations and operating plan;
- With respect to obligations of private profit making and nonprofit conduit issuers, information regarding the business or other activity, including the enterprise's form of organization and management, rate-making or pricing policies, and historical operations and plan of operation;
- A description of the issuer's outstanding debt, including the authority to incur debt, limitations on debt, and the prospective debt burden and rate of its retirement;
- A description of the basic documentation, such as indentures, trust agreements and resolutions authorizing the issuance and establishing the rights of the parties;

Financial information, including summary information regarding the issuer's or obligor's financial practices and results of operations, and financial statements, prepared in conformity with generally accepted accounting principles and audited in accordance with generally accepted auditing standards;

A discussion of legal matters, such as pending judicial, administrative, or regulatory proceedings that may significantly affect the securities offered, legal opinions, and tax considerations; and

A discussion of miscellaneous matters, including ratings and their description and meanings, underwriting arrangements, arrangements with financial advisors, interests of named experts, pending legislation, and the availability of additional information and documentation.

The guidelines prepared by the GFOA and the NFMA provide a generally comprehensive roadmap for disclosure in offering statements for municipal securities offerings. There are, however, areas that need further improvement in both the context of negotiated and competitively bid underwritings. In addition, implementation of these guidelines needs to be extended to the whole market. For example, while large repeat general obligation issuers usually have comprehensive disclosure documents, small issuers and conduit issuers, particularly in the health care, housing and industrial development areas, do not always provide the same quality of disclosure.[34]

*C. Areas Where Improvement Is Needed*

1. Conflicts of Interest and Other Relationships or Practices

Information concerning financial and business relationships and arrangements among the parties involved in the issuance of municipal securities may be critical to an evaluation of an

[30] TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

[31] Letter from Harlan E. Boyles, Treasurer of North Carolina to SEC Chairman Levitt, dated December 7, 1993. See Government Finance Officers Association, Disclosure Guidelines for State and Local Government Securities (Jan. 1991) ("GFOA Guidelines").

[32] See NFMA, Disclosure Handbook for Municipal Securities 1992 Update (Nov. 1992) ("NFMA Handbook"). See also Government Accounting Standards Board, Codification of Government Accounting and Financial Reporting Standards (2d ed. 1987); PSA, Recommendations for a Consistent Presentation of Basic Bond Provisions in Official Statements (Dec. 1989).

[33] GFOA Guidelines at xv-xix (summary).

[34] See NASACT Blue Ribbon Committee Report at 1-2; Staff Report at 26. Industry participants generally agreed in testimony before the House of Representatives Subcommittee on Telecommunications and Finance on October 7, 1993, that both the greatest disclosure problems and the greatest risk of default were with unrated hospital, housing, special district and industrial development revenue bonds.

offering.[35] Recent revelations about practices used in the municipal securities offering process have highlighted the potential materiality of information concerning financial and business relationships, arrangements or practices, including political contributions, that could influence municipal securities offerings. For example, such information could indicate the existence of actual or potential conflicts of interest, breaches of duty, or less than arm's-length transactions. Similarly, these matters may reflect upon the qualifications, level of diligence, and disinterestedness of financial advisers, underwriters, experts and other participants in an offering. Failure to disclose material information concerning such relationships, arrangements or practices may render misleading statements made in connection with the process, including statements in the official statement about the use of proceeds, underwriters' compensation and other expenses of the offering. In addition, investors reasonably expect participants in municipal securities offerings to follow standards and procedures established by such participants, or other governing authorities, to safeguard the integrity of the offering process; accordingly, material deviations from those procedures warrant disclosure.

Existing rules and voluntary guidelines call for certain specific disclosures by offering participants. GFOA guidelines call for offering statement disclosure to investors of contingency fees to named experts, including counsel, and any other interest or connection those parties have with other transaction participants.[36] MSRB rules call for dealer disclosure to issuers and investors of any financial advisory relationship between an issuer and a broker, dealer, or municipal securities dealer, under certain circumstances.[37] MSRB rules also call for dealer disclosure to investors of, among other things, certain fees and expenses in negotiated transactions.[38]

Beyond existing specific disclosure requirements and guidelines, the range of financial and business relationships, arrangements and practices that need to be disclosed depends on the particular facts and circumstances of each case. If, for example, the issuer (or any person acting on its behalf) selects an underwriter, syndicate or selling group member, expert, counsel or other party who has a direct or indirect (for example, through a consultant) financial or business relationship or arrangement with persons connected with the offering process, that relationship or arrangement may be material.[39] Areas of particular concern are undisclosed payments to obtain underwriting assignments and undisclosed agreements or arrangements, including fee splitting, between financial advisers and underwriters.[40] If the adviser is hired to assist the issuer, such relationships, financial or otherwise, may divide loyalties. Similarly, affiliations between sellers of property to be used in a financed project and conduit borrowers raise questions regarding, among other things, the determination of fair market value of the property and self-dealing.

2. Terms and Risks of Securities

Evolution in the financial markets has led to increasingly complex and sophisticated derivative and other municipal products. While these new products offer investors a wide range of investment alternatives, in choosing among the alternatives, investors need a clear understanding of the terms and the particular risks arising from the nature of the products.[41]

In particular, investors need to be informed about the nature and effects of each significant term of the debt, including credit enhancements and risk modifiers, such as inverse floaters and detachable call rights. Investors in these securities should be aware of their exposure to interest rate volatility, under all possible scenarios. In addition, any legal risk concerning the issuer's authority to issue securities with unconventional features needs to be disclosed. The PSA recently has identified disclosure that should be provided in connection with the offer of financial

[35] See SEC v. Washington County Utility District, 676 F.2d 218, 222 (6th Cir. 1982) ("Flagrant violations" of antifraud provisions arising from failure to disclose use of proceeds to purchase options on property held by issuer's manager and financial arrangements between the manager and the underwriter).

[36] Section XII.D. of the GFOA Guidelines.

[37] MSRB rule G-23.

[38] MSRB rule G-32. See Section 15B(c)(1) of the Exchange Act (15 U.S.C. 78o-4(c)(1)) (requiring compliance with MSRB rules); MSRB rule G-17.

[39] Gasparino, "The Trouble with Consultants", The Bond Buyer (Nov. 16, 1993) at 1. In his testimony before the Subcommittee on Telecommunications and Finance, Andrew Kintzinger, on behalf of the National Association of Bond Lawyers ("NABL"), stated: "(M)embers of the municipal finance bar should work with issuers to develop procurement procedures for state and local governments to ensure that all material financial arrangements between underwriters within the syndicate and between underwriters and financial advisors and possible conflicts of interest between issuers and members of the underwriting syndicate or other participants be accurately documented and disclosed or, if appropriate, prohibited." NABL Testimony at 28. See Joint Statement at 2.

[40] Gasparino, "Several Issuers Start to Scrutinize Ties Between Advisers, Bankers," The Bond Buyer (Dec. 27, 1993) at 1. See Section XII.C. of the GFOA Guidelines; rule G-23 of the MSRB.

[41] As the NABL Testimony indicates: "Derivatives are sophisticated securities products designed for sophisticated investors and should not be sold to retail investors generally and certainly not without comprehensive disclosure. If issuers choose to undertake the financial benefits of these sophisticated and complicated transactions, they can assume the financial costs of providing * * * information." NABL Testimony at 22.

instruments that include such features as auction and swap-based inverse floaters and embedded cap bonds.[42]

Credit enhancements are used with increasing frequency in the municipal market. According to published information, over 37% of the dollar volume of new long term issues carry some form of credit enhancement.[43] The existence of bond insurance or other credit enhancement creates the need for disclosure concerning the provider of the credit enhancement and the terms of the enhancement[44] to avoid misleading investors concerning the value of the enhancements provided and the party's ability to fund the enhancement. The GFOA recommends that appropriate financial information about the assets, revenues, reserves and results of operations of credit enhancers be provided in the official statement. In determining the extent of disclosure, consideration should be given to the amount of the enhancement relative to the income and cash flows of the issuer or obligor, conditions precedent to application of the enhancement, duration of the enhancement, and other factors indicating a material relationship between the enhancement and the investor's anticipated return.

In a trend that has become increasingly common, municipal bond insurers are including in indentures provisions that appear to delegate to the bond insurer the ability to modify terms of the indenture, prior to default, without the consent of, or even prior notification to, bondholders.[45] There should be clear disclosure of any such provision that may have a material impact on the rights of bondholders or the obligations of the issuer, including the specific material rights of the bondholder that could be so altered.

3. Financial Information

a. *Financial Accounting.* Sound financial statements are critical to the integrity of the primary and secondary markets for municipal securities, just as they are for corporate securities.[46] The key to the reliability and relevancy of the information contained in the financial statements of a municipal issuer is the use of a comprehensive body of accounting principles consistently applied by the issuer.[47]

Although there continues to be some diversity in the financial reporting practices used in preparing financial statements of governmental issuers, practice in the municipal market is evolving rapidly to reliance on generally accepted accounting principles ("GAAP") as determined by the Government Accounting Standards Board ("GASB").[48] Only two years after GASB was founded in 1984, financial statements prepared in accordance with GAAP, as promulgated by GASB, were required by 75.2% of cities, 78.3% of counties and 69% of school districts responding to a research survey.[49] Forty-six states currently require, or are in the process of establishing a requirement, that state government financial statements be presented in accordance with GAAP.[50] In addition, local as well as state governments that receive significant amounts of federal aid must prepare financial statements in accordance with GAAP or provide information concerning variance from GAAP.[51]

The GFOA Guidelines call for financial statements that are either prepared in accordance with GAAP or accompanied by a quantified (if practicable) explanation of the differences.[52] To avoid misunderstanding, investors need to be informed of the basis for financial statement presentation. Accordingly, when a municipal issuer neither uses GAAP nor provides a quantified explanation of material deviations from GAAP, investors need a full explanation of the accounting principles followed.

b. *Audits.* Investors in the public securities markets have a reasonable expectation that annual financial statements contained in offering documents or periodic reports are subject to audit.[53] In the case of municipal issuers, these financial statement audits are typically conducted by either an independent certified public

[42] PSA, Recommendation on Dissemination of Product–Specific Terms For Municipal Derivative Products (1993).

[43] PSA, Municipal Market Developments (Aug. 1993) at 5.

[44] See Revisions to Rules Regulating Money Market Funds, Securities Act Rel. No. 7038, 58 FR 68585, 68588 (footnote omitted) ("Money Market Fund Release"); Securities and Exchange Commission, Report by the United States Securities and Exchange Commission on the Financial Guarantee Market: The Use of the Exemption in Section 3(a)(2) of the Securities Act of 1933 for Securities Guaranteed by Banks and the Use of Insurance Policies to Guarantee Debt Securities (Aug. 28, 1987) ("SEC Financial Guarantee Report") at 82; Adopting Release, 54 FR at 28812.

[45] See Allstate Letter.

[46] See NY City Report at Ch. II p. 92.

[47] See GFOA Guidelines at 50.

[48] The financial statements of corporate obligors backing conduit securities should follow GAAP for such entities, as established by the Financial Accounting Standards Board and other bodies.

[49] Ingram & Robbins, Financial Reporting Practices of Local Governments, Government Accounting Standards Board (1987) at 12 (The survey results were based on information received from 567 respondents to a survey questionnaire mailed to 1161 government units).

[50] State Comptrollers: Technical Activities and Functions (1992 Edition).

[51] Where state and local governments programs that are subject to the federal "Single Audit Act of 1984," Public Law 98-502 et seq. prepare financial statements on a basis other than GAAP, "the audit report should state the nature of the variances therefrom and follow professional guidance for reporting on financial statements which have not been prepared in accordance with GAAP." Office of Management and Budget, "Questions and Answers on the Single Audit Process of OMB Circular A-128, 'Single Audits of State and Local Governments,' " 52 FR at 43716 (Nov. 13, 1987), question 35.

[52] GFOA Guidelines at 45.

[53] See Gauthier, An Elected Official's Guide to Auditing (1992) at vii and xi.

accountant or a state auditor. Although the frequency and timeliness of audits vary, every state requires some periodic audit verification of government financial statements.[54] A prudent investor needs to be able to evaluate the extent to which he or she can rely on the second look an auditor provides.

Accordingly, the offering statement should state whether the financial statements it contains were audited in accordance with generally accepted auditing standards ("GAAS"), as established by the American Institute of Certified Public Accountants.

c. *Other Financial and Operating Information.* Financial information beyond that contained in the financial statements--provided in tabular and narrative format, footnotes, supplemental tables, schedules and discussions of operations and financial position--is essential to the fair presentation of an issuer's financial performance and position. As reflected in industry guidelines,[55] the type of information needed (e.g., tax revenue base, budget, demographics, project revenues and operations) varies depending on the type of issuer, the type of security sold, and the sources for repayment of the bond obligations.

There are a number of areas in which greater care needs to be taken to provide investors with adequate information. In a pooled financing structure, such as that used by bond banks, in addition to providing financial information concerning the issuing authority or program in the aggregate, it may be necessary to provide information on participating obligors. This will depend on diversification and risk concentration factors, such as the significance of any single obligor to the overall financing.

Conduit bond issuers need to provide operational information concerning the activities of the private enterprise that will provide the cash flows to service the debt--for example, financial reporting, legal proceedings, changes in indebtedness, defaults and other significant developments relating to the underlying corporate obligor. Where the issuing authority in a conduit financing has no remaining obligation for the repayment of the indebtedness, in providing financial information about the issuing entity (as compared to the obligor on the bonds), care must be taken to avoid misleading investors regarding the sources of repayment.[56]

Municipal issuers also must consider disclosure issues arising from their activities as end users of derivative products. For example, the use of non-exchange traded derivatives to alter interest rate risk exposes the issuer to counterparty credit risk. Disclosure documents need to discuss the market risks to which issuers are exposed, the strategies used to alter such risks and the exposure to both market risk and credit risk resulting from risk alteration strategies. The NFMA has published sector specific secondary market disclosure guidelines calling for a discussion of the issuer's use of derivative products, especially interest rate swaps.[57]

Moreover, in addition to financial and operating data, the official statement may need to include a narrative explanation to avoid misunderstanding and assist the reader in understanding the financial presentation. A numerical presentation alone may not be sufficient to permit an investor to judge financial and operating condition of the issuer or obligor.[58] For example, it may be necessary to explain the presentation of budget information and the relationship of the budget figures to the financial statements.

In addition, issuers must assess whether the future impact of currently known facts mandate disclosure. The GFOA Guidelines call for a description of known facts that would significantly affect the financial information presented or future financial operation of the issuer, as well as a discussion of its projected operations.[59] For example, in a hospital financing, a steadily declining population in the surrounding community that, in the future, would not support the size of facility to be built would be important to investors. Disclosure of such currently known conditions and their future impact is critical to informed decisionmaking.

d. Timeliness of Financial Statements. The timeliness of financial information is a major factor in its usefulness. To avoid providing investors with a stale, and therefore potentially misleading, picture of financial condition and results of operations, issuers and obligors need to release their annual financial statements as soon as practical. After extensive discussion with market participants, it appears that, for the most part, audited financial statements of municipal issuers for the most recently completed fiscal year are available within six months after fiscal year end. The six month time period is consistent with the recommendations of NASACT's Blue Ribbon Committee Report.[60]

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[54] State Comptrollers: Technical Activities and Functions; NASACT, Municipal Task Force Report (1990) ("NASACT 1990 Task Force Report") at 12.

[55] See generally, GFOA Guidelines; NFMA Handbook. See also infra n. 84.

[56] See Letter of John Murphy, Executive Director of Association of Local Housing Finance Agencies to Chairman Levitt (Dec. 20, 1993).

[57] NFMA Handbook.

[58] See Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Securities Act Release No. 6835 (May 24, 1989), 54 FR 22427; Securities Act Release No. 6711 (April 24, 1987), 52 FR 13715.

[59] GFOA Guidelines at 55.

[60] See NASACT Blue Ribbon Committee Report at 17. While due dates for audited financial statements of government units differ, a significant majority of states currently require audited financial statements for government units to be

Unaudited financial statements should be provided when available prior to the completion of the audit.

4. Availability of Continuing Information

An investor's ability to monitor future developments affecting the issuer, as well as the likely liquidity of a security, are important to an investor's evaluation of an offering. The official statement should state clearly whether ongoing disclosure concerning the issuer or obligor will be provided, including the type, timing, and method of providing such information.[61] In deciding whether to purchase the securities or to continue to hold them, investors need to know whether the issuer has committed to provide information on an ongoing basis.[62] The absence of such a commitment can adversely affect the secondary market for the securities and increases the risks of the investment.

As discussed above, the Joint Statement recommends that the Commission adopt a rule prohibiting a municipal securities dealer from underwriting securities absent a commitment to provide ongoing information. In the Companion Release, the Commission is proposing such a rule for comment. In order to fully inform investors, an issuer needs to include in the official statement a description of the scope of its continuing disclosure commitment, the type of information that would be provided, the repositories to which the information would be sent, when annual and other periodic information would be available, and the consequences of the issuer's failure to abide by the requirements of the covenant.

5. Clarity and Conciseness

Like other disclosure documents, official statements need to be clear and concise to avoid misleading investors through confusion and obfuscation. The expanded level of disclosure in official statements and increased sophistication of municipal securities instruments have, in many cases, resulted in longer and more complex disclosure documents, with the corresponding danger of overly detailed, legalistic, and possibly obtuse disclosure.[63]

The location, emphasis, and context of the disclosure can affect the ability of a reasonable investor to understand the relationship between, and cumulative effect of, the disclosure.[64] As the U.S. Court of Appeals for the Second Circuit has stated:

(D)isclosures in a prospectus must steer a middle course, neither submerging a material fact in a flood of collateral data, nor slighting its importance through seemingly cavalier treatment. The import of the information conveyed must be neither oversubtle nor overplayed, its meaning accurate, yet accessible.[65]

Appropriate disclosure "is measured not by literal truth, but by the ability of the material to accurately inform rather than mislead" investors.[66] As the Commission has indicated in other contexts, legalistic, overly complex presentations and inattention to understandability can render the disclosure incomprehensible and consequently misleading.[67]

6. Delivery of Official Statements

One of the concerns leading to the adoption of Rule 15c2-12 was that underwriters were not receiving official statements within time periods that would allow them to examine the accuracy of the disclosure.[68] The Commission noted in proposing the rule that a thorough, professional review by underwriters of municipal offering documents could encourage appropriate disclosure of foreseeable risks and accurate descriptions of complex put and call features, as well as novel financing structures now employed in many municipal offerings. In addition, with the increase in novel or complex financings, there may be greater value in having investors receive disclosure documents describing fundamental aspects of their investment. Yet, underwriters are unable to perform this function effectively when offering statements are not provided to them on a timely basis.[69]

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filed within six months after the fiscal year end. NASACT 1990 Task Force Report at 12-22.

[61] See Fall 1992 NFMA Survey. See also American Bankers Association, Corporate Trust Committee, Four Point Public 1991 Disclosure Guidelines for Corporate Trustees ("ABA 1991 Guidelines") at 2; Stamas, "Issuers' Intentions on Secondary Disclosure are Starting to Appear in Official Statements," The Bond Buyer (Dec. 14, 1992) at 1.

[62] See MSRB, Report of the Municipal Securities Rulemaking Board on Regulation of the Municipal Securities Market (Sept. 1993) at 6-7 (Board announced plan that would include requiring underwriters to recommend to issuers that they provide continuing disclosure to the market and requiring municipal securities dealers to disclose to their customers the negative impact that the lack of secondary market information may have on the value and liquidity of the securities and whether the issuer has agreed to voluntarily provide such disclosures).

[63] See GFOA Testimony at 6. See also Allstate Letter.

[64] Isquith v. Middle South Utilities, 847 F.2d 186, 201 (5th Cir.), cert. denied, 488 U.S. 926 (1988); Kas v. Financial General Bankshares, Inc., et al., 796 F.2d 508, 516 (D.C. Cir. 1986); Kennedy v. Tallant, 710 F.2d 711, 720 (11th Cir. 1983).

[65] Isquith, 847 F.2d at 202.

[66] McMahan & Company, et. al. v. Wherehouse Entertainment, Inc., 900 F.2d 576, 579 (2d Cir. 1990).

[67] See, e.g., Limited Partnership Reorganizations and Public Offerings of Limited Partnership Interests, Securities Act Release No. 6900 (June 25, 1991) 56 FR 28979, 28980 ("Limited Partnership Release").

[68] Proposing Release, 53 FR at 37781.

[69] Proposing Release, 53 FR at 37782.

To address this concern, the rule requires any underwriter, including lead underwriters, syndicate members, and selling group members that receive in excess of the usual seller's commission, to obtain and review an official statement that is deemed final as of its date by the issuer, except for the omission of certain information, before bidding for, purchasing, offering, or selling municipal securities in a primary offering.

Since the adoption of Rule 15c2-12, however, there have been continued problems with the timeliness of receipt by underwriters of the "near final" official statement required by the Rule.[70] In addition to compromising the ability of an underwriter to make a reasonable investigation of the issuer, this problem also may limit the ability of potential customers to make informed investment decisions. In a recent NFMA survey, 59% of those responding rated the delivery of preliminary official statements in competitive sales as either not very good or poor, and 50% rated the delivery of preliminary official statements in negotiated sales as either not very good or poor.[71]

One cause of delay has been confusion as to the point at which the underwriter must have obtained and reviewed the near final official statement in a negotiated offering. The term "offer" traditionally has been defined broadly under the federal securities laws and, for purposes of Rule 15c2-12, encompasses the distribution of a preliminary official statement by the underwriter, as well as oral solicitations of indications of interest. Thus, prior to the time that the underwriter distributes the preliminary official statement to potential investors, or otherwise begins orally soliciting investors, the rule requires it to have obtained and reviewed a near final official statement. If no offers are made, the underwriter is required to obtain and review a near final official statement by the earlier of the time the underwriter agrees (whether in principle or by signing the bond purchase agreement) to purchase the bonds, or the first sale of bonds to investors.[72]

The Commission has acknowledged that the rule would require greater planning and discipline by some issuers.[73] The Commission anticipated that, in order to allow underwriters to meet their obligation to have a reasonable basis for recommending any municipal securities, issuers would have to begin drafting disclosure documents earlier, and perhaps with greater care than in the past.[74] ] This result enables underwriters to receive, and if necessary influence the content of, the final official statement before committing themselves to an offering.[75] Moreover, placing an obligation on the issuer to prepare the official statement at an earlier stage is appropriate, because it is the issuer's obligation to ensure that there is timely dissemination of disclosure documents in connection with the offer and sale of the issuer's securities.[76]

D. Conduit Financings

When financing involves a third party as the source of repayment, investors need information on that underlying borrower. The GFOA Guidelines call for description of conduit obligors, which are defined by the GFOA Guidelines to include both private profit-making and nonprofit entities.[77] The suggested information includes the nature and development of the business or other activity to be undertaken by the conduit obligor (including its form of organization and management), location of principal facilities and service area, ratemaking or pricing policies and historical operations and plan of operations.

To address disclosure issues involving conduit financings in a comprehensive fashion, however, legislation addressing the exempt status of conduit securities under the federal securities laws is necessary. Bonds used to finance a project to be used in the trade

[70] As a practical matter, near final official statements distributed to underwriters to satisfy Rule 15c2-12(b)(1) are often the same document as the preliminary official statement distributed to potential customers pursuant to Rule 15c2-12(b)(2). See Mudge Rose Guthrie Alexander & Ferndon (April 4, 1990) ("Mudge Rose") (rejecting the argument that in a negotiated offering, the identification of a credit enhancer and related information about the credit enhancer may be omitted on the assumption that the information depends on pricing). See also Fippinger & Pittman, Disclosure Obligations of Underwriters of Municipal Securities, 47 Business Lawyer 127, 140 (Nov. 1991). In addition, underwriters are required to deliver to potential customers, upon request, copies of the final official statement for a specified time period. Rule 15c2-12(b)(4).

[71] NFMA Survey. See also Letter from Jeffrey M. Baker, Chairperson, NFMA Industry Practices and Procedures Committee and Richard A. Ciccarone, Past Chairperson, NFMA Industry Practices and Procedures Committee to Arthur Levitt, Chairman, Securities and Exchange Commission, Christopher A. Taylor, Executive Director, MSRB and Joseph R. Hardiman, President and Chief Executive Officer, National Association of Securities Dealers, Inc. (Oct. 19, 1993) (regarding the timeliness of receipt of near final and preliminary official statements).

[72] See Mudge Rose.

[73] Adopting Release, 54 FR at 28804. The Commission also noted that the requirements of Rule 15c2-12(b)(1) could be met through the use of multiple documents. For example, a frequent issuer might be able to supply a recent official statement, together with supplementary information containing the terms of the current offering, as well as any material changes from the previous offering materials.

[74] Proposing Release, 53 FR at 37790.

[75] Id.

[76] See Adopting Release, 54 FR at 28811 N. 84 (official statement is issuer's document).

[77] GFOA Guidelines at 26. In a recent policy statement, the GFOA referred to "conduit bonds" as "municipal securities issued by a state or local government for the benefit of a private corporation or other entity that is ultimately obligated to pay such bonds * * *." GFOA, Committee on Governmental Debt and Fiscal Policy, Improvements in Municipal Securities' Market Disclosure (Feb. 1, 1994) ("GFOA Disclosure Policy Statement").

or business of a private corporation are, from an investment standpoint, equivalent to corporate debt securities issued directly by the underlying corporate obligor.[78] Payments on these types of conduit securities are derived solely from revenues received by the governmental entity under the terms of a contractual agreement, typically a lease or a note, from a private enterprise, rather than from the general credit and taxing power of the governmental issuer. The tax-exempt status of interest payments does not alter the fundamental analysis that these are private obligations, in which the investor looks, and can look, only to a private entity for repayment.

The private nature of many conduit enterprises distinguishes them from traditional municipal financings. The incidence of bond default appears to be inversely related to the degree a financed project represents an essential public service.[79] A study conducted by the PSA on non-rated issues that defaulted found that 75% were issued by local authorities in the areas of health care and industrial related sectors such as energy, chemical, pollution control and industrial development.[80]

Given the essentially private nature of non-governmental industrial development financings, investors need the same disclosure regarding the underlying non-municipal corporate obligor as they would receive regarding any corporate obligor, and the same regulatory and liability scheme should apply. Accordingly, the Commission has consistently supported legislative proposals to amend Section 3(a)(2) of the Securities Act[81] and Section 3(a)(29)[82] of the Exchange Act to remove the registration exemption for the corporate credit underlying municipal conduit securities involving non-governmental industrial development (private activity) financings.[83] The Commission today renews that legislative recommendation.

Pending amendment to the securities laws to eliminate the registration exemption, the disclosure provided by such non-governmental conduit borrowers should be substantially the same as if such conduit borrower were subject to the information requirements of the federal securities laws applicable to the particular conduit borrower. For example, financial statements prepared in accordance with generally accepted accounting principles prescribed by the Financial Accounting Standards Board should be provided.

## IV. Disclosure in the Secondary Market for Municipal Securities

While significant progress has been made in primary market disclosure practices in recent years, the same development has not taken place with respect to secondary market disclosure. The GFOA issued separate secondary market disclosure guidelines in 1979, but they have not yet achieved the broad acceptance accorded its primary offering guidance. In the last five years, the NFMA, the National Council of State Housing Agencies, and the Association of Local Housing Authorities have published sector specific guidelines for secondary market disclosure; the National Advisory Council of the National Association of State Auditors, Comptrollers and Treasurers ("NASACT") is in the process of preparing such guidelines for adoption by the states.[84] The GFOA's longstanding Certificate of Achievement program recognizes issuers that have prepared comprehensive annual financial reports meeting its guidelines. The NFMA's Award of Recognition Program likewise recognizes issuers that have committed to provide continuous disclosure.

### *A. Application of Antifraud Provisions*

[78] See Money Market Fund Release, 58 FR at 68588 (proposal to subject tax exempt money market fund investments in conduit securities to restrictions similar to those applicable to securities of comparable obligors offered to taxable funds).

[79] Kenny Default Report at 2.

[80] PSA Default Report at 12.

[81] 15 U.S.C. 77c(a)(2).

[82] 15 U.S.C. 78c(a)(29).

[83] See Remarks of David S. Ruder, Chairman, SEC, "Disclosure in the Municipal Securities Markets," Before the Public Securities Association (Oct. 23, 1987) at 17-18; Letter from John S.R. Shad, Chairman, SEC to Representative Timothy E. Wirth, Chairman, House Subcommittee on Telecommunications, Consumer Protection, and Finance (March 12, 1985); 124 Cong. Rec. 21, 639 (1978) (letter from SEC Chairman Harold M. Williams to Senator Harrison A. Williams). There were two bills introduced, one in 1975 and one in 1978, that would have repealed the exemption from the registration requirements of the Securities Act of 1933. The 1978 bill would have subjected certain industrial development bonds to the registration requirements of the Securities Act of 1933, the filing and qualification provisions of the Trust Indenture Act and the periodic reporting requirements of the Securities Exchange Act of 1934. Neither bill was enacted. See also "Municipal Securities Full Disclosure Act of 1976," S. 2969, 94th Cong., 2d. Sess. (Feb. 17, 1976).

Governmental industrial development financings, which would have retained their exempt status under prior proposals, include those financings in which the bonds are repaid from the general revenues of the governmental unit or the project or facility is a public facility (or part of a public facility) and owned and operated by or on behalf of the governmental unit. The prior proposals to register conduit financings would not have affected the separate exemption for securities issued by non-profit charitable organizations in Section 3(a)(4) of the Securities Act (15 U.S.C. 77c(a)(4)).

[84] See Association of Local Housing Finance Agencies, Guidelines for Information Disclosure to the Secondary Market (1992) ("Local Housing Guidelines"); National Council of State Housing Agencies, Quarterly Reporting Format for State Housing Finance Agency Single Family Housing Bonds (1989) and Multi-family Disclosure Format (1991) collectively ("State Housing Guidelines"); NFMA Handbook. See also Healthcare Financial Management Association, Statement of Principles of Public Disclosure of Financial and Operating Information by Healthcare Providers (Exposure Draft dated Aug. 1, 1993) ("Healthcare Disclosure Principles").

Participants in the municipal securities market do not dispute the need for ongoing disclosure following an offering of securities, but municipal issuers reportedly resist developing a routine of ongoing disclosure to the investing market because of concerns about the costs of generating and disseminating that information and about potential liability relating to such disclosure. These issuers and obligors are at times advised by their professional advisors that there is no duty under the federal securities laws to make disclosure following the completion of the distribution.[85] At least some municipal issuers thus appear to believe that silence shields them from liability for what may later be found to be false or misleading information. As a practical matter, however, municipal issuers do not have the option of remaining silent. Given the wide range of information routinely released to the public, formally and informally, by these issuers in their day-to-day operations, the stream of information on which the market relies does not cease with the close of a municipal offering. In light of the public nature of these issuers and their accountability and governmental functions, a variety of information about issuers of municipal securities is collected by state and local governmental bodies, and routinely made publicly available.[86] [FN86] Municipal officials also make frequent public statements and issue press releases concerning the entity's fiscal affairs.

A municipal issuer may not be subject to the mandated continuous reporting requirements of the Exchange Act, but when it releases information to the public that is reasonably expected to reach investors and the trading markets, those disclosures are subject to the antifraud provisions.[87] The fact that they are not published for purposes of informing the securities markets does not alter the mandate that they not violate antifraud proscriptions.[88] Those statements are a principal source of significant, current information about the issuer of the security, and thus reasonably can be expected to reach investors and the trading market. As the U.S. Court of Appeals for the Second Circuit has said: "The securities markets are highly sensitive to press releases and to information contained in all sorts of publicly released . . . documents, and the investor is foolish who would ignore such releases."[89] Since investors obtain information concerning the fiscal health of a municipal issuer from its public statements concerning financial and other matters, "(t)he nature of these statements and the assumptions upon which they are based must be carefully and accurately communicated to the public, so that potential investors may be fully informed of all material facts relevant to their investment decision."[90]

The current process by which municipal issuers and their officials release information to market participants does not address the risk of misleading investors, because there is no mechanism for disseminating information about the municipal issuer to the market as a whole. To the contrary, in the municipal market, information released publicly frequently is disseminated only to a narrow segment of the marketplace. For example, market participants who request current information from indenture trustees are often turned away on the grounds that they are not current holders of the securities.[91] [FN91] As a result, investors purchasing municipal securities in the secondary market risk doing so on the basis of incomplete and outdated information.

Since access by market participants to current and reliable information is uneven and inefficient, municipal issuers presently face a risk of misleading investors through public statements that

[85] See Stamas, "Issuers' Intentions on Secondary Market Disclosure Are Starting to Appear in Official Statements," The Bond Buyer (Dec. 14, 1992) at 1; Stamas, "Why the Issue of Secondary-Market Disclosure Remains on the Back Burner: It Can Be Risky," The Bond Buyer (Sept. 20, 1991) at 1; Stamas, "Analysts Warn Issuers About Some Lawyers' Disclosure Advice," The Bond Buyer (Jan. 15, 1991) at 1.

[86] See NASACT Blue Ribbon Committee Report at 2, 24; NASACT 1990 Task Force Report at 21.

[87] See Public Statements by Corporate Representatives, Securities Act Release No. 6504 (Jan. 20, 1984) 49 FR 2468, 2469; In re Ames Dept. Stores Inc. Stock Litigation, 991 F.2d 953, 965-67 (2d Cir. 1993) (with respect to corporate information).

[88] See Fippinger, The Securities Law of Public Finance (2d ed. 1993) at 291 ("(P)ress releases, conversations with analysts, information meetings, official comments on budget negotiations, and even angry reactions by public officials to rating agency downgrades" are subject to antifraud provisions).

[89] Ames, 991 F.2d at 963 (corporate information).

[90] NY City Report at Ch. III at 2. The report found that public statements by City officials were misleading, since they were characterized by unwarranted reassurances as to the soundness and attractiveness of the City's securities, including statements that the City's budget problems, no matter how serious, had nothing to do with the City's ability to pay its debts. Id. at 110-111.

Municipal issuers should also be sensitive to whether their official statements contain forward-looking statements, such as projections of revenues, that remain alive in the market and may require updating in light of subsequent events. Guides for Disclosure of Projections of Future Economic Performance, Exchange Act Rel. No. 5992 (Nov. 7, 1978), 43 FR 53246. To the extent that the official statement in many cases remains the principal (or perhaps even the sole) source of information concerning an outstanding security, the potential for an obligation to update is of particular importance.

[91] Under notice provisions of indentures, the issuer and trustee generally are required to provide notice to existing bondholders of events of default and other significant matters, such as a draw on reserves, a failure to renew a letter of credit, or a substitution of collateral. ABA 1991 Guidelines at 10. Indeed, trustees often deny requests by market participants for information out of concern for liability arising from exceeding the authority set forth in the indenture. Fippinger at 325. This situation led the American Bankers Association Corporate Trust Committee, in cooperation with the National Association of Bond Lawyers, to develop agreed upon guidelines for indenture provisions permitting the trustee to provide public notice of specified events. See ABA 1991 Guidelines.

may not be intended to be the basis of investment decisions, but nevertheless may reasonably be expected to reach the securities markets. As market participants have urged,[92] in order to minimize the risk of misleading investors, municipal issuers should establish practices and procedures to identify and timely disclose, in a manner designed to inform the trading market, material information reflecting on the creditworthiness of the issuer and obligor and the terms of the security.[93]

*B. Secondary Market Disclosure*

There is general recognition of the need for disseminating comprehensive information on an annual basis and, on a more timely basis, information about material events that reflect on the credit quality of the security.[94]

1. Annual Information

Investors need updated comprehensive information sufficient to enable them to evaluate the financial condition, results of operations and cash flows of the issuer or underlying borrower. Although the issuance of comprehensive annual information has not yet become prevailing practice, it is recommended by industry disclosure guidelines, including those published by the GFOA in connection with its Comprehensive Annual Financial Reports ("CAFRs") award program, NFMA, and the other industry specific guidelines,[95] and is an effective means of providing the market updated information about the issuer and the issue. The GFOA Guidelines for Continuing Disclosure call for, either in an official statement or comprehensive annual report, a description of:

The issuer and its structure, management, assets and operations;

The issuer's debt structure (including changes in indebtedness);

The issuer's finances (including financial condition and results of operations and financial practices of the issuer or the enterprise);

Legal matters affecting the issuer; including litigation and legislation;

Ratings; and

Interests of certain persons.

The GFOA Guidelines also specify additional information to be provided by conduit borrowers. The eligibility criteria for a Certificate of Achievement from GFOA include audited financial statements prepared in accordance with GAAP, reported upon by an independent public auditor. The guidelines for CAFRs include both a financial section and a statistical section.[96]

For frequent issuers, current information can be disseminated in official statements for new offerings, and thus is readily available without the preparation of a separate annual financial report. Regardless of the form of document relied upon to provide the marketplace with information concerning the financial condition of the issuer or obligor, to minimize risk of misleading investors, issuers or obligors should provide, as discussed above with respect to primary offerings:

- Financial statements that are audited in accordance with GAAS (or disclosure of the absence of such an audit) and that are either prepared in accordance with GAAP, or accompanied by a quantified explanation of material deviations from GAAP or a full explanation of the accounting principles used;
- Other pertinent financial and operating information (depending on the type of issuer and security sold), as well as the sources for repayment--of course, a variety of information may be appropriate for an issuer with a range of outstanding securities with differing characteristics, from general obligation to revenue and conduit bonds; and
- A narrative discussion that analyzes the issuer's or obligor's financial condition, and results of operations, as well as facts likely to have a material impact on the issuer or obligor.

Clarity and conciseness are equally relevant concerns with respect to ongoing disclosures, as with official statements.

As discussed above with respect to offering statements, as a general matter, the annual financial information may reasonably be expected to be made available within six months of the issuer's fiscal year end.[97] For some conduit entities, annual information may not be sufficient and investors may need more frequent periodic financial information. Under guidelines developed by the National

[92] See GFOA Guidelines at 91-97; Joint Statement.

[93] National Association of Bond Lawyers and Section of Urban, State and Local Government Law, American Bar Association, Disclosure Roles of Counsel in State and Local Government Securities Offerings at 135 (forthcoming 1994) (Pre-publication Draft) ("ABA Disclosure Roles") (noting that many municipal issuers have concluded that post-issuance disclosure in accordance with GFOA guidelines can be more efficient and expose them to less potential liability than ad hoc disclosures).

[94] See GFOA Testimony; Mires, "An Investor's Framework for Examining Disclosure Issues and Possible Solutions," The Bond Buyer (Feb. 7, 1994) at 24; NASACT Blue Ribbon Committee Report at 7. See also PSA Testimony at 6, supporting annual financial statement filing requirements and submission of information regarding any material fact for issuers who borrow $1 million or more annually.

[95] See ABA Disclosure Roles at 134-136; ABA 1991 Guidelines; Association of Local Housing Guidelines; Healthcare Disclosure Principles. The Disclosure Task Force of the National Council of State Housing Agencies is developing standards for the issuance of audited financial and annual reports.

[96] See GFOA Certificate of Achievement for Excellence in Financial Reporting Program; GFOA Guidelines at 64.

[97] See Section III.C.3.d. above.

Council of State Housing Agencies, for example, current information on loan portfolio status is compiled and disseminated to information repositories on a quarterly basis.[98] Similar ongoing disclosure on a periodic basis appears appropriate for analogous conduit municipal financings such as structured student loan programs, housing and health care financings.

2. Event Disclosure

In addition to periodic information, to assure that participants in the secondary market base their investment decisions on current information, commentators have called for timely disclosure of events that materially reflect on the creditworthiness of municipal securities issuers and obligors and the terms of their securities. There is a general consensus among participants in the municipal securities market that investors need information about the following events, among others, where material:[99]

a. Principal and interest payment delinquencies

b. Nonpayment-related defaults

c. Unscheduled draws on reserves

d. Unscheduled draws on credit enhancements

e. Substitution of credit or liquidity providers, or their failure to perform

f. Adverse tax opinions or events affecting the tax-exempt status of the security

g. Modifications to rights of security holders

h. Bond calls

i. Defeasances

j. Matters affecting collateral

k. Rating changes

3. Dissemination

As discussed above, the municipal market today lacks an effective mechanism for dissemination of material information to investors and the marketplace. To be effective in minimizing the issuer's risk under the antifraud provisions, the annual financial information and event disclosure should be disseminated in a manner reasonably designed to inform the holders of the issuer's securities and the market for those securities.

Trustees can serve as cost effective disseminators of information to the market due to the capacity and duties of trustees under the terms of the indentures, which positions them to have knowledge of the events requiring disclosure, and the ability and authority to communicate with bondholders.[100] The Commission encourages the inclusion of provisions in trust indentures that authorize trustees to transmit information to the market, particularly in structured financings where the issuer's obligations generally are delegated to various participants. Trustees also may provide a service to other small issuers, by enabling them to notify the market in a timely manner and at a lower cost.

The common denominator for current proposals to improve secondary market disclosure for municipal securities is the establishment and designation of one or more information repositories to serve as a collection and access point for annual and current information.[101] Such repositories would serve as predetermined sources for information concerning a particular issuer, allowing participants to verify that they have the latest available information concerning the issuer before recommending, purchasing, or bidding for a security. The repositories would supplement, not substitute for, the existing access bondholders may have to issuers to obtain current information.[102]

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[98] State Housing Guidelines.

[99] In 1990, the American Bankers Association Corporate Trust Committee drafted a proposal identifying 16 factors that it believed were important for issuers to disclose to bondholders and the marketplace. American Bankers Association Corporate Trust Committee, Proposed Disclosure Guidelines for Corporate Trustees (ABA Draft for Discussion Purposes) (June 12, 1990) ("ABA 1990 Guidelines"). As published in final form in September of 1991 ("ABA 1991 Guidelines"), the Guidelines contained a nonexclusive list of five types of events that could be disclosed by notice to a repository. Numerous market participants have referenced the ABA draft proposal, or variations of that proposal, as a starting point for identifying straightforward, nonjudgmental, categories of events that call for prompt disclosure. An addendum to the Joint Statement provided four examples of "significant information" that the participants considered appropriate for disclosure. The nonexclusive examples were (1) nontechnical defaults, (2) draws from a debt service reserve fund, (3) failure to make a regularly scheduled payment, and (4) any draws on any credit enhancement. Joint Statement, Addendum. The list set forth above is drawn from these proposals.

[100] See ABA 1991 Guidelines at 3.

[101] Consistent with the recent recommendation of the Joint Statement, the GFOA Guidelines call for lodging secondary market disclosure with a repository, as did the ABA guidelines published in 1991. GFOA Guidelines, Procedural Statement No. 8; ABA 1991 Guidelines at 3.

[102] The American Bankers Association Corporate Trust Committee and the National Association of Bond Lawyers, as well as the Joint Statement, have expressed concern that securities depositories and their participants do not retransmit notices they receive from trustees and issuers to the beneficial owners of the issuer's securities. The ABA Corporate Trust Committee sought to address the problem by calling for simultaneous dissemination of the information to the marketplace through an information repository. The National Association of Bond Lawyers has suggested that the Commission promulgate a rule mandating that all depositories and their direct and indirect participants promptly retransmit notices received from the issuer or indenture trustee. While the establishment of information repositories may address the problem to some extent, the Commission staff intends to work with the relevant

In the Companion Release, the Commission is proposing an amendment to Rule 15c2-12 to prohibit, as suggested by the Joint Statement, underwriting of a municipal securities issue unless the issuer of the municipal security has covenanted to provide annual and ongoing disclosure to a repository.

**V. Interpretive Guidance With Respect to Obligations of Municipal Securities Dealers**

In the Proposing and Adopting Releases for Rule 15c2-12, the Commission set forth its interpretation of the obligation of municipal underwriters under the antifraud provisions of the federal securities laws. The interpretation discussed the duty of underwriters to the investing public to have a reasonable basis for recommending any municipal securities, and their responsibility, in fulfilling that obligation, to review in a professional manner the accuracy of statements made in connection with the offering. The interpretation was set out in the Proposing Release, and modified slightly in the Adopting Release. The Commission reaffirms its Interpretation with respect to underwriters' responsibilities under the antifraud provisions of the federal securities laws.[103]

Furthermore, the Commission believes that it is also appropriate to emphasize the responsibilities of brokers and dealers in trading municipal securities in the secondary market. The Commission historically has taken the position that a broker-dealer recommending securities to investors implies by its recommendation that it has an adequate basis for the recommendation.[104] A dealer, unlike an underwriter, ordinarily is not obligated to contact the issuer to verify information. A dealer must, however, have a reasonable basis for its recommendation.[105] If, based on publicly available information, a dealer discovers any factors that indicate the disclosure is inaccurate or incomplete, or signal the need for further inquiry, a municipal securities dealer may need to obtain additional information, or seek to verify existing information.[106]

One of the rules proposed simultaneously with the issuance of this release would require a broker, dealer or municipal securities dealer to review current information provided by the issuer prior to recommending a transaction in a municipal security. In the absence of such current information, the dealer could not recommend a transaction in the issuer's securities. That rule, which would be applicable to municipal securities issued subsequent to the effective date of the proposed rule, would reinforce the obligations of dealers under the antifraud provisions of the federal securities laws to have a reasonable basis for recommendations of outstanding municipal securities.

The Joint Statement also called for a strengthening of the suitability rules to require disclosure of ratings and whether the issuer has committed to provide annual financial reports. Today, the Commission is proposing amendments to its confirmation rules to require disclosure of the absence of a rating in confirmations. The MSRB has indicated it has under consideration a plan requiring municipal securities dealers to disclose to their customers the importance of secondary market information and whether the issuer has agreed to voluntarily provide such disclosures.[107] The Commission will defer to the MSRB's reexamination of its suitability rules in implementing those aspects of the Joint Statement.

**VI. Request for Comments**

The Commission intends to continue to monitor developments in municipal securities disclosure practices. Comment is requested regarding the disclosure items discussed in this release, and in particular, items warranting event disclosure. Comment also is

organizations to assure that steps are taken to provide for consistent retransmission of the information.

[103] In light of the underwriter's obligation, as discussed in the prior releases, to review the official statement and to have a reasonable basis for its belief in the accuracy and completeness of the official statement's key representations, disclaimers by underwriters of responsibility for the information provided by the issuer or other parties, without further clarification regarding the underwriter's belief as to accuracy, and the basis therefor, are misleading and should not be included in official statements.

[104] See Donald T. Sheldon, Securities Exchange Act Release No. 31475 (Nov. 18, 1992); Elizabeth Bamberg, Securities Exchange Act Release No. 27672 (Feb. 5, 1990); Feeney v. SEC, 564 F.2d 260 (8th Cir. 1977); Nassar & Co., Securities Exchange Act Release No. 15347 (Nov. 22, 1978). See also Proposing Release, 53 FR at 37787, n.72-73.

[105] Richard J. Buck & Co., 43 SEC 998 (1968), aff'd sub nom. Hanley v. SEC, 416 F.2d 589 (2d Cir. 1969). See also The Obligations of Underwriters, Brokers and Dealers in Distributing and Trading Securities, Particularly of New High Risk Ventures, Securities Act Release No. 5275 (Aug. 9, 1972) 37 FR 16011, 16012-13; In Re Blumenfeld. Securities Exchange Act Release No. 16437 (Dec. 19, 1979) (broker-dealer charged unfair mark-ups and recommended transactions in municipal securities without a reasonable basis); J.A. Winston & Co., Inc., 42 S.E.C. 62 (1964) (broker-dealer recommended transactions without a reasonable basis, and made representations that were false and misleading).

[106] See Merrill, Lynch, Pierce, Fenner & Smith, Securities Exchange Act Release No. 14149 (Nov. 9, 1977) ("A recommendation by a broker-dealer is perceived by a customer as (and in fact it should be) the product of an objective analysis (which) can only be achieved when the scope of an investigation is extended beyond the company's management); John R. Brick, Securities Exchange Act Release No. 11763 (Oct. 24, 1975) ("the professional...is not an issuer. But he is under a duty to investigate and see that his recommendations have a reasonable basis"); M.G. Davis & Co., 44 SEC 153, 157-58 (1970) (broker-dealer registration revoked because "representations and predictions" made and market letter relied on by registrant "were without reasonable basis," and "registrant could not reasonably accept all of the statements in the (market letter) without further investigation"), aff'd sub nom. Levine v. SEC, 436 F.2d 88 (2d Cir. 1971). See also Merrill, Lynch, Pierce, Fenner & Smith, Securities Exchange Act Release No. 14149 (Nov. 9, 1977) (noting that if a broker-dealer lacks sufficient information to make a recommendation, the lack of information is material and should be disclosed).

[107] See supra n. 62.

requested regarding additional action that should be taken with respect to disclosure in the municipal securities market by the Commission, the MSRB, or Congress.

**List of Subjects in 17 CFR Parts 211, 231 and 241**

Securities.

**Amendment of the Code of Federal Regulations**

For the reasons set out in the preamble, title 17 chapter II of the Code of Federal Regulations is amended as set forth below:

**PART 211--INTERPRETATIONS RELATING TO FINANCIAL REPORTING MATTERS**

1. Part 211, Subpart A, is amended by adding Release No. FR-42 and the release date of March 9, 1994, to the list of interpretive releases.

PART 231--INTERPRETATIVE RELEASES RELATING TO THE SECURITIES ACT OF 1933 AND GENERAL RULES AND REGULATIONS THEREUNDER

2. Part 231 is amended by adding Release No. 33-7049 and the release date of March 9, 1994, to the list of interpretive releases.

PART 241--INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER

3. Part 241 is amended by adding Release No. 34-33741 and the release date of March 9, 1994, to the list of interpretive releases.

By the Commission.

Dated: March 9, 1994.

**Margaret H. McFarland,**

*Deputy Secretary.*

(FR Doc. 94-5922 Filed 3-16-94; 8:45 am)

**BILLING CODE 8010-01-P**

# EXHIBIT NO. 40

(916) 739-4426
(916) 739-2300 FAX

SEP 18 1991

Mr. Charles Yackly
Deputy Water Utilities
Department Director
City of San Diego
First Interstate Plaza
401 B Street, Suite 400
San Diego, CA 92101-4227

Dear Mr. Yackly:

FINAL REVENUE PROGRAM APPROVAL -- CITY OF SAN DIEGO, CLEAN WATER GRANT PROJECT NO. C-06-1092-210, -510, -520, -530 AND -540

The City of Chula Vista recently received approval of their final revenue program and sewer use ordinance. All member agencies of the City of San Diego Wastewater Treatment Facilities now have an approved revenue program and sewer use ordinance. Congratulations, the City of San Diego has complied with all the appropriate revenue program requirements applicable to the above referenced projects.

Implementation and maintenance of the user charge system is a requirement of the grant regulations (refer to 40 CFR 35.2208). Both the user charge system and sewer use ordinance must be implemented for the useful life of the facilities. The California State Water Resources Control Board, Division of Clean Water Programs, must be notified when either of these ordinances/resolutions are changed. In addition, your agency must maintain records necessary to document compliance with these requirements.

If you have any questions about this letter, please contact me at (916) 739-4426.

Sincerely,

ORIGINAL SIGNED BY

Ronald R. Blair
Revenue Program Specialist

cc: Ms. Trina Blake
City of San Diego
First Interstate Plaza
401 B Street, Suite 400
San Diego, CA 92101-4227

bcc: Fred Johansen, DCWP
Christine Bailey, DCWP

RBLAIR/DYEE/ATDISK3:SANDIEGO.LTR/17 SEP 91

SURNAME RBlair 9/10/91 | 11 Nov 1991

SWRCB1158

# EXHIBIT NO. 41

(916) 227-4489
(916) 227-4349 FAX

Mr. Jack McGrory
City Manager
City of San Diego
202 C Street
San Diego, CA 92101-4230-

Dear Mr. McGrory:

REVENUE PROGRAM REVIEW -- CITY OF SAN DIEGO, CLEAN WATER GRANT PROJECT NO. C-06-1092

I wish to express my appreciation for the cooperation the staff of the City of San Diego (City) gave me during my recent visit to your office. The following information is requested by November 1, 1994, to complete my review of the City's compliance with the requirements of USEPA's Clean Water Grant requirements.

1. Please explain the purpose and rational of the "reverse repurchase agreement" item that appears in the wastewater budgets and audits.

2. Please provide the legal basis for charging the wastewater fund for "use of city owned right-of-way. Also provide the data that was used to determine the amount that is charged for this item.

3. Please provide the rational for charging "outside city" direct billed accounts twice the normal rate for sewer service. Under USEPA regulations the City must charge all users in proportion to the cost of providing treatment services.

In addition, the City must adopt the following charges to bring its wastewater user charge system into compliance with the requirements of the existing and past Clean Water Grants.

a. The City must modify their agreements with all participating agencies to include charges for BOD and TSS content as well as flow discharged into City facilities.

b. The City must include septage discharges into their rate ordinance/resolution. The City is accepting discharges from septage haulers. However, I was unable to find any mention of septage haulers in the City rate codes.

c. The City must develop forecast unit costs, including appropriate indirect markups, for wastewater flow, BOD removal and TSS removal. These unit costs should be based on the prior year's costs and forecast increases. The forecast unit costs must be transmitted to all participating agencies as soon as possible each year to allow them to implement any needed rate adjustments prior to the start of the next fiscal year.

Please provide the information requested in Items 1-3, above and a timetable for compliance with Items a-c by November 1, 1994. If you are unable to meet this deadline please contact me at (916) 227-4489.

Sincerely,

Ronald R. Blair
Revenue Program Specialist

bcc: John Herren, CWP
San Marcos Trng Ctr
Bruce Posthumus, San Diego Regional Water Quality Control Board

# EXHIBIT NO. 42

1999

NEW ISSUE - BOOK ENTRY ONLY

*In the opinion of Orrick, Herrington & Sutcliffe LLP, Los Angeles, California and Webster & Anderson, Oakland, California, Co-Bond Counsel, based upon an analysis of existing laws, regulations, rulings and court decisions, and assuming, among other matters, compliance with certain covenants, interest on the Series 1999 Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 and is exempt from State of California personal income taxes. In the further opinion of Co-Bond Counsel, interest on the Series 1999 Bonds is not a specific preference item for purposes of the federal individual or corporate alternative minimum taxes, although Co-Bond Counsel observe that such interest is included in adjusted current earnings when calculating corporate alternative minimum taxable income. Co-Bond Counsel express no opinion regarding any other tax consequences related to the ownership or disposition of, or the accrual or receipt of interest on, the Series 1999 Bonds. See "TAX MATTERS."*

# $315,410,000
# PUBLIC FACILITIES FINANCING AUTHORITY OF THE CITY OF SAN DIEGO
## Sewer Revenue Bonds, Series 1999A and Series 1999B
(Payable Solely From Installment Payments Secured By Wastewater System Net Revenues)

Dated: March 1, 1999

Due: May 15, as shown on the inside cover page

The Series 1999A Bonds and the Series 1999B Bonds (collectively, the "Series 1999 Bonds") are issuable as fully registered bonds and when initially issued will be registered in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York ("DTC"). Purchases of the Series 1999 Bonds will be made in book-entry form only, in denominations of $5,000 or any integral multiple thereof, through brokers and dealers who are, or who act through, DTC Participants. Beneficial Owners of the Series 1999 Bonds will not be entitled to receive physical delivery of bond certificates so long as DTC or a successor securities depository acts as the securities depository with respect to the Series 1999 Bonds. So long as DTC or its nominee is the registered owner of the Series 1999 Bonds, reference herein to Bondholders or registered owners shall mean Cede & Co., as aforesaid, and payments of principal of and interest on the Series 1999 Bonds will be made directly to DTC by State Street Bank and Trust Company of California, N.A., as Trustee. Disbursement of such payments to DTC Participants is the responsibility of DTC and disbursement of such payments to the Beneficial Owners is the responsibility of DTC Participants. See "DESCRIPTION OF THE SERIES 1999 BONDS — Book-Entry-Only System." Interest on the Series 1999 Bonds is payable on May 15 and November 15 of each year, commencing November 15, 1999.

The Series 1999 Bonds are subject to optional and mandatory redemption prior to maturity as described herein.

Proceeds of the Series 1999A Bonds are to be applied to (i) pay for certain capital improvements to the Metropolitan System of the City of San Diego (the "City"), (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds (defined below) and (iii) to pay certain costs of issuance. Proceeds of the Series 1999B Bonds are to be applied to (i) pay for certain capital improvements to the Municipal System of the City, (ii) to fund a portion of the debt service reserve fund securing the Series 1999 Bonds and the Outstanding Parity Bonds and (iii) to pay certain costs of issuance.

The payment of principal of and interest on the Series 1999 Bonds, excluding the Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 (collectively, the "Insured Series 1999 Bonds"), when due will be guaranteed by a municipal bond insurance policy issued simultaneously with the delivery of the Insured Series 1999 Bonds. **The Series 1999 Bonds maturing on May 15, 2000 and May 15, 2001 are not insured.**

FGIC. Financial Guaranty Insurance Company

FGIC is a registered service mark used by Financial Guaranty Insurance Company, a private company not affiliated with any U.S. Government agency.

The Series 1999 Bonds are limited obligations of the Public Facilities Financing Authority of the City of San Diego (the "Authority") payable solely from Revenues, which Revenues include Installment Payments to be made by the City to the Authority from Net System Revenues pursuant to an Installment Purchase Agreement, as amended and supplemented, including as supplemented by the 1999-1 Supplement to the Master Installment Purchase Agreement, each between the Authority and the City, and amounts on deposit in the funds and accounts established under the Indenture (other than amounts on deposit in the Rebate Fund). The City has pledged Net System Revenues pursuant to the Installment Purchase Agreement to the payment of the Installment Payments. The Series 1999 Bonds are issued on a parity with the Authority's Sewer Revenue Bonds, Series 1993, Series 1995 and Series 1997 (collectively, the "Outstanding Parity Bonds").

**The obligation of the City to make Installment Payments does not constitute an obligation of the City for which the City is obligated to levy or pledge any form of taxation or for which the City has levied or pledged any form of taxation. Neither the pledge made by the Authority, nor the obligation of the City to make Installment Payments, creates a legal or equitable pledge, charge, lien or encumbrance upon any of the City's property, or upon its income, receipts or revenues other than Net System Revenues. The Authority has no taxing power.**

This cover page contains certain information for general reference only. It is not a summary of the issue. Investors are advised to read the entire Official Statement to obtain information essential to the making of an informed decision.

SEE MATURITY SCHEDULES ON INSIDE FRONT COVER

*The Series 1999 Bonds will be offered when, as and if issued and received by the Underwriters, subject to the approval of validity by Orrick, Herrington & Sutcliffe LLP, Los Angeles, California and Webster & Anderson, Oakland, California, Co-Bond Counsel, and to certain other conditions. Certain legal matters in connection with the Series 1999 Bonds will be passed upon by Casey Gwinn, Esq., City Attorney of the City of San Diego and General Counsel to the Authority and Orrick, Herrington & Sutcliffe LLP, Los Angeles, California, Disclosure Counsel. O'Melveny & Myers LLP has acted as counsel to the Underwriters for specified purposes. See "CERTAIN LEGAL MATTERS." It is expected that the Series 1999 Bonds will be available for delivery through DTC in New York, New York, on or about March 17, 1999.*

Bear, Stearns & Co. Inc. NationsBanc Montgomery Securities LLC

The Chapman Company First Albany Corporation Prudential Securities

March 2, 1999

## WASTEWATER SYSTEM REGULATORY REQUIREMENTS

### General

The Wastewater System is subject to regulations imposed by the Clean Water Act. The regulatory requirements are administered by the United States Environmental Protection Agency (the "EPA"), the California State Water Resources Control Board (the "State Board") and the San Diego Regional Water Quality Control Board (the "Regional Board"). Regulations of these agencies deal primarily with the quality of effluent which may be discharged from the Wastewater System, the disposal of sludge generated by the Wastewater System, the discharge of pollutants into groundwater, and the nature of waste material (particularly industrial waste) discharged into the collection system. The Point Loma Plant functions as an advanced primary treatment plant and the North City Plant functions as a tertiary treatment plant under the Clean Water Act.

On November 9, 1995, the City received from the EPA a five-year waiver of the secondary treatment requirements for the Point Loma Plant based on the successful implementation of certain requirements contained in OPRA. See "ACTIONS UNDER THE CLEAN WATER ACT -- Relief From Secondary Treatment Requirements" for information regarding the extension of the waiver and the possible legislative amendments to OPRA. The waiver allowed the City to obtain a modified NPDES permit. The City must operate the Wastewater System according to the discharge limitations set forth in its NPDES permit in order to comply with federally mandated effluent quality and disposal criteria. The NPDES permit and the waiver both expire on November 9, 2000 and the City will need to apply for successive five-year extensions in order to continue to be exempt from the secondary treatment standards of the Clear Water Act.

To comply with other federal regulations concerning the discharge of waste materials into the Wastewater System, the City must administer and enforce industrial pretreatment limitation standards upon industrial users of the Wastewater System. The City has had an industrial waste program in effect since the early 1970s. The City's industrial waste ordinance sets forth water quality standards that industrial users must meet and provides enforcement procedures for violators. The Industrial Waste Division of the MWWD is currently responsible for monitoring an average of 1,000 permitted industries located in the Metropolitan System service area. In addition, each Participating Agency is required to permit and monitor all industries within its respective service area. While each Participating Agency as a condition of the Regional Wastewater Disposal Agreement is required to comply with quality standards set by the City, the City, at the urging of the EPA, has required separate pretreatment agreements with each Participating Agency to ensure industrial pretreatment requirements are met. All Participating Agencies have entered into such pretreatment agreements.

As a condition of having received federal EPA grant funds under the Clean Water Act for the planning and construction of various improvements to the Wastewater System, the City is subject to additional regulatory requirements. For example, a federal EPA grant of approximately $76 million that the City received and used for the construction of the North City Plant provides that the City shall attempt to meet the goal of beneficial reuse of 25% of the flows treated at the North City Plant by December 31, 2003 and 50% by December 31, 2010. The goal of 25% beneficial reuse by 2003 can be achieved by the existing reclaimed water distribution system that is owned and operated by the City's Water Department. The City is currently evaluating the various alternatives for compliance with the goal of 50% beneficial reuse by 2010. If the City were found by the EPA to have not met the conditions of this grant or any other federal EPA grants, the City could be required to return the grant moneys to the EPA.

Among other grant-related requirements are guidelines which must be followed concerning planning methodologies, design criteria, construction activities, and the operation, maintenance and financing of facilities. As another condition of its past receipt of federal grants, the State Board, as the delegate of the EPA, must approve the sewer service charge structures of the City and the Participating Agencies. Such service charge structures require the recovery of annual operations, maintenance and replacement costs from users of the system in a proportionate manner according to the customer's level of use. Such factors as volume, infiltration/inflow, delivery flow rate, and strength of sewage are to be considered for determining proportionate use. Sewer service charge rates for all retail users are reviewed annually and established at a level necessary to generate sufficient revenues to recover the annual operations, maintenance and replacement costs. Sewer service charge rates for users are established to recognize the volume and strength characteristics of wastewater contributed to the Wastewater System. The City's rate structure

organics and TSS

acknowledging duties to bill customers based on strength

all while they know they need to put in organics

has been reviewed by the State Board and no grant funds or costs under grant funded programs have been disallowed based on the nature of the rate structures.

In addition to federal requirements, the City must also comply with water quality based effluent State requirements, otherwise known as the State Ocean Plan. Another State law concerned with control of water quality is the Porter-Cologne Water Quality Control Act of 1969, as amended. The Porter-Cologne Act directly addresses the problem of water reclamation and reuse. A declared policy of the law is that the people of the State of California have a primary interest in the development of facilities to reclaim wastewater to supplement existing surface and underground water supplies in order to meet their water requirements. The legislative intent was to undertake all possible development of water reclamation facilities to make reclaimed water available for use. The law requires the State Department of Health Services to establish statewide reclamation criteria for each type of use where such use involves public health. The City's proposed water reclamation projects are subject to the Porter-Cologne Act and are being designed in consultation with State officials to comply with its requirements.

The City believes that it is in compliance with all federal and state laws relating to the Wastewater System.

**Certain Compliance Actions and Other Litigation**

On February 8, 1996, the Regional Board accepted a proposal offered by the City to resolve all outstanding enforcement and liability issues relating to alleged sewer overflows involving the Wastewater System and inadequate reporting of such events. Without admitting any liability for pending issues related to sewer overflows and reporting, the City agreed to a cash payment of $350,000 and approximately one million dollars total in environmental credit projects extending over five years, from 1996 to 2001. This settlement resulted in a full satisfaction of all issues between the City and the Regional Board through the date of settlement. To date, all requirements of the settlement have been met and there are no pending complaints involving the City before the Regional Board.

The City is not presently involved in nor has received notice of any claim pertaining to regulation relief.

## ACTIONS UNDER THE CLEAN WATER ACT

**General**

In 1972, Congress enacted the Clean Water Act, which among other things, directs the EPA to monitor and to regulate the discharge of pollution into navigable water ways and to enforce the requirement that all wastewater treatment plants in the nation provide full secondary treatment for sewage. In 1977, Congress amended the Clean Water Act to allow waivers of secondary treatment standards for certain ocean discharges. In September 1979, the City submitted an application to the EPA for a waiver from the secondary treatment standards based upon the EPA's proposed waiver regulations. The EPA tentatively approved the City's waiver application in September 1981. A revised waiver application incorporating updated flow projections was submitted to the EPA in November 1983. However, in September 1986, the EPA reversed its tentative approval of the City's 1979 waiver application and tentatively denied the City's 1979 and 1983 applications. In February 1987, the City Council decided to discontinue its efforts to obtain a waiver. However, see "Relief From Secondary Treatment Requirements" below for information regarding the waiver from secondary treatment standards of the Clean Water Act which the City received in 1995 and which expires in November 2000.

**Litigation and Final Order**

In July 1988, the United States of America, acting through the Department of Justice and the EPA, and the State of California filed suit against the City in U.S. District Court for alleged violations of the Clean Water Act, its NPDES permit, sewer overflows, and alleged irregularities in the City's pretreatment program that regulates industrial waste. The plaintiffs sought injunctive relief and monetary damages for alleged effluent limit violations, failure to meet secondary treatment standards, past sewer spills, and pretreatment violations. The lawsuit was divided into a penalty proceeding and a remedies proceeding.

# EXHIBIT NO. 43

**Office of**
**The City Attorney**
**City of San Diego**

**MEMORANDUM**

**DATE:** November 15, 1999

**TO:** Casey Gwinn, City Attorney

**FROM:** Ted Bromfield, Deputy City Attorney

**SUBJECT:** Councilmember Kehoe's Memo on Sewer Cost-of-Service Report

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As you noted, the Cost-of-Service Report and Ms. Kehoe's memo present significant issues on the City's sewer rate structure. In responding to her, I've taken the unusual tack of a short, hopefully diplomatic, response pointing out that the Report does not support her assertion that "single-family homeowners pay almost double." The longer response, more controversial because of my view on Proposition 218, treats her question as a hypothetical and analyzes the Proposition 218 implications.

I recommend the shorter response, but certainly am available to discuss other avenues of response.

Ted

TB:mb
Attachments:2



For USAO 7.26.05
Part of SEC COS Subpoena

# EXHIBIT NO. 44

**Office of**
**The City Attorney**
**City of San Diego**

**MEMORANDUM**

**DATE:** December 22, 1999

**TO:** File

**FROM:** Ted Bromfield

**SUBJECT:** Ms. Kehoe's Request for 218 Analysis on the Cost of Service Report

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Ms. Kehoe requested a legal opinion on whether the conclusions of the Cost of Service Report show a violation of Proposition 218. Her request was made on November 3, 1999, and the City Attorney requested a response by November 17, 1999.

On November 15, 1999, I prepared both an eight-page Memorandum of Law and a two-page response, both confirming no Proposition 218 violation. However, due to the sensitivity of the 218 analysis and the City Manager's pending update of the Cost of Service Report, the Office decided a meeting with Ms. Kehoe would be preferable.

On November 24, 1999, Keri Katz and I met with Ms. Kehoe and her assistant, Craig Adams, and presented the issues. We mutually agreed that a formal legal opinion would not be necessary but a timeframe for the Manager's update was needed. I communicated this need to Deputy City Manager George Loveland, who promised such a timeframe. As of this date, the Manager has been unable to supply a timeframe. Hence I have reminded him by e-mail (attached).

TB:mb
Attachment



For USAO 7.26.05
Part of SEC COS Subpoena

# EXHIBIT NO. 45

U.S. Securities and Exchange Commission

# Municipal Bond Participants: Public Officials and Obligated Persons

## Public Officials

## Report under Section 21(a) of the Exchange Act

***Report of Investigation in the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors.***, Exchange Act Release No. 36761 (January 24, 1996).

## I. Introduction

The staff of the Division of Enforcement has conducted an investigation into various events in 1993 and 1994 involving material misrepresentations and omissions in connection with the offer and sale of certain municipal securities, including those issued by the County of Orange, California (the "County" or "Orange County"). Six of these municipal offerings by the County collectively raised approximately $1.3 billion and are the subject of this report. These offerings were related to the Orange County investment pools (the "County Pools"),[1] in one or more of the following ways: 1) the proceeds from one of the offerings were reinvested in the County Pools to obtain interest earnings; 2) the funds pledged to repay certain of the securities were invested in the County Pools; 3) the County Pools agreed to repurchase or repay certain of the securities; and/or 4) the County's economic reliance on the County Pools materially affected its ability to repay the securities. The Official Statements for these municipal securities offerings contained material misstatements and omissions concerning the risks relating to, among other things, the County Pools and the financial condition of Orange County, including its ability to repay the securities.

Based upon information obtained during the investigation, the Commission deems it appropriate that it issue this Report of Investigation ("Report") pursuant to Section 21(a) of the Securities Exchange Act of 1934 "Exchange Act") with respect to the conduct of the individual members of the Board of Supervisors of Orange County, California (the "Supervisors" or "Board members") in authorizing the issuance of these municipal securities.[2]

Simultaneous to the issuance of this Report, the Commission has filed and settled a related civil injunctive action against the former County Treasurer-Tax Collector, Robert L. Citron (the "Treasurer"), and the former Assistant Treasurer, Matthew R. Raabe (the "Assistant Treasurer"), pursuant to which they will be

enjoined from future violations of the antifraud provisions of the federal securities laws.[3] The Commission has also instituted and settled a related cease and desist proceeding pursuant to Section 8A of the Securities Act of

1933 ("Securities Act") and Section 21C of the Exchange Act against Orange County, the Orange County Flood Control District and the Board of Supervisors of Orange County pursuant to which they will be ordered to cease and desist from violations of the antifraud provisions.[4] The Commission's investigation is ongoing.

The Commission is issuing this Report to emphasize the responsibilities under the federal securities laws of local government officials who authorize the issuance of municipal securities and related disclosure documents and the critical role such officials play with respect to the representations contained in the Official Statements for those securities.[5]

Public entities that issue securities are primarily liable for the content of their disclosure documents and are subject to proscriptions under the federal securities laws against false and misleading information in their disclosure documents.[6] In addition to the governmental entity issuing municipal securities, public officials of the issuer who have ultimate authority to approve the issuance of securities and related disclosure documents have responsibilities under the federal securities laws as well. In authorizing the issuance of securities and related disclosure documents, a public official may not authorize disclosure that the official knows to be false; nor may a public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading. When, for example, a public official has knowledge of facts bringing into question the issuer's ability to repay the securities, it is reckless for that official to approve disclosure to investors without taking steps appropriate under the circumstances to prevent the dissemination of materially false or misleading information regarding those facts. In this matter, such steps could have included becoming familiar with the disclosure documents and questioning the issuer's officials, employees or other agents about the disclosure of those facts.

In this case, the Supervisors approved Official Statements that, among other things, failed to disclose certain material information about Orange County's financial condition that brought into question the County's ability to repay its securities absent significant interest income from the County Pools. The Supervisors were aware of material information concerning Orange County's financial condition; this information called into question the County's ability to repay its securities. Nevertheless, the Supervisors failed to take appropriate steps to assure disclosure of these facts. In light of these circumstances, the Board members did not fulfill their obligations under the antifraud provisions of the federal securities laws in authorizing the issuance of the municipal securities and related disclosure documents.

## II. Background

### A. The Orange County Board Of Supervisors

The Orange County Board of Supervisors (the "Board") is the body through which the County exercises its powers.[7] Orange County is a body corporate and politic and has the powers specified in the California (the "State") Constitution, State statutes, and such implied powers as are necessary for the execution of the powers expressly granted.[8] The Board consists of five full-time members, each serving a term of four years. The Board has

legislative, financial and police powers.

The Board exercises its financial powers through its general supervision of and control over the financial affairs of the County. The powers of the Board include, among others: 1) examination and audit of the financial accounts and records of all officers having responsibility for County moneys;[9] 2) supervision of the official conduct of all County officers, including the Treasurer, "particularly insofar as the functions and duties . . . relate to the assessing, collecting, safekeeping, management or disbursement of public funds";[10] 3) investment and reinvestment of County funds;[11] 4) fiscal powers, including approving the County's proposed budget and adopting the County's final budget;[12] and 5) contracting for County indebtedness,[13] including the issuance of municipal securities.

Although the Board may delegate certain of these duties to County officers and employees, it is ultimately responsible for the execution of these duties. In 1985, the Board formally delegated its authority to invest County funds to its Treasurer.

**B. The Supervisors**

1. Thomas F. Riley, age 83, was appointed Supervisor in 1974, elected to the Board two years later, and served continuously through 1994, after which he retired. Riley was the Chairman of the Board in 1994.

2. William G. Steiner, age 58, was appointed Supervisor in 1993, elected in 1994, and is currently a member of the Board. His term expires on December 31, 1998.

3. Roger R. Stanton, age 58, was first elected Supervisor in 1980, and is currently a member of the Board and its Chairman. His term expires on December 31, 1996.

4. Gaddi H. Vasquez, age 40, was appointed to the Board in 1987, elected in 1988, and served continuously until his resignation on September 27, 1995. Prior to his resignation, Vasquez was the Chairman of the Board in 1995.

5. Harriett M. Wieder, age 75, was first elected Supervisor in 1978, was Chairman of the Board in 1993 and a member through 1994.

**C. The County Pools And Orange County's Financial Dependence On The Pools**

The County Pools were instrumentalities of the County and were not established as legal entities distinct from the County. The County Pools operated as an investment fund managed by Orange County through which the Treasurer invested public funds deposited by various local governments or districts (the "Pool Participants" or the "Participants"). As of December 6, 1994, the County Pools held approximately $7.6 billion in Participant deposits, including County funds.

Under California law, the Board may delegate its authority to invest or to

reinvest County funds to the County Treasurer, who thereafter assumes full responsibility for such transactions and who must make monthly reports of the transactions to the Board.[14] Pursuant to this law, the Board delegated its authority to invest and reinvest County funds to the County Treasurer. Notwithstanding this delegation of authority, the Treasurer was required to seek approval from the Board for various kinds of investments.[15] The investment strategy devised by the County Treasurer was risky and was predicated on the assumption that interest rates would remain low. The strategy involved a high degree of leverage through the use of short-term reverse repurchase agreements and a substantial investment in derivative securities of a longer term (including inverse floaters that are negatively affected by a rise in interest rates). For example, on December 6, 1994, when the County Pools held deposits of approximately $7.6 billion, the book value of the leveraged investment portfolios was $20.6 billion.

Orange County's financial condition was closely tied to the financial condition of the County Pools. The County was heavily dependent on the County Pools as a source of income to balance its discretionary budget. The County's discretionary budget was the portion of the County's total budget over which the Board had authority to determine how funds would be allocated.[16] The discretionary budget was also a source of funds for repayment of the municipal securities that are the subject of this report.

The County's use of interest income as a revenue source to balance its discretionary budget had been increasing since at least fiscal year 1991-92, and increased dramatically for fiscal year 1994-95.[17] This increased use of interest income was due to a decline in revenue from other sources, particularly property taxes.[18] By budgeting increased projected interest revenue, Orange County was able to balance its budget and avoid implementing other fiscal measures.

The County had two sources of funds to invest in the County Pools and earn investment interest: its own liquid assets and the proceeds of its municipal securities offerings. From January 1993 to December 6, 1994, Orange County had invested essentially all of its liquid assets in the County Pools, almost $2.3 billion. In 1993 and 1994, Orange County issued $1 billion in municipal securities for the purpose of reinvesting the proceeds in the County Pools.

In early December 1994, the County announced that the County Pools' $20.6 billion investment portfolio had suffered a loss in market value of approximately $1.5 billion. Following liquidation of the portfolio, the County realized a loss of approximately $600 million of its investment in the County Pools.

The County also suffered a loss of $157 million in estimated and budgeted interest earnings from the County Pools, contributing to a projected deficit for fiscal year 1994-95 of approximately $172 million. On December 6, 1994, the County filed a petition for bankruptcy under Chapter 9 of the United States Bankruptcy Code. As a result of Orange County's economic dependence on the County Pools and their subsequent collapse, the County has not repaid or repurchased approximately $910 million in municipal securities at the time they were to mature by their original terms or were tendered for repurchase.[19]

## III. The Supervisors Authorized the Issuance of Municipal Securities in 1994

### A. The Municipal Securities Offerings

In 1994, the County conducted the six municipal securities offerings that are the subject of this report. These offerings were directly related to the County Pools in one or more of the following ways: 1) the proceeds from certain offerings were reinvested in the County Pools to obtain interest earnings; 2)

the funds pledged to repay certain of the securities were invested in the County Pools; 3) the County Pools agreed to repurchase or repay certain of the securities; and/or 4) the County's economic reliance on the County Pools materially affected its ability to repay the securities.

The Official Statements for these offerings variously contained material misstatements and omissions of fact regarding:

1) the County Pools, including the County Pools' investment strategy and investment results, and the manipulation of the County Pools' yield, which matters affected the issuer's ability to repay the municipal securities and the County Pools' ability to perform under agreements to repurchase or provide for repayment of the municipal securities; 2) Orange County's financial condition, including its economic reliance on the investment results of the County Pools as a source of funds to repay its obligations on the securities; 3) the tax-exempt status of the offering; 4) an undisclosed cap on the interest rate payable to investors on certain variable rate municipal securities sold in the offerings; and 5) the unauthorized use of an audit report.

1. The Reinvestment Offering

The County conducted one reinvestment offering in 1994, the $600,000,000 COUNTY OF ORANGE, CALIFORNIA 1994-95 TAXABLE NOTES, issued on July 8, 1994. The purpose of this offering was to raise funds to reinvest in the County Pools for profit. In such transactions, an issuer such as Orange County expects to generate profits by investing at a rate of return that is higher than the rate of interest to be paid to the purchasers in the offering.

The County deposited the proceeds from this Reinvestment Offering into an account pledged to repay the notes. The Official Statement for this Reinvestment Offering disclosed that the County intended to invest the pledged funds in the County Pools and that, if an investment loss occurred, the County would satisfy the deficiency from any other moneys lawfully available for repayment. The lawfully available funds consisted essentially of funds in the discretionary budget.

2. The Tax And Revenue Anticipation Note Offerings

In 1994, the County conducted two separate offerings of tax and revenue anticipation notes ("TRANs"), raising a total of $200 million for the purpose of funding cash flow deficits. These offerings were the $169,000,000

COUNTY OF ORANGE, CALIFORNIA 1994-95 TAX AND REVENUE ANTICIPATION NOTES, SERIES A, issued on July 5, 1994, and the $31,000,000 COUNTY OF ORANGE, CALIFORNIA

1994-95 TAX AND REVENUE ANTICIPATION NOTES, SERIES B, issued on August 11, 1994. TRANs are designed to help local governments cover periodic cash flow deficits that arise because they receive revenues infrequently during the year while their working capital expenses remain constant. Such notes are later repaid with the expected tax and other revenue received.

In the Official Statements for these offerings, the County represented that the money pledged to repay the notes would be deposited in the County Pools. The Official Statements further advised prospective investors that, if Orange County suffered an investment loss and the repayment funds were insufficient to repay the notes, the County would satisfy the deficiency from any other moneys lawfully available for repayment. The lawfully available funds consisted essentially of funds in the discretionary budget.

3. The Teeter Offerings

The County conducted two Teeter offerings in 1994: the $111,000,000 COUNTY OF ORANGE, CALIFORNIA 1994-95 (TEETER PLAN) TAXABLE NOTES, issued on July 20, 1994; and the $64,000,000 COUNTY OF ORANGE, CALIFORNIA 1994-95 (TEETER PLAN) TAX-EXEMPT NOTES, issued on August 18, 1994. Separately, the County Pools guaranteed repayment of the Teeter notes pursuant to Standby Note Purchase Agreements. The purpose of the Teeter offerings was to fund the Teeter Plan, which is an alternate method of property tax distribution. Pursuant to this plan, Orange County pays local taxing entities (such as school districts) their share of property taxes based upon levy rather than actual collection. Orange County then retains all property taxes, and the penalties and interest thereon, upon collection.

The Official Statements for the Teeter notes represented that the County planned to invest certain delinquent tax receipts pledged to repay the Teeter Notes in the County Pools. The County Pools also agreed to repurchase the Teeter Notes, through Standby Note Purchase Agreements, which agreements obligated the Treasurer, as fund manager of the County Pools, to purchase the Teeter notes to the extent that there were insufficient funds to repay them. The Official Statements further advised prospective investors that if the repayment funds were insufficient, any deficiency would be satisfied from moneys received under the Standby Note Purchase Agreements and other moneys lawfully available for repayment. The lawfully available funds consisted essentially of funds in the discretionary budget.

4. The Pension Bond Offering

Finally, in September 1994, the County issued taxable Pension Obligation Bonds for the purpose of funding the County's unfunded, but accrued, pension liability. The Pension Bonds were issued on September 28, 1994, in two series: the $209,840,000 COUNTY OF ORANGE, CALIFORNIA TAXABLE PENSION OBLIGATION BONDS SERIES 1994A; and the $110,200,000 COUNTY OF ORANGE, CALIFORNIA TAXABLE PENSION OBLIGATION BONDS

SERIES 1994B. One feature of the Series 1994B bonds was that investors had the right to tender their bonds to a remarketing agent for repurchase. A remarketing agent would attempt to resell the bonds during a seven-day period. If the bonds could not be remarketed, the County Pools, pursuant to a Standby Withdrawal Agreement, stood ready to purchase the tendered securities in an amount up to the County's unrestricted funds in the County Pools, which included funds in the County's discretionary budget.

**B. Procedures Regarding Approval Of Municipal Securities Offerings**

Final authority to approve each issuance of Orange County municipal securities rested with the Supervisors, pursuant to State law. Short-term financings in which the securities matured in thirteen months or less were submitted to the Supervisors for approval on the Treasurer's recommendation. With respect to debt securities in which the maturities exceeded thirteen months, the County Administrative Officer initiated the recommendation for Board action instead of the Treasurer.

Municipal securities offerings were submitted to the Board for its approval through a document entitled Agenda Item Transmittal, prepared by the Treasurer for short-term note offerings and the County Administrative Officer for long-term bond offerings. The Agenda Item Transmittal typically contained a very brief description of a particular transaction and was sent to the Supervisors three to five business days prior to a Board meeting. For short-term financings, other documents such as a Contract of Purchase, a proposed Board resolution and a draft of a Preliminary Official Statement were also prepared in advance of the Board meeting. These documents were known as "back-up" to the Agenda Item Transmittal.[20]

For the six offerings discussed in this Report, the Board adopted authorizing and sale resolutions. For each offering, the resolution adopted by the Supervisors: 1) authorized the issuance of the notes or bonds in a specified dollar amount; 2) approved the Preliminary Official Statement in the draft form presented; 3) delegated authority to the Treasurer or the Assistant Treasurer (or, in the case of the Pension Obligation Bonds, to the County Administrative Officer) to: execute a "deemed final" certificate pursuant to Exchange Act Rule 15c2-12; cause the blanks in the Preliminary Official Statement to be filled in and finalize the Preliminary Official Statement; and execute the Official Statement and to deliver the same to the underwriter; and 4) approved the Official Statement for the offering with such revisions as the Treasurer or Assistant Treasurer (or, in the case of the Pension Bonds, the County Administrative Officer) determined were necessary to make the Official Statement true and correct in all material respects.

In addition, the County retained financial advisers, bond counsel and underwriters to assist in these municipal securities offerings. The County also retained a national accounting firm to audit the County's financial statements. The Supervisors approved the retention of these professionals. While the Supervisors believed that they could rely on these professionals, the Supervisors never questioned the professionals regarding the disclosure in the Official Statements, despite their knowledge of facts calling into question the County's ability to repay the securities.

In preparation for Board meetings, the Supervisors and/or their executive assistants attended weekly briefings regarding the items on the upcoming

agenda, which might consist of 100 or more items. These briefings generally lasted between one and two hours and were conducted by the County Administrative Officer and/or his staff. Prior to the briefing, the County Administrative Officer reviewed each agenda item, including those concerning the securities offerings, and typically concurred with the recommendations made by the Treasurer. The County Administrative Officer's review was principally focused on ensuring that the agenda item was consistent with both the adopted budget and the Board's policies.

The Supervisors' executive assistants reviewed the Agenda Item Transmittals and occasionally the back-up documentation. The level of review performed by an executive assistant varied considerably, ranging from mere receipt of the Agenda Item Transmittal to reviewing and summarizing both the Agenda Item Transmittal and back-up documentation, when such documentation was available.

The level of review performed by each Supervisor varied. For example, some of the Supervisors reviewed the Agenda Item Transmittal and summaries of the Agenda Item Transmittal back-up documentation; however, no Supervisor recalled reading any of the draft Preliminary Official Statements or related documents. At least one Supervisor did not review any written documentation and instead relied on the County Administrative Officer and his staff and that Supervisor's executive assistant for advice on how to vote.

Each of the six offerings was placed on the Board's "consent calendar" which contained the vast majority of the agenda items. Each of the subject offerings was approved by consent.

**IV. The Supervisors failed to take steps to assure that the County's financial condition was disclosed when they authorized the issuance of Municipal Securities in 1994**

Through the formulation and adoption of the County budget, the Supervisors were aware of the County's increasing use of interest earnings from County funds invested in the County Pools as a source of revenue to balance the discretionary portion of the County's budget.

In connection with the budget approval process in fiscal years 1993-94 and 1994-95, the Supervisors were copied on reports from the County Auditor-Controller (the "County Auditor") to the County Administrative Officer discussing the availability of discretionary funds. These documents reported that interest income was a significant factor in balancing the discretionary budget, particularly in 1994.[21]

The first report in 1994 was distributed in February, and referred to the County's use of interest earnings to offset decreases in other revenue sources. Similarly, the May 1994 County Auditor's report cautioned that the projected budget included interest earnings that were "significant," and that the County could not rely on that source "for the long term." The report further stated that interest earnings had "become an increasingly important source of revenue" and were subject to a variety of factors that may cause such revenue to fluctuate significantly." The May County Auditor's report concluded by advising that "prudent management of one-time revenues

[e.g., certain kinds of interest income] is critical to our investment policies and bond rating."

In the August 1994 County Auditor's report, which was copied to the Supervisors prior to the Pension Bond Offering, the County Auditor asserted that "we should be concerned that interest income . . . [is] financing a significant portion of the budget. The [fiscal year] 1995 interest income projection represents 35 percent of the available financing and is our single largest source of discretionary revenue." Further, the report advised that "[i]nterest income is projected based on increased earnings due to increased taxable and nontaxable borrowings," making clear that, in order to balance the budget, the County was issuing an increasing number of municipal securities offerings in order to obtain increased interest earnings on the investment of such funds.[22]

Despite the use of investment income to balance the County's discretionary budget, the Supervisors testified that they did not understand the investment strategy, the risks of that strategy or the potential risk of loss to the County Pools' principal.[23] However, the Board was provided with certain information regarding the County Pools. This information consisted of the Treasurer's annual financial statements, which statements discussed in general terms the County Pools, including the investment strategy and results. For example, in the September 1993 annual financial statement addressed to, and received by the Board, the Treasurer reported to the Supervisors that the County Pools' strategy involved the use of leverage of approximately 2 to 1 and structured or floating rate securities, and was predicated on interest rates remaining low over the next three years. The Treasurer further advised that the County's investment returns were higher than other local investment pools because of the use of reverse repurchase agreements which added an additional two and one-half percent to the yield. Additionally, the Treasurer also stated that it was his investment policy to hold all securities purchased to maturity, that it was his opinion that interest rates could not be sustained at a high rate and that it was also his opinion that there was no risk of principal loss. In September 1994, the Treasurer reported to the Board that he continued to use reverse repurchase agreements which added an additional two percent yield to the portfolio.

The Treasurer had in prior years submitted to the Board monthly reports of investment transactions, as required by California law; however, he ceased submitting such reports in 1991. The Board took no steps to require the Treasurer to comply with State law and produce the reports.

As a result, the Supervisors failed to have sufficient information concerning the investment of County funds and the impact of the investment of those funds on the financial condition of the County and its ability to repay investors in Orange County's municipal securities.

When the Supervisors approved the 1994 offerings of municipal securities discussed above, they were well aware of the increasing budgetary pressure caused by the declining availability of property tax revenues and other discretionary revenues. Indeed, at least one of the offerings was conducted for the sole purpose of providing additional income to the County. Moreover, the Supervisors were informed that interest projections were based on increased amounts of borrowing.

Despite their knowledge of the County's increasing use of interest income from the County Pools to balance the discretionary budget, the Supervisors approved the Official Statements for the various offerings without taking steps to assure disclosure of this information. They never received or asked to receive a copy of any Preliminary Official Statement once finalized, or any final Official Statement; nor did they question the County's officials, employees or other agents concerning the disclosure regarding the County's financial condition. Thereafter, the Supervisors chose to authorize and approve approximately $1.3 billion of municipal securities offerings.

**V. Conclusion**

In addition to the responsibilities imposed on issuers of municipal securities, the antifraud provisions of the federal securities laws impose responsibilities on a public official who authorizes the offer and sale of securities. A public official who approves the issuance of securities and related disclosure documents may not authorize disclosure that the public official knows to be materially false or misleading; nor may the public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading. When, for example, a public official has knowledge of facts bringing into question the issuer's ability to repay the securities, it is reckless for that official to approve disclosure to investors without taking steps appropriate under the circumstances to prevent the dissemination of materially false or misleading information regarding those facts. In this matter, such steps could have included becoming familiar with the disclosure documents and questioning the issuer's officials, employees or other agents about the disclosure of those facts.

The Supervisors were aware of the financial condition of the County and that interest income from the County Pools had become a major component of the County's discretionary budget in an environment of increasing budgetary pressure. The Supervisors also knew that the increase in such interest income was connected to the increased amount of County municipal securities offerings and approved at least one offering conducted solely to raise funds for reinvestment. Based on the Supervisors' significant knowledge relating to the County's finances, they should have understood the materiality of that information to the County's ability to repay the municipal securities. The Supervisors therefore had a duty to take steps appropriate under the circumstances to assure accurate disclosure was made to investors regarding this material information. The Supervisors, however, failed to take appropriate steps. For example, while the Supervisors believed that they could rely on the County's officials, employees or other agents with respect to these offerings, they never questioned these officials, employees or other agents regarding the disclosure of this information; nor did they become familiar with the disclosure regarding the County's financial condition. Had they taken such or similar steps, it should have been apparent to each Supervisor, in light of his or her knowledge, that the disclosure regarding the County's financial condition may have been materially false or misleading.

Consequently, the Supervisors failed to assure appropriate disclosure of these matters by authorizing and approving the dissemination of misleading disclosure documents. This failure denied investors the fair and accurate disclosure required under the federal securities laws.

By the Commission.

**Footnotes**

-[1]-As discussed below, the County Pools were instrumentalities of the County and were not established as legal entities distinct from the County. The County Pools operated as an investment fund managed by Orange County in which the County and various local governments or districts invested or deposited public funds.

-[2]-Section 21(a) of the Exchange Act authorizes the Commission, in its discretion, to publish information "concerning any . . . violations" and to investigate "any facts, conditions, practices or matters which it may seem necessary or proper" in fulfilling its responsibilities under the Exchange Act. This does not constitute an adjudication of any fact or issue addressed herein. The Supervisors have consented to the issuance of this Report without admitting or denying any of the statements or conclusions set forth herein.

-[3]-See Securities and Exchange Commission v. Robert L. Citron and Matthew R. Raabe, Civil Action No. (C.D. Cal.).

-[4]-In the Matter of County of Orange, California; Orange County Flood Control District; and County of Orange, California Board of Supervisors, Exchange Act Release No. _____ (January ___, 1996).

-[5]-The Commission has previously reviewed disclosure practices of issuers and others in connection with offerings of municipal securities. See Staff of the Securities and Exchange Commission, Staff Report on Transactions in Securities of the City of New York, Transmitted to subcommittee on Economic Stabilization of the Committee on Banking, Finance and Urban Affairs, House of Representatives, 95th Cong., 1st Sess. (Comm. Print 1977); Final Report in the Matter of Transactions in the Securities of the City of New York, Exchange Act Release No. 15,547, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) 81,936 (Feb. 5, 1979); Staff Report on the Investigation in the Matter of Transactions in Washington Public Power Supply System Securities, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) 84,327 (1988); Proposal of Exchange Act Rule 15c2-12, Exchange Act Release No. 26,100, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) 84,326 (Sept. 22, 1988); Adoption of Exchange Act Rule 15c2-12, Exchange Act Release No. 26,985, 4 Fed. Sec. L. Rep. (CCH) 25,098 (June 28, 1989) (the "1989 Release"); Division of Market Regulation, Securities and Exchange Commission, Staff Report on the Municipal Securities Market (Sept. 1993); Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Securities Act Release No. 7049 and Exchange Act Release No. 33,741, 7 Fed. Sec. L. Rep. (CCH) 72,442 (March 9, 1994) (the "March 1994 Release"); Proposal of Amendments to Exchange Act Rule 15c2-12, Exchange Act Release No. 33,742, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) 85,324 (March 9, 1994); Adoption of Amendments to Exchange Act Rule 15c2-12, Exchange Act Release No. 34,961, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) 85,456 (Nov. 10, 1994).

-[6]- See March 1994 Release; 1989 Release, supra note 5, at 18,199-10 and n.84; see also In re Citisource, Inc. Securities Litigation, 694 F. Supp.

1069, 1072-75 (S.D.N.Y. 1988); Draney v. Wilson, Morton, Assaf & McElligot, 597 F. Supp. 528, 531 (D. Ariz. 1983).

-[7]-See Board of Supervisors of Modoc County v. Archer, 18 Cal. App. 3d 717, 721, 96 Cal. Rptr. 379, 382 (1971); Cal. Gov't Code § 23005 (West 1988).

-[8]- Cal. Const. Art XI, § 1 (West Supp. 1995); Cal. Gov't Code § 23003 (West 1988).

-[9]-Cal. Gov't Code § 25250 (West 1988).

-[10]-Cal. Gov't Code § 25303 (West 1988).

-[11]-Cal. Gov't Code § 53601 (West Supp. 1995).

-[12]-Cal. Gov't Code §§ 29000-29093 (West 1988 & Supp. 1995).

-[13]-Cal. Gov't Code § 25256 (West 1988).

-[14]-See Cal. Gov't Code §§ 53601, 53607 and 53608 (West 1983 & Supp. 1995). See also Cal. Gov't Code § 25303 (West 1988) ("board of supervisors shall supervise the official conduct of all county officers, . . . particularly insofar as the functions and duties . . . relate to the assessing, collecting, safekeeping, management, or disbursement of public funds").

-[15]-For example, at the Treasurer's request in 1985, the Board authorized the Treasurer to engage in reverse repurchase agreements. Additionally, in 1993, the Treasurer sought and received Board authorization to invest in securities with maturities exceeding five years.

-[16]-For fiscal year 1994-95, Orange County's total budget was approximately $3.7 billion. Of that amount, the County was required to spend about 88%, or $3.266 billion, for specific purposes. The remaining 12%, or $462.5 million, comprised Orange County's discretionary budget. The largest portion of the $462.5 million discretionary budget, $162 million, or 35%, was budgeted to come from investment income on Orange County's investment in the County Pools.

-[17]-For fiscal year 1991-92, interest earnings were $36.8 million, or 7.4% of the discretionary budget; for fiscal year 1992-93, $64.5 million, or 12.4% of the discretionary budget; and for fiscal year 1993-94, they were budgeted at $58.3 million, or 15.1% of the discretionary budget.

-[18]-Property tax revenues comprised 52.8% of the total discretionary budget for fiscal year 1991-92, 49.1% for fiscal year 1992-93, 33.4% for fiscal year 1993-94, and were projected to be only 25.4% for fiscal year 1994-95.

-[19]-These municipal securities have been rated in default by one rating agency. In Orange County's bankruptcy proceeding, the County, the noteholders and the creditors' committee agreed to extend, or rollover, the maturity of approximately $800 million of these municipal securities to June 30, 1996.

-[20]-The back-up documentation was not always submitted with the Agenda Item Transmittal. In some instances, the back-up documentation was only filed the day before the Board meeting, or was not distributed to the Supervisors' offices but only to the Clerk of the Board. For example, for two offerings in 1994, the draft Preliminary Official Statements were not filed with the Clerk of the Board until the day before the meeting. For a third offering in 1994, the draft Preliminary Official Statement was filed with the Clerk of the Board on the Friday before the meeting scheduled for Tuesday.

-[21]- In the 1993 County Auditor's reports, the County Auditor stated that one-time revenues, such as certain types of interest earnings, were increasingly being used to balance the County budget and that it was "not fiscally responsible to continue budgeting in this manner any longer."

-[22]-The six offerings, raising a total of approximately $1.3 billion, were authorized by the Supervisors during a three-month period in 1994 --the same three months during which the Supervisors were also in the process of adopting the County's final budget. Further, the municipal securities issued in all but one of the offerings matured one year from the date of their issuance, thereby increasing the significance of the County's current financial condition as it related to the County's ability to repay the securities.

-[23]-During the course of the Treasurer's re-election campaign in the Spring of 1994, the Treasurer's investment strategy was criticized by his opponent as too risky for public funds. The Supervisors were aware of the criticism. The public criticism, however, did not prompt any inquiry or review by the Supervisors.

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**Injunctive Proceedings**

***Securities and Exchange Commission v. Larry K. O'Dell***, Civ. Action No. 98-948-CIV-ORL-18A (M.D. Fla.); Litigation Release No. 15858 (August 24, 1998) (settled final order).

The Securities and Exchange Commission today announced the filing of a Complaint against Larry K. O'Dell, the former Director of Public Works for Osceola County, Florida, for failing to disclose his receipt of bribes for assisting a brokerage firm in its selection to sell County bonds.

The Complaint, filed in the Middle District of Florida, alleges the following: In 1992, while the Director of Public Works, O'Dell entered into a secret arrangement with a consultant working for a brokerage firm. The arrangement provided that, in exchange for O'Dell's assistance with the brokerage firm's selection as one of the firms to sell the $149,999,313 Osceola Parkway Project bonds (dated July 15, 1992), the consultant would share his compensation from the firm with O'Dell. After entering into the arrangement, O'Dell persuaded the Osceola County Manager to put the firm in the selling group for the bonds, without disclosing his economic interest in the matter to the County Manager. Following closing of the bond offering,

the consultant gave O'Dell money and other things of value totaling $1,755.82. Neither the arrangement nor the benefits conferred thereunder were disclosed to the issuer of, or investors in, the bonds. O'Dell's failure to disclose the arrangement, the payments, and the actual and potential conflicts of interest created thereby, violated the following antifraud provisions of the federal securities laws: Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder.

Simultaneously with the filing of the Complaint, and without admitting or denying the allegations contained in the Complaint, O'Dell agreed to the entry of a final judgment permanently enjoining him from future violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; and ordering him to pay (1) disgorgement to Osceola County totaling $2,649.57, consisting of the $1,755.82 O'Dell received pursuant to the undisclosed arrangement, plus prejudgment interest thereon, and (2) a civil penalty of $5,000.

Also today, the United States Attorney for the Middle District of Florida filed a criminal plea agreement with O'Dell, pursuant to which O'Dell has agreed to plead guilty to a single felony count of bribery in violation of 18 U.S.C. § 666, arising from the conduct that is the subject of the Commission's Complaint.

The Commission's investigation concerning pay-to-play practices in Florida continues.

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***SEC v. Robert L. Citron and Matthew R. Raabe***, Civ. Action No. SACV 96-74 GLT (C.D. Cal.), Litigation Release No. 14792 (January 24, 1996) (complaint).

The United States Securities and Exchange Commission announced that on January 24, 1996, the Commission brought its first enforcement actions relating to the Commission's investigation into the financial collapse of Orange County, California and the Orange County Investment Pools (the "County Pools"). Specifically, the enforcement actions taken by the Commission today are:

- the filing of a complaint in the United States District Court against former Orange County Treasurer-Tax Collector Robert L. "Bob" Citron and former Assistant Treasurer Matthew R. Raabe

- the institution of a cease and desist administrative proceeding and the entry of a cease and desist order against Orange County, the Orange County Flood Control District and the Orange County Board of Supervisors

All of the above parties were charged with violations of the antifraud provisions of the federal securities laws, Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Citron and Raabe, without admitting or denying the

allegations in the complaint, consented to the entry of final judgments of permanent injunction, enjoining them from future violations of the antifraud provisions. Orange County, the Flood Control District and the Board of Supervisors submitted an Offer of Settlement, in which, without admitting or denying the findings, they consented to the entry of an Order which makes findings and orders them to cease and desist from committing or causing any violation and any future violation of the antifraud provisions. In addition, all of the parties agreed to cooperate with the Commission staff in the continuing investigation and any resulting litigation.

Also on January 24, the Commission issued a Report of Investigation concerning the conduct of individual members of the Board of Supervisors, namely, Thomas F. Riley, William G. Steiner, Roger R. Stanton, Gaddi H. Vasquez and Harriett M. Wieder. The Report of Investigation does not constitute an adjudication of any fact or issue addressed in the Report. The Supervisors have consented to the issuance of the Report without admitting or denying any of the statements or conclusions addressed therein. The enforcement proceedings concern the fraudulent offer and sale of over $2.1 billion in municipal securities issued in 1993 and 1994 by Orange County, the Flood Control District and a school district located within Orange County, which was not named in the actions. Raabe, acting in his capacity as a County employee, was principally responsible for the two offerings by the school district.

THE MUNICIPAL SECURITIES OFFERINGS

The following eleven municipal securities offerings are the subject of the enforcement actions taken today:

- the $400,000,000 COUNTY OF ORANGE, CALIFORNIA 1993-94 TAXABLE NOTES issued on July 1, 1993 ("Reinvestment Notes")
- the $600,000,000 COUNTY OF ORANGE, CALIFORNIA 1994-95 TAXABLE NOTES issued on July 8, 1994 ("Reinvestment Notes")
- the $299,660,000 COUNTY OF ORANGE, CALIFORNIA 1994-95 POOLED TAX AND REVENUE ANTICIPATION NOTES, issued on July 1, 1994 ("TRANs")
- the $169,000,000 COUNTY OF ORANGE, CALIFORNIA 1994-95 TAX AND REVENUE ANTICIPATION NOTES, SERIES A issued on July 5, 1994 ("TRANs")
- the $31,000,000 COUNTY OF ORANGE, CALIFORNIA 1994-95 TAX AND REVENUE ANTICIPATION NOTES, SERIES B issued on August 11, 1994 ("TRANs")
- the $111,000,000 COUNTY OF ORANGE, CALIFORNIA 1994-95 (TEETER PLAN) TAXABLE NOTES issued on July 20, 1994 ("Teeter Notes")
- the $64,000,000 COUNTY OF ORANGE, CALIFORNIA 1994-95 (TEETER PLAN) TAX-EXEMPT NOTES issued on August 18, 1994 ("Teeter Notes")

- the $209,840,000 COUNTY OF ORANGE, CALIFORNIA TAXABLE PENSION OBLIGATION BONDS SERIES 1994A and the $110,200,000 COUNTY OF ORANGE, CALIFORNIA TAXABLE PENSION OBLIGATION BONDS SERIES 1994B both issued on September 28, 1994 ("Pension Bonds")

- the $100,000,000 ORANGE COUNTY FLOOD CONTROL DISTRICT TAXABLE NOTES issued on August 2, 1994 ("Reinvestment Notes")

- the PLACENTIA-YORBA LINDA UNIFIED SCHOOL DISTRICT $50,000,000 TAXABLE NOTES issued on August 26, 1993 ("Reinvestment Notes")

- the PLACENTIA-YORBA LINDA UNIFIED SCHOOL DISTRICT $50,000,000 TAXABLE NOTES issued on August 1, 1994 ("Reinvestment Notes")

The County Pools and their relation to the Municipal Securities offerings

Each of the municipal securities offerings was significantly dependent upon the County Pools such that accurate disclosure about the County Pools was material to investors. The County Pools operated as an investment fund managed by Orange County in which the County and various local governments or districts invested or deposited public funds. The County Pools consisted of the Commingled Pool, the Bond Pool and Specific Investments. Each of the municipal securities offerings was connected to the County Pools in one or more ways:

- the proceeds from certain offerings were reinvested in the County Pools to obtain interest earnings;

- the funds pledged to repay certain of the securities were invested in the County Pools;

- the County Pools agreed to repurchase or repay certain of the securities; and/or

- the County's economic reliance on the County Pools materially affected its ability to repay the securities.

Misstatements and omissions alleged in the Commission's Actions

As set forth below, the County, the Flood Control District, the Board of Supervisors, Citron and Raabe variously made material misstatements and omissions of fact in the Official Statements for the eleven offerings, regarding:

- the County Pools, including the County Pools' investment strategy and investment results, manipulation of the County Pools' yield and investment in the County Pools of the funds pledged to repay the municipal securities. These matters affected the issuer's ability to repay the securities and the County Pools' ability to perform under agreements to repurchase or provide for repayment of the securities;

- Orange County's financial condition, including its economic reliance on interest income from the County Pools as a source of funds to repay the purchasers of the securities;
- the tax-exempt status of the offering;
- an undisclosed interest rate cap on certain variable rate securities sold in the offerings; and
- the unauthorized use of an audit report prepared by an outside accounting firm.

In addition, in connection with the offer and sale of certain of the securities, misrepresentations were made to national securities rating agencies concerning the County Pools.

Misstatements and Omissions Regarding the County Pools

The Official Statements for the eleven offerings misrepresented or omitted to disclose material information concerning the County Pools, despite their significance to each of the offerings. Where the funds pledged to repay the noteholders were invested in the County Pools, the issuer looked to that investment to satisfy its repayment obligations. Any risks that those pledged funds would decrease affected the issuer's ability to repay the noteholders. Similarly, in the offerings where the County Pools agreed to repurchase the securities, disclosure regarding the County Pools was important so that investors could evaluate the County Pools' financial strength and ability to perform under the agreement. In addition, in certain Orange County offerings in which other County funds were a source of repayment, disclosure regarding the County Pools was important to investors because availability of such other funds depended upon the County Pools' performance.

Citron and Raabe caused the County Pools to engage in a very risky investment strategy. The strategy involved using a high degree of leverage by obtaining funds through reverse repurchase agreements on a short-term basis (less than 180 days), and investing in securities with a longer maturity (generally two to five years), many of which were volatile derivative securities.

The County Pools' investment return was to result principally from the interest received on the securities in the County Pools. Leverage enabled the County Pools to purchase more securities for the purpose of generating increased interest income. This strategy was profitable as long as the County Pools were able to maintain a positive spread between the long-term interest rate received on the securities and the short-term interest rate paid on the funds obtained through reverse repurchase agreements.

The Official Statements variously contained false or misleading disclosure regarding the County Pools in four areas:

1. Investment Strategy and the Risks of That Strategy

The Official Statements for all eleven offerings misrepresented and/or failed

to disclose material information concerning the County Pools' investment strategy and the risks of that strategy. With respect to the investment strategy, the Official Statements failed adequately to disclose that the strategy: 1) was risky; 2) was predicated upon the assumption that prevailing interest rates would remain at relatively low levels; 3) involved a high degree of leverage through the use of reverse repurchase agreements; 4) involved a substantial investment in derivative securities, including inverse floaters that are negatively affected by a rise in interest rates; and 5) was very sensitive to changes in the prevailing interest rate because of the leverage.

During 1993 and 1994, Citron and Raabe leveraged the County Pools to amounts ranging from 158% to over 292%. Moreover, volatile derivative securities comprised from 27.6% to 42.2% of the combined County Pools' portfolio and from 31% to 53% of the Commingled Pool's portfolio. From January 1993 through November 1994, from 24.89% to 39.84% of the County Pools' total portfolio consisted of inverse floaters. In contrast, the County Pools invested only sparingly in securities that paid interest rates directly related to the prevailing interest rate (variable rate securities) or securities that paid interest rates that rose at certain stated intervals to certain stated rates (step-up securities). From January 1993 through November 1994, only 1.84% to 5.59% of the County Pools' portfolio consisted of such securities. Accordingly, the County Pools invested in inverse floaters to speculate on the direction of short and long-term interest rates.

The Official Statements also failed to adequately disclose the risks of the investment strategy. Specifically, if interest rates rose, as they did in 1994, it would have a substantial negative impact on the County Pools and, because of its dependence on the County Pools, the County itself.

First, the reverse repurchase costs would increase and the income that the County Pools earned from the inverse floaters in the portfolio would decrease, creating lower earnings for the County Pools. Second, the County Pools' securities would decline in market value. Third, as the value of the County Pools' securities fell, the County would suffer collateral calls from broker-dealers and reductions in loan amounts on the reverse repurchase agreements. All three events would reduce the income that Orange County would receive from the County Pools, with the possible loss of principal of invested funds as well. None of these risks were disclosed.

2. Investment Results

The Official Statements for the nine offerings conducted in 1994 failed to disclose material information concerning the County Pools' investment results. During 1994, the County Pools' investment income declined because reverse repurchase costs had increased while the income that the County Pools earned from inverse floaters had decreased. Additionally, the County Pools had suffered substantial market losses in the overall value of the portfolio. The declining market value of securities in the County Pools resulted in collateral calls and reductions in amounts obtained under reverse repurchase agreements and liquidity. These results were not disclosed to investors in the 1994 offerings.

3. Manipulation of the Yield

The Official Statements for eight offerings--the three 1994 Reinvestment Notes, the $169 Million and the $31 Million TRANs, the two Teeter Notes and the Pension Bonds--misrepresented that the County Pools' yield would be distributed pro rata to the Participants. Citron and Raabe had in fact diverted interest income from certain Commingled Pool Participants to an account for the benefit of Orange County. As a result, the Commingled Pools' yield was misrepresented in the Official Statements for these offerings. In late 1994, Citron and Raabe used a portion of the misappropriated funds to supplement the Commingled Pools' yield. The "supplemented" yield was then falsely reported in the Official Statement for the Pension Bonds.

Citron and Raabe also shifted market losses from some Specific Investment Participants, including the County, to the Commingled Pool, causing the Commingled Pool Participants to suffer losses that should have been borne by others. This information was not disclosed and also rendered false the representations regarding the pro rata distribution.

4. Investment in the County Pools

The Official Statements for the $400 Million Reinvestment Notes, the 1993 $50 Million Reinvestment Notes and the $299.66 Million Pooled TRANs stated that the funds pledged to repay the Notes would be invested as permitted by the resolutions authorizing the issuance and sale of the Notes and by California law. None of the Official Statements for these three offerings disclosed that the issuer intended to invest such funds in the County Pools. In fact, there is no narrative discussion of the Pools in the Official Statements for the two reinvestment offerings.

Misstatements and Omissions Regarding the Financial Condition of the County

The Official Statements for six of Orange County's offerings failed to disclose Orange County's true financial condition, in particular, that the County was using interest income from the County Pools as the largest single source of revenue for its discretionary budget. These offerings are the $600 Million Reinvestment Notes, the $169 Million and $31 Million TRANs, the two Teeter Notes and the Pension Bonds. Further, the County's use of this interest income as a revenue source was increasing while other traditional revenue sources, such as property taxes, were decreasing. The funds invested to generate investment income came from two sources, the County's own funds and proceeds from the reinvestment offerings. Orange County had invested essentially all of its liquid assets in the County Pools, including funds to repay its municipal securities. In addition, the investment of virtually all of the County's liquid assets in the County Pools exposed Orange County to the volatility of the County Pools, including the potential loss of not only interest income, but of principal as well. The failure to disclose this information rendered disclosure regarding the County's financial condition and its ability to repay its securities materially misleading.

This information regarding Orange County's financial condition was important as it related to Orange County's ability to repay its obligations, including the municipal securities debt. Moreover, with the exception of the Pension Bonds, these County offerings were short-term general obligations,

which, under California law, the County could repay only with funds received or accrued during fiscal year 1994-95. Therefore, given the County's use of interest income from the County Pools, if the County Pools' investments performed poorly, as eventually occurred, the County would have a budget deficit and could not repay the securities and meet its other expenses. The County's financial condition was also material to the County's ability to perform under certain agreements to repurchase or provide for repayment of the securities.

Misstatements and Omissions Regarding the Tax-Exempt Status of the Offering

The Official Statements for the $169 Million and $31 Million TRANs represented that these securities offerings were tax-exempt. These TRAN offerings were to fund the County's cash flow deficit. In order to qualify for tax-exempt status, the offerings must comply with certain IRS regulations that limit the amount that may be raised through tax-exempt offerings. With respect to both of these offerings, the County jeopardized the tax-exempt status of these offerings by increasing the size of its cash flow deficit, and, thereby, the size of the offering, through artificial means. None of the facts relating to the County's artificial increase of the size of its cash flow deficit were disclosed in the Official Statements for these offerings.

Misstatements and Omissions Regarding an Undisclosed Cap on the Interest Rate Payable to Investors

The Official Statements for the $600 Million Reinvestment Notes, the $111 Million Teeter Notes and the $100 Million Reinvestment Notes each stated that they paid a variable interest rate connected to the one-month LIBOR. Undisclosed, however, was the fact that the Notes for each of these offerings contained a 12% cap on the maximum variable interest rate that would be paid by the County. While the existence of this cap was indicated on the face of the Notes, no disclosure was made to noteholders prior to purchase.

Misstatements and Omissions Regarding the Unauthorized Use of an Audit Report

The Official Statements for seven offerings falsely represented that the County's auditor "consented to the inclusion . . . of the County's audited financial statements. . ., together with the report accompanying the audited financial statements." The offerings which contained the false statement were the $600 Million Reinvestment Notes, the $400 Million Reinvestment Notes, the two Teeter Notes, the $169 Million TRANs, the $31 Million TRANs and the $100 Million Reinvestment Notes. This report and Orange County's audited financial statements were included as exhibits to the Official Statements for these offerings.

In fact, the auditors did not consent to the inclusion of their report, did not conduct any post-audit review and were not even aware that the Official Statements represented that they consented to the inclusion of the report until after the County filed for bankruptcy.

Misrepresentations to Rating Agencies

In presentations to national rating agencies relating to eight offerings--the $600 Million, the $100 Million and the 1994 $50 Million Reinvestment Notes, the $169 Million and the $31 Million TRANs, the two Teeter Notes and the Pension Bonds--Raabe misrepresented the County Pools' holdings. These misrepresentations ultimately ran to the purchasers of these securities. Raabe represented that only 20% of the County Pools' portfolio consisted of derivative securities. In fact, derivative securities comprised from 27.6% to 42.2% of the combined County Pools' portfolio and from 31% to 53% of the Commingled Pool's portfolio. In particular, inverse floaters comprised from 24.89% to 39.84% of the County Pools' holdings.

Raabe also misrepresented to rating agencies that money in an Orange County account designated the "Economic Uncertainty Fund" was available to pay the principal and interest on five offerings--the $600 Million Reinvestment Notes, the $169 Million and the $31 Million TRANs and the two Teeter Notes--and omitted to disclose that such funds had been misappropriated from the Commingled Pool Participants.

Report of Investigation Issued concerning Individual Members of the Board of Supervisors

Additionally, the Commission issued a Report of Investigation pursuant to Section 21(a) of the Exchange Act with respect to the conduct of the individual members of the Board of Supervisors in authorizing six of the Orange County offerings. The individual members of the Board of Supervisors have consented to the issuance of the Report, without admitting or denying any of the statements or conclusions contained in the Report.

In 1993 and 1994, the individual members of the Board included:

- Thomas F. Riley, age 83, who was appointed Supervisor in 1974, elected to the Board two years later, and served continuously through 1994, after which he retired. Riley was the Chairman of the Board in 1994.

- William G. Steiner, age 58, who was appointed Supervisor in 1993, elected in 1994, and is currently a member of the Board. His term expires on December 31, 1998.

- Roger R. Stanton, age 58, who was first elected Supervisor in 1980, and is currently a member of the Board and its Chairman. His term expires on December 31, 1996.

- Gaddi H. Vasquez, age 40, who was appointed to the Board in 1987, elected in 1988, and served continuously until his resignation on September 27, 1995. Prior to his resignation, Vasquez was the Chairman of the Board in 1995.

- Harriett M. Wieder, age 75, who was first elected Supervisor in 1978, was Chairman of the Board in 1993 and a member through 1994.

The Commission is issuing this Report to emphasize the responsibilities under the federal securities laws of local government officials who authorize

the issuance of municipal securities and related disclosure documents and the critical role such officials play with respect to the representations contained in the Official Statements for those securities.

In authorizing the issuance of securities and related disclosure documents, a public official may not authorize disclosure that the official knows to be false; nor may a public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading. When, for example, a public official has knowledge of facts bringing into question the issuer's ability to repay the securities, it is reckless for that official to approve disclosure to investors without taking steps appropriate under the circumstances to prevent the dissemination of materially false or misleading information regarding those facts. In this matter, such steps could have included becoming familiar with the disclosure documents and questioning the issuer's officials, employees or other agents about the disclosure of those facts.

In this case, the Supervisors approved Official Statements that, among other things, failed to disclose certain material information about Orange County's financial condition that brought into question the County's ability to repay its securities absent significant interest income from the County Pools. The Supervisors were aware of material information concerning Orange County's financial condition; this information called into question the County's ability to repay its securities. Nevertheless, the Supervisors failed to take appropriate steps to assure disclosure of these facts. In light of these circumstances, the Board members did not fulfill their obligations under the antifraud provisions of the federal securities laws in authorizing the issuance of the municipal securities and related disclosure documents.

The Commission's investigation remains ongoing.

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***SEC v. Robert L. Citron and Matthew R. Raabe***, Litigation Release No. 14913 (May 17, 1996) (settled final orders).

The United States Securities and Exchange Commission announced that on May 9, 1996, the Honorable Gary L. Taylor, United States District Court for the Central District of California, entered final judgments of permanent injunction against Robert L. Citron and Matthew R. Raabe. In its Complaint filed January 24, 1996, the Commission charged former Orange County Treasurer-Tax Collector Robert L. Citron and former Assistant Treasurer Matthew R. Raabe with violations of the antifraud provisions of the federal securities laws, Section 17(a) of the Securities Act of 1933 and Section 10 (b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Citron and Raabe, without admitting or denying the allegations in the Complaint, consented to the entry of final judgments of permanent injunction, enjoining them from future violations of the antifraud provisions. In addition, they agreed to cooperate with Commission staff in the continuing investigation and any resulting litigation.

The Complaint concerned the fraudulent offer and sale of over $2.1 billion in municipal securities issued in 1993 and 1994 by Orange County, the Orange County Flood Control District, and a school district located within

Orange County. The Complaint alleged that Citron and Raabe made material misstatements and omissions of fact in the Official Statements for eleven municipal securities offerings, regarding:

- the Orange County Investment Pools, including the County Pools' investment strategy and investment results, manipulation of the County Pools' yield and investment in the County Pools of the funds pledged to repay the municipal securities. These matters affected the issuer's ability to repay the securities and the County Pools' ability to perform under agreements to repurchase or provide for repayment of the securities;

- Orange County's financial condition, including its economic reliance on interest income from the County Pools as a source of funds to repay the purchasers of the securities;

- the tax-exempt status of certain offerings;

- an undisclosed interest rate cap on variable rate securities sold in certain offerings; and

- the unauthorized use of an audit report in certain offerings.

In addition, Raabe made misrepresentations to national securities rating agencies concerning the County Pools in connection with certain offerings.

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***Securities and Exchange Commission v. Louis Bethune, Charles L. Howard and John Jackson***, Civ. Action No. CV:95-B2509 (N.D. Ala.), Litigation Release No. 14675 (October 2, 1995) (complaint).

The United States Securities and Exchange Commission ("Commission") announced that on September 29, 1995, a complaint was filed in the United States District Court for the Northern District of Alabama seeking to permanently enjoin Louis Bethune ("Bethune"), Charles Howard ("Howard") and John Jackson ("Jackson") from further violations of the antifraud provisions of the federal securities laws. Bethune and Howard are longtime residents of Birmingham. Jackson is the mayor of a White Hall, a small town in central Alabama. The complaint alleges that the defendants participated in a fraudulent scheme to pledge $300 million in revenue bonds purportedly issued by the Redevelopment Authority of White Hall ("Authority") in an attempt to obtain a $255 million margin loan from a Sarasota, Florida office of Smith Barney, Inc. ("Smith Barney"). The complaint also alleges that prime bank securities do not exist and that all series of the bonds issued by the Authority contained multiple misrepresentations, including fundamental misrepresentations that the bonds were "Bank Guaranteed," and that they were backed by "Prime Bank Securities, issued by an acceptable institution in good standing, rated AA+ or higher by Standard & Poors. "The complaint seeks a permanent injunction, an order imposing civil monetary penalties on the defendants and other equitable relief.

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***Securities and Exchange Commission v. Louis Bethune, Charles L. Howard and John Jackson***, Litigation Release No. 15024 (August 26, 1996) (settled final order).

The United States Securities and Exchange Commission ("Commission") announced that on August 8, 1996, the Honorable Sharon Lovelace Blackburn of United States District Court for the Northern District of Alabama entered a final judgment of permanent injunction against defendant John Jackson, Mayor of White Hall, Alabama, prohibiting Jackson from future violations of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934. Jackson consented to the entry of the permanent injunction against him without admitting or denying the allegations of the complaint.

The Commission's complaint, filed September 29, 1995, alleged that the defendants participated in a fraudulent scheme to pledge $300 million in revenue bonds purportedly secured by prime bank securities and issued by the Redevelopment Authority of White Hall ("Authority") in an attempt to obtain a $255 million margin loan from a Sarasota, Florida office of Smith Barney, Inc. ("Smith Barney"). The complaint also alleges that prime bank securities do not exist and that all series of the bonds issued by the Authority contained multiple misrepresentations, including fundamental misrepresentations that the bonds were "Bank Guaranteed," and that they were backed by "Prime Bank Securities, issued by a an acceptable institution in good standing." See also, LR.-14675/October 2, 1995.

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***Securities and Exchange Commission v. Louis Bethune, Charles L. Howard and John Jackson***, Litigation Release No. 15271 (February 28, 1997) (settled final order).

The Securities and Exchange Commission announced today that on February 20, 1997, the Honorable Sharon Lovelace Blackburn, United States District Judge for the Northern District of Alabama, entered a final judgment of permanent injunction against defendant Charles L. Howard ("Howard"), enjoining him from violating Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Upon sworn representations of a financial inability to pay a fine, no civil penalties were imposed. Howard consented to the relief without admitting or denying the allegations set forth in a complaint filed by the Commission on September 29, 1995. The complaint alleged that Howard, along with codefendants Louis Between and John Jackson, violated the antifraud provisions of the securities laws in the offer and sale of municipal bonds, the proceeds of which were to be used for downtown redevelopment projects in White Hall, Alabama. Howard and codefendant Bethune persuaded city officials to allow them to sell the bonds at face values disproportionate to the costs of the projects being funded by the bonds. The complaint also alleged that Howard and his codefendants misrepresented to investors that the bonds were backed by "Prime Bank Securities. "In fact, none of the bonds offered for sale by Howard were ever

guaranteed or secured by any financial instrument which could be described as a prime bank security.

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***Securities and Exchange Commission v. Terry D. Busbee and Preston C. Bynum***, Civ. Action No. 95-30024 RV (N.D. Fla.), Litigation Release No. 14387 (January 23, 1995) (complaint).

The Securities and Exchange Commission ("Commission") announced today that it filed a Complaint for Injunctive and Other Equitable Relief and Civil Money Penalties ("Complaint") in the United States District Court for the Northern District of Florida against Terry D. Busbee ("Busbee"), an elected public official of the Escambia County Utilities Authority ("ECUA") from approximately 1984 through 1994, and Preston C. Bynum ("Bynum"), an employee of Stephens Inc. ("Stephens"), a municipal securities underwriter. The Complaint alleges that from at least 1990 through at least 1993, the defendants defrauded the ECUA and investors in three offerings of municipal securities issued by the ECUA. According to the Complaint, Busbee and Bynum entered into certain financial arrangements, pursuant to which Busbee received certain benefits from Bynum, during a time when Busbee had an important role in selecting the underwriter for municipal securities issued by the ECUA. The Complaint alleges that Bynum caused the following benefits to be provided to Busbee: 1) the extension and guarantee of four loans totaling $36,700 from an Arkansas bank; 2) repayment of approximately $27,000 in principal and interest on three of the loans; and 3) payment of approximately $3,500 to Busbee directly. The Complaint further alleges that Busbee voted to select, and otherwise participated in the selection of Bynum's employer as the underwriter or senior managing underwriter for three ECUA municipal securities offerings.

According to the Complaint, Busbee and Bynum each had a duty to disclose the financial arrangements to the ECUA in connection with Stephens' selection as underwriter in the three offerings and to investors in the three offerings. The Complaint alleges that Busbee's and Bynum's failure to disclose the financial arrangements and the actual and potential conflicts of interest created by those arrangements, at the time Bynum's employer was selected as underwriter and at the time those ECUA securities were offered and sold to the public, violated the following antifraud provisions of the federal securities laws: Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder. In addition, the Complaint alleges that Bynum also violated Rules G-17 and G-20 of the Municipal Securities Rulemaking Board ("MSRB"), which prohibit unfair practices in the conduct of municipal securities business and place limitations on gifts in relation to certain municipal securities activities, and Section 15B(c)(1) of the Exchange Act, which prohibits effecting transactions in municipal securities in contravention of any rule of the MSRB.

In its Complaint, the Commission seeks permanently to enjoin both defendants from violating the antifraud provisions described above, and to enjoin Bynum from violating MSRB Rules G-17 and G-20, as well as Section 15B(c)(1) of the Exchange Act. In addition, the Commission seeks orders requiring each of the defendants to pay civil money penalties.

Also today, the United States Attorney for the Northern District of Florida announced that a federal grand jury indicted Busbee and Bynum on charges relating to the conduct alleged in the Complaint.

The Commission's investigation continues as to the conduct of other individuals and entities involved in this matter.

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***Securities and Exchange Commission v. Terry D. Busbee and Preston C. Bynum***, Litigation Release No. 14508 (May 24, 1995) (settled final order).

The Securities and Exchange Commission announced today that Terry D. Busbee and Preston C. Bynum agreed to settle the civil action brought by the Commission in United States District Court for the Northern District of Florida on January 23, 1995. Without admitting or denying the allegations contained in the Complaint, Busbee, an elected public official of the Escambia County Utilities Authority ("ECUA") from approximately 1984 through 1994, and Bynum, formerly an employee of the public finance department of Stephens Inc., consented to the entry of final judgments of permanent injunction providing for all of the equitable relief sought by the Commission.

The Complaint filed by the Commission alleges that from at least 1990 through at least 1993, the defendants defrauded the ECUA and investors in three offerings of municipal securities issued by the ECUA. According to the Complaint, Busbee and Bynum entered into certain financial arrangements, pursuant to which Busbee received certain benefits from Bynum, during a time when Busbee had responsibility for selecting the underwriter for municipal securities issued by the ECUA. The Complaint alleges that Bynum caused the following benefits to be conferred on Busbee: (1) the extension and guarantee of four loans totaling $36,700 from an Arkansas bank; 2) repayment of approximately $27,000 in principal and interest on three of the loans; and 3) payment of approximately $3,500 to Busbee directly. The Complaint further alleges that Busbee voted to select, and otherwise participated in the selection of Bynum's employer as the underwriter or senior managing underwriter for three ECUA municipal securities offerings. See Litigation Rel. No. 14387 (January 23, 1995).

Bynum has consented to the entry of a final judgment that permanently enjoins him from future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 15B(c)(1) of the Exchange Act and Rules G-17 and G-20 of the Municipal Securities Rulemaking Board. In addition, Bynum also has agreed to pay a civil money penalty in the amount of $25,000. Busbee also has consented to the entry of a final judgment that permanently enjoins him from future violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and that notes that no penalty is imposed on Busbee based on his demonstrated inability to pay.

As part of the settlement, Bynum has also agreed to the issuance by the Commission of an Order Instituting Proceedings, Making Findings and Imposing Sanctions, that bars him permanently from association with any

entity regulated by the Commission.

Last week, H. Michael Patterson, the United States Attorney for the Northern District of Florida, announced that in related criminal proceedings, on May 17 Busbee was sentenced to twenty-seven months in prison, with three years probation for his violations of *18 U.S.C. § 666* (bribery concerning programs receiving federal funds) and *26 U.S.C. § 7206* (false statement on an income tax return); and that on May 18 Bynum was sentenced to a prison term of twenty-four months with two years probation, for his violation of *18 U.S.C. § 666*. Both defendants had previously pleaded guilty to those charges, on March 3, 1995.

The Commission acknowledges the assistance of the United States Attorney for the Northern District of Florida and the Criminal Investigation Division of the Internal Revenue Service.

The Commission's investigation continues as to the conduct of other entities and individuals involved in this matter.

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***SEC v. Whatcom County Water District No. 13, et al.***, Civ. Action No. C77-103, (W.D. Wash.), Litigation Release No. 7810 (March 7, 1977) (complaint); Litigation Release No. 7592 (May 10, 1977) (settled final orders).

***See "The Issuer" section.***

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***SEC v. Washington County Utility District, et al.***, Civ. Action No. CA-2-77-15 (E.D. Tenn.), Litigation Release No. 7782 (February 15, 1977) (complaint).

***See "The Issuer" section.***

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***SEC v. Washington County Utility District, et al.***, Litigation Release No. 7868 (April 14, 1977) (settled final orders).

Jule B. Greene, Administrator of the Atlanta Regional Office of the Securities and Exchange Commission, announced that on March 30, 1977, the Honorable Charles G. Neese, Judge of the United States District Court for the Eastern District of Tennessee, Northeastern Division in Greeneville, issued orders of preliminary and permanent injunction from further violations of the anti-fraud provisions of the federal securities laws against Washington County Utility District ("WCUD"), of Washington County, Tennessee, a "municipality or public corporation", Commissioners Paul G. Puckett of Johnson City, Tennessee, and Stella B. Harwood of Jonesboro, Tennessee and Hertz N. Henkoff of Boston, Massachusetts, an attorney who

served as bond counsel for several issues of revenue bonds of WCUD.

WCUD was further directed to make an accounting of the receipt and disbursement of all funds received in connection with all revenue bonds it has issued.

Puckett and Harwood were ordered to disgorge certain bonds of WCUD in their possession and to pay over to the Clerk of the Court for the benefit of bondholders the proceeds from the sale of certain other bonds of WCUD.

In addition, Judge Neese signed an order of preliminary injunction with respect to Wade H. Patrick of Johnson City, Tennessee, the manager of WCUD and ordered that a trust be impressed upon all of his assets and that he make an accounting of all income, property or other assets received by him from WCUD or from other source as a result of activities involving WCUD.

Between 1965 and 1975 WCUD had made seven different bond offerings; four for its garbage division ($2,175,000) and three for its cable antenna television division ($1,500,000).

The complaint alleged numerous untrue statements of material facts concerning, among other things, the use of the proceeds obtained from the sale of revenue bonds issued by WCUD; the purposes for which the bonds were issued; the priority of liens of the bondholders on property owned by WCUD or its divisions; and the sufficiency of revenues in each division of WCUD to meet expenses including debt service. The complaint also alleged numerous omissions to state material facts including the following: that WCUD bonds were sold at substantial discounts, ranging from 10 to 42 percent; that WCUD prior to 1975 failed to have audited financial statements prepared; that WCUD was not making payments into a sinking fund to retire the bonds outstanding; that proceeds from the sale of bonds were used for purposes other than represented in prospectuses or authorized in the bond resolutions, such as loans to Patrick and companies controlled by Patrick or his relatives, payment of interest on prior issues of bonds, and loans or advances to other divisions of WCUD.

The individual defendants consented to the relief requested; the decree against WCUD was entered by default. For further information, see Litigation Release No. 7782.

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***SEC v. Washington County Utility District, et al.***, Litigation Release No. 8410 (May 15, 1978) (settled final order).

Jule B. Greene, Administrator of the Atlanta Regional Office of the Securities and Exchange Commission, announced that on May 5, 1978, the Honorable Charles G. Neese, Judge of the United States District Court for the Eastern District of Tennessee, Northeastern Division, in Greenville, issued an order of permanent injunction from further violations of the anti-fraud provisions of the federal securities laws against Henry C. Miller of Johnson City, Tennessee, in connection with the offer and sale of revenue

bonds of Washington County Utility District, Washington County, Tennessee (WCUD) or any other security.

Miller was further ordered to waive claim to a bond of WCUD and monies paid over to the Clerk of the Court.

Between 1965 and 1975 WCUD had made seven different bond offerings; four for its garbage division ($2,175,000) and three for its cable antenna television division ($1,500,000).

The complaint alleged numerous untrue statements of material facts concerning, among other things, the use of the proceeds obtained from the sale of revenue bonds issued by WCUD; the purposes for which the bonds were issued; the priority of liens of the bondholders on property owned by WCUD or its divisions; and the sufficiency of revenues in each division of WCUD to meet expenses including debt service. The complaint also alleged numerous omissions to state material facts including the following: the WCUD bonds were sold at substantial discounts, ranging from 10 to 42 percent; that WCUD prior to 1975 failed to have audited financial statements prepared; that WCUD was not making payments into a sinking fund to retire the bonds outstanding; that proceeds from the sale of bonds were used for purposes other than represented in prospectuses or authorized in the bond resolutions, such as loans to the manager of WCUD or companies controlled by him or his relatives, and loans or advances to other divisions of WCUD.

Miller consented to the relief requested without admitting or denying the allegations in the Complaint. For further information, see Litigation Release Nos. 7782 and 7868.

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***SEC v. Washington County Utility District, et al.***, 1982 U.S. Dist. LEXIS 17316 (E.D. Tenn. Dec. 2, 1982).

*Opinion: NEESE*, Senior District Judge: The Court hereby ADOPTS, as its own, the findings of fact and conclusions of law proposed jointly by the remaining parties and filed herein on November 3, 1982.

Proposed Findings of Fact and Conclusions of Law

The Plaintiff, Securities and Exchange Commission, and the Defendant, Wade H. Patrick, pursuant to order of this Court dated May 25, 1982, jointly present the following proposed Findings of Fact and Conclusions of Law:

Findings of Fact

**I. Background**

1. Washington County Utility District ("District") was organized under the laws of the State of Tennessee in 1955 as the Garbage Disposal District of Washington County, Tennessee. Its name was changed to its present form

in 1966. (Stipulation)

2. Wade H. Patrick has, since at least 1956, been manager of the District and has dominated and controlled its affairs. (Stipulation; Ex. 104B pp. 18-19, 78-80, 84-85; 105, p. 17; Alcock Tr. 51)

3. HPO Services, Inc ("HPO") is a company owned by Wade H. Patrick. (Ex. 102B pp. 64-65; Patrick Tr. 42-44)

4. Diversified Securities, Inc. ("Diversified") is a New York corporation owned by Thomas R. Alcock. (Stipulation)

5. Thomas R Alcock through Diversified Securities, Inc. or doing business as T.R. Alcock & Co. has acted as underwriter of all the bonds sold by the District since 1965 and as its fiscal agent. (Stipulation)

**II. Bond Offerings**

6. From 1965 through 1975 the District issued seven different bond issues; three were for its Community Antenna Television System Division (CATV), and four issues were for its Garbage Division. (Stipulation)

7. The total amount of the bonded indebtedness for the Utility District as a result of the bond offerings was $3,675,000. The bonds issued by the CATV Division total $1,500,000; the Garbage Division has issued a total of $2,175,000. (Stipulation)

8. Each of the issues of bonds was payable solely from revenue generated from the particular division which issued the bonds. (Stipulation)

9. Each of the bond resolutions authorizing the issuance of bonds by the District specified the purposes for which the funds were being raised. (Stipulation) The major purposes specified in the bond resolutions were as follows:

(a) The 1965 Garbage Division offering was to refund a prior bond issuance; (Ex. 4)

(b) The 1968 CATV Division offering was to construct a CATV system; (Prel. Ex. 11)

(c) The 1970 Garbage Division offering was to pay for the cost of constructing and acquiring extensions and improvements to the garbage disposal system including the acquisition of an additional landfill site; (Prel. Ex. 11)

(d) The 1971 CATV bond offering was to provide for the acquisition, construction and operation of extensions to the system; (Prel. Ex. 11)

(e) The 1972 Garbage Division bond offering was to provide funds for the cost of constructing and acquiring extensions and improvements to that system; (Prel. Ex. 11)

(f) The 1973 CATV bond offering was for the acquisition, construction and operation of extensions to that system; (Ex. 3)

(g) The 1974 Garbage Division bond offering was for the purchase and operation of a landfill. (Prel. Ex. 11)

10. Monies from each bond offering, with the possible exception of the 1965 Garbage Division Offering, were used for purposes other than those provided in the bond resolutions.

11. The bonds specifically stated that the District covenanted to charge sufficient fees to provide for the operation of the particular divisions including the payment of interest on the bonds and to provide for the retirement thereof. (Stipulation) The bonds further provided that the Tennessee laws required revenue to be sufficient to meet all such items. (Prel. Ex. 11, 12)

12. Even though the bonds specifically represented that the District would charge sufficient fees to cover the cost of operations, including the payment of interest and principal on the bonds issued, the District never charged sufficient fees to cover costs including amortization of the bonded indebtedness, and the only way it was able to continue its operations was through the fraudulent sale of additional bonds to cover the cost of operations, particularly interest on prior issues of bonds. (Tr. 80, 180-181)

13. It was expressly provided in the bond resolution that funds would be disbursed solely for the purposes for which the bonds were authorized and remaining funds would be put into a sinking fund which constituted a trust fund. (Stipulation)

14. Funds received from the sale of the bonds were regularly and routinely disbursed for purposes not disclosed in the bond resolutions, and no funds were ever put into a sinking fund for the retirement of the bonds as represented in the bond resolutions. (Prel. Tr. 40, Tr. 145-146, 158-159)

15. Each of the bond resolutions required that accurate records would be kept. (Prel. Ex. 11; Ex. 4)

16. Patrick knew that the records being kept by the District were totally inadequate and not accurate so as to reflect the use of funds and was repeatedly advised of the inadequacies of the books and records by the accountant engaged by the District. (Prel. Tr. 35-36; Tr. 84-86) Despite being told by the accountant for the District that the records were not accurate and not adequate, Patrick continued to make representations as to the accuracy of the records in all of the bond resolutions, which resolutions were incorporated by reference in each of the bonds. (Prel. Ex. 11; Ex. 4)

17. Each of the bond resolutions provided that the Utility District would have certified financial statements prepared yearly. The bonds incorporated by reference the resolutions authorizing the issuance thereof together with the representations contained therein. (Stipulation)

18. Patrick knew that the above representations contained in the bond resolutions, and in the bonds by incorporation, were false because the

Utility District never had an audited financial statement prepared until 1975. (*Tr. 84-85 Ex. 102, pp. 37-38* [6-29-76])

19. The law under which the Utility District was organized required that the Utility District have annual financial statements prepared. (Stipulation)

20. Although Patrick knew that the laws of the State of Tennessee required the Utility District to have annual financial statements prepared, he never advised or required that each purchaser of the bonds be advised that the Utility District was not complying with State law in that respect. (Tr. 193-196, Ex. 129)

21. Each bond resolution provided that the bondholders would have a lien on the assets owned or thereafter acquired by the Division of the District offering the particular bonds. (Stipulation; Ex 3; and Prel. Ex. 11)

22. Knowing full well that the first three issues of the Garbage Division had granted a lien on the assets owned or thereafter acquired by the Garbage Division of the Utility District, the District, with Patrick's knowledge, nevertheless falsely represented, in connection with the fourth issue of the Garbage Division's bonds, that the bondholders would have a first lien on certain properties which the Garbage Division had already acquired and to which a lien had attached in favor of the bondholders of the three previous bond offerings. (Tr. 166-167)

**III. Financial Condition of the District**

23. The Garbage Division operated at a loss for the fiscal years 1969 and 1970. (Prel. Tr. 26; Prel. Ex. 1)

24. Washington County Utility District is and has been insolvent since at least June 30, 1973, in that its assets are less than its liabilities. (Stipulation)

25. For the fiscal year ending June 30, 1973, its liabilities exceeded its assets by over $200,000. For the fiscal year ending June 30, 1974, the liabilities of the District exceeded its assets by over $337,000. (Stipulation)

26. The deficit for the fiscal year ended June 30, 1975, increased to over $550,000, and by the year ended June 30, 1976, the liabilities exceeded the assets by over $656,000. This excess of liabilities over assets has increased for the year ending June 30, 1977, to over $813,600. (Stipulation)

27. As of June 30, 1974, the total bonds payable by the District exceeded the total assets by over $225,000; by June 30, 1976, the total bonds payable exceeded the total assets by over $300,000; and by June 30, 1977, the total bonds payable exceeded total assets by over $338,000. (Prel. Ex. 5 & 17; Ex. 1; Prel. Tr. 53)

28. If the amount of depreciation and amortization could be calculated, the effect would be to further increase the deficit. (Prel. Tr. 38-39, 53; Tr. 80-81)

29. The Statute of the State of Tennessee requiring utility districts to prepare annual financial statements was ignored by the District until at least 1974. (Stipulation) J. B. Holt, a certified public accountant, did accounting work for the District from 1958 through 1974, and repeatedly told Patrick that the District's books and records were inaccurate and inadequate. (Prel. Tr. 23-24; Tr. 84-86) Holt, in 1975, completed an audit of the District for the fiscal years ending June 30, 1973, and June 30, 1974. (Prel. Tr. 37; Prel. Ex. 5)

30. The financial statements prepared by Holt were not certified as required by the bond resolutions and the laws of Tennessee because, among other deficiencies, depreciation of fixed assets and amortization of bond costs could not be calculated since records were incomplete. (Stipulation; Prel. Tr. 35-36; Tr. 80-81, 100-101)

31. The District's liabilities exceeded its assets by approximately $230,000 at June 30, 1973 (Stipulation); this was not disclosed in the bond resolution dated April 1, 1974, for the fourth issue of Garbage Division Bonds. (Prel. Ex. 11)

32. There was no disclosure that the District was not and had not been charging sufficient fees to meet all expenses. (Lamberson Tr. 29, 33-35; Carty Tr. 19, 23-24; Glidden Tr. 9, 12-13, 32, 35; Ex. 47, 102 p. 25; Prel. Ex. 5, 16, 17)

33. Patrick signed and caused to be issued an unaudited earnings statement for the Garbage Division for the six months ending December 31, 1973, to be utilized in the offering and sale of the Garbage Division's fourth issue of bonds which earnings statement represented that the Garbage Division was operating at a profit. (Tr. 181-182, Ex. 47)

34. Patrick, subsequent to April 1974, falsely represented to William Carty, a principal of the broker-dealer selling the Fourth issue of bonds of the Garbage Division, that "the District was operating profitably and everything was all right" when Carty called and expressed concern about the market for the bonds. (Carty Tr. 19) Patrick omitted to tell him material facts, including but not limited to the following: that the District had never had an audited financial statement prepared, and consequently, could not ascertain what its condition was; that records of receipts and expenditures were not appropriately maintained; that the District's assets were less than its liabilities; that the District's Divisions were not operating at a profit; that funds of one Division were used for another Division without receiving interest; that such inter-division transfers were used to keep outstanding bonds current by payment of interest; and that funds were loaned to Patrick, his friends and relatives. (Carty Tr. 20-32)

35. Broker-dealers would not have purchased bonds of the District or sold the District's bonds to their customers if apprised that the District was insolvent in that its liabilities exceeded its assets, or if purchased, it would only be for clients who were absolute speculators who purchased such bonds at five cents on the dollar. (Michaels Tr. 14; Carty Tr. 30, 32; Glidden Tr. 35-36; Lamberson Tr. 22-23)

**IV. Misuse of Bond Proceeds**

36. Patrick caused the District to use proceeds from one bond offering to pay interest on other bond offerings (Prel. Tr. 43, Ex. 1); even though the bond resolutions required that the funds be expended only for the purpose for which such bonds were issued and any funds remaining were to be put in a sinking fund which was to constitute a trust fund. (Stipulation; Tr. 85-86; Prel. Tr. 28-29, 42-43) Patrick as manager and controlling person caused this course of business. He handled all receipts and disbursements of funds by the District without direction or authority from the Commission except in a few instances. (Ex. 103, p. 80; Ex. 104, p. 97; Ex. 105, p. 41, 59, 75)

37. Despite the fact that each of the bond resolutions required sinking fund payments to be made for the purposes of retiring the bonds as they came due, the Utility District has not made any sinking fund payments and Patrick did not disclose such information to purchasers of the District's bonds. (Prel. Ex. 5, 11, 16, 17; Ex. 1; Prel. Tr. 54-55)

38. Despite the fact that the bonds issued by the CATV Division and the Garbage Division are revenue bonds payable solely from revenues generated by the appropriate Division, monies have been advanced from one Division of the District to another Division of the District without the payment of interest by the borrower Division. In fact, no interest has ever been paid on advances from one Division to another. (Stipulation)

39. Broker-dealers would not have sold the District's bonds to their customers if they had known that proceeds of the bond offerings of one Division were being loaned to another Division without interest or documentation. (Michaels Tr. 15; Glidden Tr. 18-19)

**A. 1970 Garbage Division Bond Offering**

40. The 1970 bond offering by the Garbage Division was for the purpose of acquiring a landfill for the District. The offering of $650,000 in bonds was authorized by the Commissioners on July 20, 1970. (Stipulation; Prel. Ex. 11)

41. An offering circular utilized in the sale of these bonds by T. R. Alcock represented that the cost of the property to be acquired by the District was $297,500, fraudulently omitting the material fact that the property was to be acquired from Patrick and Alcock at a profit to them of approximately $225,000. (Prel. Ex. 20)

42. No disclosure was made in the bonds, the bond resolution nor the sales literature that of the $297,500 approximately $228,000 in bonds were to be issued to Patrick and Alcock for the transfer of an option to purchase the property for $70,000. (Prel. Tr. 64-65; Prel. Ex. 10, 11 & 12; Alcock Tr. 56-68, 97-98)

43. Patrick omitted to disclose that 6 months prior to transferring the option to the Utility District he paid only $2,000 or $3,000 for the option. (Ex. 102 pp. 35-36; Ex. 102B pp. 8-9; Prel. Tr. 63-65)

44. While the District, in fact, did not pay Patrick $228,000 for the transfer of the option, Patrick did receive approximately $70,000 in bonds, the

cancellation of indebtedness, payment of debt and other consideration. (Prel. Tr. 66-67; Ex. 102B pp. 9-10; 102A pp. 107) This was never disclosed. (Prel. Ex. 11 & 12; Glidden Tr. 28-29; Lamberson Tr. 43) $40,000 par value bonds were given by Patrick to Commissioners Harwood, Miller and Puckett, which have subsequently been disgorged pursuant to the Commissions' settlements. (Tr. pp. 122, 158-159)

45. Bonds or a part thereof received by Patrick in connection with the sale of the option to the District were transferred to the Commissioners without consideration. (Ex. 102 pp. 28-29; 102B pp. 9-10; 103 pp. 70-71) Bondholders were never advised of this fact. (Prel. Ex. 11 & 12)

46. Alcock was paid $32,500 in fiscal agent's fees of which one-half or $16,250 was paid to Patrick. (Alcock Tr. 22-25)

47. Commissioners are prohibited by statute from receiving compensation for their services unless specifically authorized and then they are limited to $600 per year. (Judicial Notice – Tenn. Annotated Statute Ch. 26, Sec. 6-2615; Stipulation)

**B. 1971 CATV Division Bond Offering**

48. Holt prepared and sent to Patrick a schedule of receipts and disbursements for the 1971 CATV Division bond offering which reflected that the District realized only a total of $378,000 including over $10,000 in accrued interest from the sale of bonds with a face amount of $500,000. (Prel. Tr. 32-34; Prel. Ex. 4)

49. Despite the fact that the fiscal agent's fees were excessively set at five or six percent of face rather than the net amount received, Alcock was paid $38,000, of which one-half or $19,000 was paid to Patrick, from the 1971 CATAV Division bound offering which is almost eight percent of par. In addition, over $82,000 was paid in interest on bonds from the proceeds, and the maximum amount which could have been paid by July 31, 1973, on the 1971 bonds was only $49,500; thus pursuant to Patrick's direction there was a diversion of over $32,000 for other issues. (Prel. Ex. 4; Alcock Tr. 22-23)

**C. 1972 Garbage Division Bond Offering**

50. In July 1972, the District authorized the issuance and sale of $500,000 in Revenue Bonds for the Garbage Division for the purpose of "constructing and acquiring extensions and improvements to the system." (Prel. Ex. 11) The District received $400,000 for the $500,000 face amount of the bonds. (Prel. Ex. 5 & 16) All of the bonds were acquired by Alcock at a discount of twenty (20) percent. (Prel. Tr. 27, 41; Prel. Ex. 2; Ex. 21) In addition, the District paid to Alcock or Diversified $57,000 as a fiscal agent's fee, of which one-half or $28,500 was paid to Patrick. Also, it paid legal and auditing expenses of $7,247.11. From the bond proceeds, bond interest and fees of $11,191 were paid. Moreover, from the bond proceeds, funds were diverted in the form of loans directly to Patrick of $11,500 and to D & P Development Co., a partnership in which he had an interest, of $125,000. Bullington Enterprises, an entity controlled by Patrick's son and son-in-law also received $45,000 as a loan. All of the aforesaid loans have been repaid

with interest. From the $400,000 of proceeds realized by the District in this bond offering only $65,874.55 was actually expended for the acquisition of equipment and the construction of improvements to the Garbage Division System. (Prel. Ex. 5, 16; Prel. Tr. 41-45)

51. At Patrick's direction at least $189,000 of the proceeds of the 1972 Garbage Division bond offering was eventually used for a proposed sewer project contrary to the provisions of the bond resolution. (Prel. Ex. 2; Prel. Tr. 28-29; Tr. 160-161)

52. Only one month after misapplying bond proceeds in the form of loans to Bullington Enterprises and D & P Development, the District borrowed funds from a finance company to purchase a truck for the District. (Stipulation; Prel. Ex. 8; Tr. 159-160)

**D. 1973 CATV Division Bond Offering**

53. Only $309,000 was realized by the District from the sale of $400,000 face amount of the 1973 CATV Division bonds. The proceeds together with the $6,135.27 of interest thereon were commingled with $7,000 transferred from the Garbage Division. From such funds and at Patrick's direction $90,375 was used to pay interest on prior bond issues, including Garbage Division issues; $21,875 was used to pay fiscal agent's fees, of which one-half or $10,937.50 was paid to Patrick; and $3,825 was used to pay legal, printing and audit costs. The sum of $5,500 was transferred to the Sewer Division, and $1,000 was transferred to the Transit Division. (Prel. Ex. 5, 16)

54. Alcock knew, before all bonds of the 1973 CATV issue were sold, that the District was about to default by non-payment of interest and conspired with Patrick to pay the interest to conceal the District's financial plight. As consideration for agreement to pay the interest, Alcock was permitted to buy $50,000 of the bonds at a forty-two (42) percent discount with payment for the bonds being deferred over a period of nine months. (Prel. Ex. 6; Ex. 21, 102B p. 55; Alcock Tr. 76-78)

55. Bonds of the third issue of the CATV Division were sold to Carty & Co., Inc., a Memphis broker-dealer, for $990,000 per hundred in 1973 and then resold to customers and other brokers for prices ranging from $89.00 to $97.15. (Michaels Tr. 5-7; Carty Tr. 24-27; Ex. 46)

56. Broker-dealers were not told the above-mentioned material facts and would not have solicited purchases of the District's third issue of CATV Division's bonds at $90.00 per hundred if they had known that the underwriter had paid only $58.00 per hundred for some of the bonds and even in unsolicited trades would have advised purchasers of the fact that the underwriter had paid substantially less for some of the bonds. (Michaels Tr. 18; Carty Tr. 27-28)

**E. 1974 Garbage Division Bond Offering – Landfill**

57. The 1974 Bond Offering by the Garbage Division was in the amount of $675,000. Alcock sold, by the end of June, 1974, bonds with the face amount of $500,000 at seventy-five (75) percent of par; the District thus

realized $375,000 before expenses. (Prel. Ex. 5; Ex. 21)

58. Patrick and Alcock agreed to use proceeds for purposes other than stated in the bond resolution. (Stipulation; Ex. 55-61, 64, 109, 114; Prel. Ex. 5 & 16)

59. The District paid Alcock $33,750 in fiscal agent's fees of which one-half or $16,875 was paid to Patrick. (Alcock Tr. 22-25)

60. Diversified deposited through May 14, 1975 proceeds of $481,641.94 in its client's funds account from the sale of the Garbage Division's 1974 bond issue from the sale of $635,000 face amount of bonds at seventy-five (75) percent of par. (Ex. 114)

61. Alcock personally handled the distribution of funds from the 1974 Garbage Division bond offering. With Patrick's consent over $140,000 was used for the CATV Division contrary to the provisions of the bond resolution. (Ex. 114; Stipulation; Tr. 166-168)

62. Patrick received a loan of $9,000 and Bullington Enterprises received a loan of $10,000 from funds diverted from the bond proceeds (Prel. Ex. 5), both of which have been repaid.

63. In addition to the $64,000 bond interest paid for CATV Division, Patrick paid bond interest on earlier issues of the Garbage Division of over $40,000 contrary to the provisions of the bond resolution. (Prel. Ex. 5, 16; Ex. 114)

64. The Sewer Division received $9,000 from the proceeds of the 1974 bond offering at Patrick's direction. (Prel. Ex. 5 & 16)

65. Although the purported purpose of the 1974 bond offering was to purchase a landfill, only $20,550 was used to partially pay for the Bowers' property, after Patrick caused the District to issue bonds with a face amount of $675,000. (Prel. Ex. 5, 16)

66. Michaels, a representative of Carty & Co., Inc. a broker-dealer, understood proceeds from the Fourth Issue of Bonds of the Garbage Division were to be utilized only for purposes stated in the offering circular. (Michaels Tr. 14)

67. Because of the information furnished to it, Carty & Co., Inc. purchased $600,000 face amount of the Fourth Issue of the Garbage Division at $80.00 per $100 face amount from Cecil Lamberson. The bonds were then resold to the public at prices ranging from $82 to $89 per $100 face amount. (Ex. 46; Michaels Tr. 11; Carty Tr. 8-14)

68. At the time the purchase of the Fourth issue of bonds of the Garbage Division was agreed upon between Lamberson and Carty & Co., an offering circular and an up-to-date financial statement of the District was requested by representatives of Carty & Co. (Michaels Tr. 11; Carty Tr. 15)

69. Broker-dealers would not have purchased the bonds or sold the bonds of the Fourth Issue of the Garbage Division had they known that proceeds of the bond offering were to be used to pay interest on prior bond issues.

Such information was considered material. (Michaels Tr. 14; Glidden Tr. 18-19)

70. The offering circular for the Fourth Issue of the Garbage Division of the District represented that $68,000 of the proceeds were to be used to purchase land and $204,000 was to be used to pay off equipment notes and was so understood by representatives of Carty & Co. who sold the bonds to the public. (Ex. 47; Michaels Tr. 19) With the benefit of all inferences to the defendants only $37,350 could have been used to pay for real estate and only $167,093.97 was used to pay for equipment. (Prel. Ex. 16; Ex. 114)

**V. False Representation That Bondholders of the Garbage Division's Fourth Bond Offering Would Have a Superior Lien**

71. The Utility District's Garbage Division has utilized only one landfill since its organization in which it had a beneficial interest, that being the landfill commonly referred to as the Jonesboro site. The Garbage Division at no time had a special landfill for the refuse of residential users of the service as opposed to refuse of commercial or industrial users of the service. (Stipulation)

72. As early as 1973 the State of Tennessee was demanding that the Utility District take steps to close its Jonesboro site. At the time of trial the Utility District had closed its Jonesboro site and was utilizing the landfill site owned by the City of Johnson City. (Stipulation)

73. The resolutions for the 1965, 1970 and 1972 Garbage Division bond offerings, which were made at Patrick's direction, provided that the bondholders would have a lien on all property then owned by the Garbage Division or thereafter acquired by the District for the Garbage Division. (Stipulation; Prel. Ex. 11; Ex. 4)

74. The fourth issue of the Garbage Division, in 1974 in the face amount of $675,000, was for the specific purpose of acquiring a landfill. (Prel. Ex. 11) In fact, no properties were acquired by the District subsequent to the offer and sale of such bonds. (Prel. Ex. 9, 16 & 17; Ex. 102B pp. 27 & 35)

75. The bond resolution, for the fourth issuance of bonds for the Garbage Division provided, with Patrick's knowledge and consent, that the bondholders would have a first lien on the property to be acquired for the District. Since the prior shareholders already had a lien on the property owned by the District for the Garbage Division, this representation was false and totally misleading. (Stipulation; Prel. Ex. 11)

**VI. Omissions of Material Facts concerning Fiscal Agents Fees Paid by the District and the Financial Feasibility of the Offerings**

76. Customary discount in municipal bond underwritings are one and one-half (1 1/2) to two and one-half (2 1/2) percent of par. Discounts of three (3) to five (5) percent are unusual but at times are given. (Prel. Tr. 14)

77. The cost of a bond offering requiring discounts of ten (10) percent and fiscal agent's fees of five (5) percent plus the issuer paying the cost of the

issue is exhorbitant as a general rule. (Prel. Test. pp. 15-16)

78. A revenue bond offering providing for a twenty (20) percent discount is very risky, fiscally not feasible nor advisable. (Prel. Tr. 17)

79. Increasing the discount to twenty-five (25) percent results in an exhorbitant cost and a discount of thirty (30) percent becomes disastrous. (Prel. Tr. 17)

80. When Patrick's knowledge and consent, bonds of the second Garbage Division offering were sold by the District at prices ranging from sixty-five (65) percent to ninety (90) percent of par value, or at discounts ranging from ten (10) percent to thirty-five (35) percent and $445,000 of the par value of bonds of this issue were exchanged at par value for certificates of indebtedness. (Ex. 116)

81. With Patrick's knowledge and consent, the third Garbage Division issue was sold by the District at a discount of twenty (20) percent. (Ex. 116)

82. With Patrick's knowledge and consent, the fourth Garbage Division issue was sold by the District at discounts from seventeen and one-half (17 1/2) percent to twenty-five (25) percent of par value. (Ex. 116)

83. With Patrick's knowledge and consent, the first CATV Division issue was sold by the District at discounts from twenty (20) percent to fifty (50) percent of par value. (Ex. 116)

84. With Patrick's knowledge and consent, the second CATV Division issue was sold by the District at discounts from twenty-five (25) percent to forth (40) percent of par value.

85. With Patrick's knowledge and consent, the third CATV Division issue was sold by the District at discounts of twenty (20) percent and forty-two (42) percent of par value. (Ex. 5)

86. Of the $400,000 face amount 1973 CATV Division bond offering with Patrick's knowledge and consent, $350,000 were sold at $80 per hundred and the balance, namely $50,000, was sold to Alcock at $58 per hundred which was a discount of forty-two (42) percent. (Prel. Tr. 47; Prel. Ex. 5) Only one-half of the consideration, $14,500, was paid by June 30, 1974 although the sale was in January, 1974. The other $14,500 was not paid until December 13, 1974. (Prel. Ex. 6; Alcock Tr. 71-83)

87. The purported reason Alcock was getting such a substantial discount on the 1973 bond offering was his agreement to pay interest on the 1973 CATV Division bonds coming due in March and September 1974 to prevent default on the bonds which Patrick knew was not being told to purchasers of the bonds. (Prel. Ex. 6)

88. From the difference between the par value and the price paid by the underwriter (discount) the underwriter usually pays all legal, accounting and fiscal agent's fees; however, the District paid all legal, accounting and fiscal agent's fees in addition to the tremendous discounts. (Prel. Tr. p. 14-15) (Prel. Ex. 5, 16, 17; Ex. 116)

89. The District, at Patrick's direction, agreed to pay Diversified fiscal agent's fees from 1965 to 1975, as follows: 1965 Garbage Division 5% of $350,000 or $17,500; 1968 CATV Division 5% of $600,000 or $30,000; 1970 Garbage Division 5% of $650,000 or $32,000; 1971 CATV Division 5% of $500,000 or $25,000; 1972 Garbage Division 6% of $500,000 or $30,000; 1973 CATV Division $25,000 and 1974 Garbage Division 5% of $675,000 or $33,750. (Prel. Ex. 5, 16, & 17; Ex. 9, 10, 11, 116; Alcock Tr. 22-23)

90. For the fiscal year ending June 30, 1973, Alcock received fiscal agent's fees from the 1972 Garbage Division bond offering of $57,000 rather than the $30,000 per agreement. For the fiscal year ending June 30, 1974, Alcock received fees of $46,875 as fiscal agent and $8,208.54 for the fiscal year ending June 30, 1975, or a total of $55,083.54. (Prel. Ex. 5, 16, 17)

91. Patrick unlawfully received one-half of such fiscal agent's fees. (Alcock Tr. 22-23; Tr. 145-156)

92. Patrick authorized Alcock to obtain the bonds of the District at discounts ranging between ten (10) and forty-two (42) percent. Most of the bonds were at discounts of twenty (20) percent or more. The Commissioners were not advised by Patrick prior to the issuance of the bonds what discount would be granted to Alcock. (Alcock Tr. 76-80; Prel. Ex. 5, 6, 11, 13, 15, 16 and 17; Ex. 8 [4/30/68], 16, 17, 21, 50, 89, 93 102B pp. 51-57)

93. The discounts permitted by Patrick were not disclosed. (Lamberson Tr. 18-19; Alcock Tr. 83; Glidden Tr. 20)

94. Despite the abnormal discounts authorized by Patrick the bonds of the District were offered and sold at substantial markups including par or face value by Alcock and others. (Ex. 2, 20, 30, 33, 38, 40, 42, 45, 46, 72, 110, 111; Prel. Ex. 13)

**VII. The District Exceeded the Statutory Interest Limit**

95. The interest rate on Utility District revenue bonds cannot exceed eight (8) percent. (Judicial Notice – Tenn. Annotated Statute Ch. 26, Sec. 6-2620; Prel. Tr. 17-19; Stipulation)

96. Patrick caused the CATV Division to exceed the statutory rate of interest limitation; the interest being eight and eighty-two one hundredths (8.82) percent. (Prel. Tr. 17-18)

**VIII. Misrepresentations and Omissions of Material Facts Concerning the District's Financial Condition, Records and Management's Conflicts of Interest**

97. The District did not maintain accurate books and records. (Prel Ex. 5, 16, Ex. 1; Stipulation)

98. The District bond resolutions presented to the Commissioners by Patrick in 1970, 1972 and 1974 directing the issuance and sale of bonds for the Garbage Division do not disclose that the required sinking fund payments were not met on the prior issues. (Prel. Ex. 11)

99. The District bond resolutions for the CATV Division in 1971 and 1973 presented to the Commissioners by Patrick do not disclose that the required sinking fund payments had not been made as required by the prior bond resolution for the CATV Division. (Prel. Ex. 11; Ex. 3)

100. The conflicts of interest of Patrick and Alcock, including but not limited to the division of fiscal agent's fees with Patrick and Patrick's misapplication of bond proceeds, were not disclosed to investors. (Carty Tr. 21-22, Michael Tr. 15-17, Lamberson Tr. 34-35, Glidden Tr. 12-14, 20, 26-29, 41-42; Prel. Ex. 11 & 12; Ex. 2, 20 & 47)

**IX. Funds Unlawfully Diverted to Patrick or Affiliates**

101. Patrick dominated and controlled the District and its affairs. (Ex. 104B pp. 78-80, 84-85; 105 p. 17; Alcock Tr. 51)

102. Patrick obtained payments from Alcock of one-half the fiscal agent's fees which totaled $96,604.27. (Prel. Tr. pp. 73-74; Ex.102B p. 44; Alcock Tr. 24-28; Prel Ex. 5, 16, 17, Ex. 9. 10, 11, 116, 117)

103. Broker-dealers would not have purchased bonds of the District or sold such bonds to customers if they had been apprised that Alcock, the fiscal agent and underwriter, was making kickbacks to Patrick, the District manager. (Michaels Tr. 15; Glidden Tr. 13-14)

104. From January 1, 1970 to June 30, 1977 Patrick received $97, 450 in salary from the District. (Ex. 117)

105. Diversified with Patrick's knowledge and consent improperly paid from the proceeds of the District's 1974 Garbage Division offering, which proceeds had been deposited in its clients' funds account, $712.50 in legal fees and $2,500.00 in accounting fees in connection with an Internal Revenue Service inquiry into the personal tax returns of Patrick and Alcock. (Ex. 94, 95, 114, 133; and Alcock Tr. 126-128, 130-131)

106. Patrick authorized Diversified to pay from the proceeds of the District's 1974 Garbage Division bond offering, legal and professional fees of $865.00 and $250.00 in connection with Eastern TV Cable Corp., a company owned by Alcock. (Ex. 94, 114, 133; Alcock Tr. 128-130)

107. Property of the District was commingled with property of Patrick. (Patrick Tr. pp. 57-66)

108. There was no disclosure in the bonds or in the bond resolutions of the loans to Patrick or his affiliates. (Stipulation; Prel. Ex. 11, 12; Ex. 3, 4)

109. Broker-dealers would not have purchased the bonds of the District or sold them to their customers if aware that Patrick was causing the District to loan proceeds of the bond offerings to himself, relatives or entities in which he or his relatives had a beneficial interest. (Michaels Tr. 15; Glidden Tr. 26-32; Lamberson Tr. 21-22)

110. Patrick's self-dealing, besides making and receiving loans and selling land to the District, included obtaining $23,316.66 in commissions for the

sale of equipment to the District (Prel. Tr. 72; Ex. 102 pp. 33-35; 117; Patrick Tr. 35-38)

111. The District paid $10,000 to General Electric for D & P Development Company at Patrick's direction in connection with the sale to the District of the option to purchase the Milhorn property. (Ex. 117)

112. Patrick received four (4) $4,500 bonds with a total face value of $20,000 of the 1970 Garbage Division issue in connection with the sale to the District of the option to purchase the Milhorn property. (Ex. 117)

113. Patrick received four (4) $4,500 bonds with a total face value of $20,000 of the 1971 CATV Division issue which were sold for total proceeds of $13,316.66. (Ex. 117)

114. Patrick sold 15,000 par value of the CATV Division's first issue of bonds to T.R. Alcock & Co. on April 26, 1973 for $10,500. (Ex. 49, 50) On May 3, 1973, the District deposited $10,500 from T.R. Alcock & Co. to its bank account and credited Patrick for monies he had previously received from the District. (Ex. 118)

115. Patrick and his wife jointly owned four (4) lots in Johnson City, Tennessee, which they leased to the District at a rental of $400 per month since about 1968. The District at such a rate has paid Patrick $34,000 from December 1, 1968 through December 1975. (Ex. 102B pp. 49-50)

116. No accounting was made by Patrick or the District for the proceeds of the sale of the District's bonds and certificates of indebtedness or transactions between Patrick and the District prior to January 1, 1970, nor of any rents that may have been paid by the District to Patrick. (Ex. 102B pp. 49-50; Ex. 116, 117, 118, 119 & 121)

117. Patrick's brother, a sister, a son, a son-in-law, a daughter and sister-in-law were on the payroll of the District (Ex. 102A p. 108; 103 p. 81; 104B p. 4, 45, 67, 81; 105 p. 68-69; Patrick Tr. p. 13-14)

118. The District at Patrick's direction paid $1,250 to J. B. Holt for accounting fees in connection with the Internal Revenue Service Audit of Patrick personally. (Ex. 118)

119. Simple interest computed at the rate of eight (8) percent on half the fiscal agent's fees received by Patrick from Alcock or Diversified is as follows:

1965
Garbage $8,750.00 at 8% From 6/30/66 to 6/30/79=13 yrs. $9,100.00
1968
CATV $15,000.00 at 8% From 6/30/69 to 6/30/79=10 yrs. $12,000.00
1970
Garbage $16,250.00 at 8% From 6/31/71 to 6/30/79=8 yrs. $10,400.00
1971
CATV $12,500.00 at 8% From 6/30/72 to 6/30/79=7 yrs. $7,000.00
1972

| | | |
|---|---|---|
| Garbage 1973 | $15,000.00 at 8% From 6/30/73 to 6/30/79=6 yrs. | $7,200.00 |
| CATV 1974 | $12,500.00 at 8% From 6/30/74 to 6/30/79=5 yrs. | $5,000.00 |
| Garbage | $16,604.27 at 8% From 6/30/75 to 6/30/79=4 yrs. | $5,313.36 |
| Total | | $56,013.36 interest |

120. Simple interest computed at the rate of 8% on accounting and attorney fees paid by the District for Patrick's personal matters from June 30, 1975 to June 30, 1979 amounts to $1,428.

**Conclusions of Law**

From the foregoing facts, the Court adopts the following conclusions of Law:

1. This Court has jurisdiction of this action under Section 22(a) of the Securities Act of 1933, as amended *(15 U.S.C. 77v*[a] and Section 27 of the Securities Exchange Act of 1934, as amended *(15 U.S.C. 78aa),* and it has in personam jurisdiction of the defendants.

2. Defendant Patrick has violated the antifraud provisions of the Federal Securities Laws, namely Section 17(a) of the Securities Act of 1933 *(15 U.S.C. 77q*[a]0 and Section 10(b) of the Securities Exchange Act of 1934 *(15 U.S.C. 78j*[b]) and Rule 10(b)5 promulgated thereunder (17 C.F.R. 240.10b-5). As part of his scheme all bond resolutions, bond certificates, and bond offering circulars misrepresented or failed to disclose:

(1) The payments made by Diversified to HPO (Patrick) of half of the fiscal agent's fees;

(2) Commissions paid to HPO (Patrick) on the sale of equipment to the District;

(3) Excessive fiscal agent's fees paid by the District;

(4) Loans and other payments by the District to Patrick and relatives or entities controlled by them;

(5) That accurate books and records were not maintained as required by the bond resolutions;

(6) That the District failed to have audited financial statements as required by the bond resolutions and state law;

(7) Excessive discounts given on the sale of the bonds;

(8) The purchase by the District from Patrick of an option to purchase land;

(9) That Patrick and not the Board of Commissioners controlled the District;

3. A duty to disclose material information arises when a person possessing that information has direct contact with investors. Such direct contact does not require physical presence or face-to-face conversation but is satisfied when an agent of an entity undertakes to transmit, for use of investors, information concerning that entity's securities or the entity itself. *Securities and Exchange Commission v. Coffey, 493 F.2d 1304 (6th Cir. 1974);* Securities and Exchange Commission v. Washington County Utility District, Case No. 80-1261, slip opinion, pp. 7-9.

4. The Securities Act "was intended to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary market trading" *U.S. v. Naftalin, 99 S.Ct. 2077, 2084 (1979).*

5. The repeated and continuous securities offerings from 1969 through 1974 without complying with any of the promises and representations contained in the resolutions and the bonds; the disregard of State law; the active concealment of the financial condition of the District; the payment and concealment of fiscal agent's fees and other payments made in connection with the sales; and the self-dealing by Patrick, particularly the accepting of one-half of commissions from Alcock, sales of property and loans to himself and entities controlled by him, constitute a violation of the anti-fraud provisions of the Federal Securities Laws.

Securities and Exchange Commission v. Blatt, *583 F.2d 1325 (5th Cir. 1978);* Securities and Exchange Commission v. Commonwealth Chemicals Securities, Inc., *574 F.2d 90, 100 (2nd Cir. 1978).*

6. "Disgorgement is remedial" and forces the wrongdoer "to give up . . . the amount by which he was unjustly enriched. "Thus, the Court has the power "to order disgorgement . . . with interest" of the amount the person "profited from his wrongdoing."

Securities and Exchange Commission v. Blatt, supra at 1335.

7. Injunctive actions brought by the Securities and Exchange Commission are not governed by state statutes of limitations or laches.

United States v. Summerlin, *310 U.S. 414, 416 (1940);* Costello v. United States, *365 U.S. 265, 281 (1961)* ; United States v. Kellum, *523 F.2d 1284, 1286 (5th Cir. 1975).*

8. Utility Districts are prohibited from paying interest over eight per cent.

Tennessee Code Annotated, Chapter 26, Sec. 6-2620

9. A final judgment of permanent injunction should be granted.

10. Disgorgement to prevent Patrick from being unjustly enriched and benefited should be ordered as follows:

A. One-half of the fiscal agent'sfee received from Alcock or Diversified

$96,604.27

B. Amount misappropriated by Patrick for payment to General Electric on behalf of D & P Development Company

10,000.00

C. Amount received by Patrick as commission on the sale of packers to the District

23,316.66

D. Amount credited to Patrick from the sale $15,000 face amount of the CATV Division's first issue of bonds to T.R. Alcock & Co. on April 26, 1973

10,500.00

E. Amount paid to J. B. Holt for accounting services in connection with the Internal Revenue Service audit of Patrick personally

1,250.00

F. Amounts misappropriated from the proceeds of the District's 1974 Garbage Division offering for payment of legal ($712.50) and accounting ($2,500) fees in connection with an Internal Revenue Service inquiry into the personal tax returns of Patrick and Alcock

3,212.50

11. In view of the fact that Patrick worked for the District, disgorgement of the salary received by Patrick will not be ordered; and because the District obtained the use of Patrick's property, disgorgement of the rental payments received by Patrick is, similarly, not ordered, nor the amounts paid on behalf of Eastern TV Cable Corp. or the proceeds obtained by Puckett from bonds given to him by Patrick because he, Patrick, did not get the use or benefit of such funds.

**Table of Abbreviations**

| | |
|---|---|
| Alcock Tr. | Alcock Transcript |
| Carty Tr. | Carty Transcript |
| Ex. | Exhibit admitted at the pre-trial hearing |
| Glidden Tr. | Glidden Transcript |
| Lamberson Tr. | Lamberson Transcript |
| Michael Tr. | Michael Transcript |
| Patrick | Patrick Transcript |
| Prel. Ex. | Exhibit admitted at hearing on motion for Preliminary Injunction |
| Prel. Tr. | Transcript of testimony at hearing on motion for Preliminary Injunction |

To Contents

***SEC v. Reclamation District No. 2090, et al.***, Civ. Action No. C76-1231-

SAW (N.D. Cal.), Litigation Release No. 7460 (June 22, 1976) (complaint).

***See "The Issuer" section.***

To Contents

***SEC v. Reclamation District No. 2090, et al.***, Litigation Release No. 7547 (September 2, 1976) (settled final order).

Gerald E. Boltz, Regional Administrator of the Los Angeles Regional Office, and Michael J. Stewart, Acting Associate Regional Administrator of the San Francisco Branch Office, announced that on August 27, 1976, the Honorable Robert H. Schnacke, United States District Judge for the Northern District of California, on motion of the Commission, entered an Order of Preliminary Injunction against James H. Dondich of Santa Ana, California, and Roy J. Jackson of Ogden, Utah, proscribing violations of the anti-fraud provisions of the federal securities laws in connection with offers and sales of securities issued by Reclamation District No. 2090 ("the District") and any other security of any other issuer.

Judge Schnacke also entered Final Judgments of Permanent Injunction against Max H. Mortensen of Oakland, California, All-States Tax Exempt Securities, Inc., and Pasquale "Pat" Tamburri, of Clearwater, Florida on August 18, 1976; against Norton McGiffin of Largo, Florida, George E. Grills of Dunedin, Florida, and Jules L. Steele of Clearwater, Florida, on August 16, 1976; against Robert D. Lewis of Palo Alto, California, and John B. Schoenfeld and Lowell C. Lundell of Atherton, California, on August 19, 1976; and against National Municipal Bond Co., Inc. and Roger W. Osness of St. George, Utah on August 24, 1976. The permanent injunctions enjoin these defendants from violations of Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder in connection with offers and sales of any securities issued by the District and any other issuer. These defendants consented to the entry of the permanent injunctions without admitting or denying the allegations of the Commission's complaint.

The Commission's complaint alleged that the defendants' activities in violation of the anti-fraud provisions of the federal securities laws resulted in the sales of approximately $2.2 million of the notes issued by the District to approximately 161 persons residing in at least 12 states. Pursuant to Court approval, the Commission is also participating as a party in interest in a proceeding commenced by the District under Chapter IX of the Federal Bankruptcy Act. For further information, see Litigation Release No. 7460.

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**Commission Orders - Settled Administrative Proceedings**

***In re City of Syracuse, New York, Warren D. Simpson, and Edward D. Polgreen***, Securities Act Release No. 7460, Exchange Act Release No. 39149, AAE Release No. 970, A.P. File No. 3-9452 (September 30, 1997).

***See "The Issuer" section.***

To Contents

**Obligated Persons**

**Report under Section 21(a) of the Exchange Act**

***SEC, Staff Report on Transactions in the Marine Protein Corporation Industrial Development Revenue Bonds***, Exchange Act Release No. 15719 (April 11, 1979).

**Introduction**

The staff of the Division of Enforcement pursuant to a formal order of investigation authorized by the Commission on April 13, 1976, conducted a private investigation In the Matter of Marine Protein Corporation Industrial Development Revenue Bonds, Mammoth Spring, Arkansas. The Commission now makes this report of that investigation.[n1] This case is another in the series of investigations which focuses on abuses in connection with the issuance of IDR bonds.[n2] It focuses on, among other things: (1) the standards of disclosure required in an industrial revenue bond offering, and (2) the responsibility of the corporate lessee, the underwriter and the financial adviser to the issuer for full disclosure, in connection with the offer of industrial revenue bonds.

According to monthly statistical bulletins edited by the Public Securities Association, the number of tax exempt industrial development bond issues (excluding pollution control issues) since 1972 were: 1972 - 125 issues totaling $296 million; 1973 - 280 issues totaling $573 million; 1974 - 274 issues totaling $493 million; 1975 - 263 issues totaling $455 million; 1976 - 285 issues totaling $487 million; 1977 - January-May, 79 issues totaling $237 million.

The staff's inquiry principally focused on the period from January 1972 when the bond offering was conceived through 1976 when the bonds were declared to be in default. During the investigation, the staff obtained numerous documents and compiled 3,000 pages of transcribed investigative testimony. The staff's Report is a summary of the evidence that has been obtained to date. The Commission has decided to release this Report in the public interest pursuant to Section 21(a) of the Securities Exchange 1934. This is not to be construed as an adjudicative determination. Nor is the investigation or this Report a determination of the rights or liabilities of any person.

**Background**

This matter involves two successive efforts of a small, newly formed corporation, Marine Protein Corporation ("Marine") to raise financing for the establishment of facilities for Marine's operations. During 1972 the company raised $3.5 million through the offering of common stock to the public. This offering was registered with the Commission pursuant to the Securities Act of 1933. Later in 1972, through an offering of industrial

development revenue bonds that were sold pursuant to a claimed exemption from registration with the Commission (pursuant to Section 3(a)(2) of the Securities Act), Marine raised an additional $2.5 million. The striking contrast between the disclosure of material matters contained in the prospectus utilized for the offering of common stock registered with the Commission and the material omissions contained in the offering circular used to promote the sale of the industrial development revenue bonds makes it clear that the participants in the bond underwriting failed to comply with the standards of disclosure that are required by the antifraud provisions in connection with the offering and sale of any securities. The information gathered in the Commission's investigation, demonstrates that Marine fell short of its obligation to public investors by failing to assure that the information being disseminated to the public in connection with the sale of the industrial development revenue bonds was adequate, accurate and consistent with the information it had provided to the bond underwriters.

Marine is a Delaware corporation with headquarters formerly in New York City. The company was incorporated in 1969 and its primary business venture was to perfect a method to breed fish under environmentally controlled, high density conditions (Silo Fish Farms) for ultimate commercial sale. The controlling persons of the company which comprised its executive-managerial staff possessed varied business backgrounds unrelated to the fish industry and Marine's claimed advance research and development relating to the commercial growth of fish was based upon the invention principally of one marine biologist whose theories had never been tested beyond two pilot programs.

At its inception in 1969-1970 the company raised approximately $2.5 million through private placements of securities. In February 1972, the company raised $3.5 million through a public offering of securities registered with the Commission pursuant to the Securities Act of 1933. Prior to Marine's public offering, its activities had been limited to research and development at a pilot facility in Pennsylvania. The proceeds from the sale of the common stock were to be used primarily to begin construction of a trout farm in Mammoth Spring, Arkansas. Because the company was using a completely new technique for raising fish which had not yet been proven commercially feasible, the Commission's Division of Corporation Finance required Marine to make full disclosure of the risks involved in the purchase by investors. Marine's registration statement and prospectus ("stock prospectus") enumerated certain risk factors which prospective investors were warned to "carefully consider". Disclosure of these risk factors and other statements about the company's processes followed closely those disclosures which were included previously by the company in its private placement memoranda that was utilized to raise financing for the company's 1969-70 placement of securities referred to above.

**Sale of Industrial Development Revenue Bonds**

On May 16, 1972, some three months following issuance of the registered common stock, the City of Mammoth Spring, Arkansas, held a special election for the purpose of authorizing a total of $4 million of Industrial Development Revenue Bonds for the benefit of Marine. On the advice of the bond underwriter, it initially was decided that bonds in the amount of $2.5 million would be offered to the public and that the remaining $1.5 million would be sold whenever Marine requested it. On October 6, 1972, Marine

announced to its shareholders the signing of an agreement with the bond underwriter for the sale of $2.5 million of 26-year maturity industrial revenue bonds. This underwriter purchased the bonds from the City of Mammoth Spring, Arkansas, on December 1, 1977, at a discount price of 91 and wholesaled the bonds at 97 to the now defunct municipal bond broker-dealer, Seaney Jones & Co. of Atlanta, Georgia, ("Seaney"). Seaney sold most of the bonds to Paragon Securities of New Jersey ("Paragon") at 99.[n3] Paragon retailed most of the issue to individual investors all over the United States at premium prices as high as 116. The bond underwriter had characterized the issue as "speculative" to its trading desk and elected not to allow its trading desk to make retail sales of the bonds to their own customers. This underwriter's role in the offering was that of structuring the issue and preparing the "offering prospectus." For its efforts, the underwriter collected a fee of $142,500 or the difference between purchasing the bonds at 91 from the issuing authority and selling them to Seaney at 97.

The "offering prospectus" was prepared in-house by the bond underwriter's staff and was given to Seaney, Paragon and another bond house in New York that retailed a small percentage of the bonds. The finished document was used by Paragon to prepare a brief two-page summary of the offering which included pertinent facts about the bonds including: Denominations; Date; Interest; Security; Bond Counsel; Marine net worth, etc. Paragon disseminated this information sheet to its retail customers.

The "offering prospectus" was prepared only some eight months after the company's common stock offering. Material about Marine and its operational plans and projections was copied from advertising brochures, news articles and the 1972 Annual Report to Shareholders which had previously been furnished to the underwriter by Marine. In addition to this material, Marine also provided the bond underwriter with a copy of the common stock prospectus. The bond concerning the risks of fish farming or the risks involved in investing in Marine (discussed more fully under "Comparison of Disclosure") that were contained in the common stock prospectus. The bond prospectus did contain misleading bullish information as described below but failed to include disclosures concerning the use of the proceeds of the bond offering. The bond offering prospectus also included excerpts from the bond indenture.

**Events Subsequent to Bond Sale**

Marine's commercial application of its silo system from research laboratory to its anticipated production site at Mammoth Spring, Arkansas, experienced a variety of problems which over a two-year period contributed to the ultimate collapse of the company. From the date of the bond closing on December 1, 1972, the company had a 10-month grace period in which to complete its major facility in Arkansas and begin marketing fish because first payments for principal on the bonds became due on October 1, 1974. Site preparation at Mammoth Spring began in June 1972 which was several months before the bond financing was obtained. The bond money enabled the company to develop its site in a more grandiose style with the immediate installation of 36 silos and plans for an additional 36 silos if the first set proved the process to be a commercial success. A combination of natural disasters and faulty planning delayed completion of the facility by over seven months.

By October 1973, the first set of 36 silo tanks was in place. But, even at this time, the system was far from final working order. The first harvest, which was smaller than anticipated, did not begin until late February 1974. When the fish were ready for harvesting, the company did not have adequate facilities at the site to dress, package, freeze and ship the product to established markets. Therefore, excessive costs were incurred because the fish had to be air freighted to New York from Arkansas. This requirement diminished whatever advantages the company hoped to obtain through use of the silo systems.

Marine's indebtedness continued to increase and on January 20, 1976, the trustee for bondholders filed a complaint in Arkansas federal court asking that the court decree Marine in default on the bonds. The court appointed a receiver to take custody and control over Marine's only real asset – the silo farm at Mammoth Spring, Arkansas.

**Comparison of Disclosure**

The disclosures of information contained in the bond prospectus differ significantly from and in some respects are inconsistent with the disclosures in the common stock prospectus. Risk factors and other Important information relating to the speculative nature of an investment in Marine that were included in the common stock prospectus are absent from the bond "offering prospectus" and that document contains considerable bullish promotional information that is inappropriate in a prospectus used to sell securities. A comparison of some of these matters follows:

(1) Fish Production – The bond prospectus states that Marine "has developed one of the most important breakthroughs in fish production since the ancient Chinese" and that "Marine is able to produce over 3,000 times as many pounds of fish in the same surface area as a farmer can raise in a fish pond. "It also states that "A Marine Protein Silo Fish Farm is capable of producing 1,000,000 pounds of fish per surface area per year, even after deducting space for road and equipment."

In fact, these figures were mere estimates which were predicted by the company's scientists based on a pilot project, and were never the result of actual silo production. The common stock prospectus states that "Because of the variety of circumstances under which fish were grown, the Company is unable to state the length of time it takes fish to grow in their natural environment or to be farmed and harvested by conventional means."

(2) Advantages of the Silo System – The bond prospectus states 11 advantages of Marine's silo system as compared to conventional systems. There is no mention of these advantages in the common stock prospectus. The advantages cited include location, non-pollution, predator control, healthy fish, economy in feeding, fast growth, uniform fish sizes, year-round availability, harvesting economy, processing savings and brood stock and spawning.

In fact, Marine's own scientists did not regard these advantages to be particularly unique to the silo system. The same results were achieved by fish farmers using conventional raceway techniques.

(3) Fast Growth/Uniform Fish Sizes – The bond offering prospectus emphasizes particularly the silo's advantage in achieving fast growth and uniform sizes in fish.

As stated under #1 above, scientists are unable to compare fish growth under natural and under artificial conditions with any degree of accuracy.

(4) Harvesting Economy/Processing Savings – The bond prospectus states that Marine's larger harvests are economical because fish can be easily transferred to the "Marine processing plant "Also, it is stated that "Large production facilities make it economically feasible to locate processing plants adjacent to Marine Protein Silo Fish Farms."

In fact, the company never had the type of processing facilities alluded to in the bond prospectus although they had plans for the development. The common stock prospectus does state the company's intention to erect a processing plant in Mammoth Spring but also states with respect to "the commercial feasibility of its operations" that "it is not certain, however, that such processing plants will function according to plan."

(5) Fish Mortality – The bond offering prospectus states that conventional fish rearing systems suffer from considerable mortality because of imposed environmental stresses and that Marine's silo system protects fish from their natural enemies and the stresses of intensive fish culture are reduced to a minimum.

In fact, early tests did not prove that the system could limit the environmental stresses. Moreover, the common stock prospectus specifically stated that Marine's fish are not immune from disease, and their main research facility had experienced losses of fish resulting from temperature changes and poor water quality.

(6) Silo Farm Location – The bond prospectus boasted that the silo system was capable of being installed close to major markets thereby reducing excessive transportation costs.

In fact, the silo system, much like the traditional systems, still depended upon a sufficient supply of water of adequate quality which naturally limited the potential location to land areas where such water is available. As is stated in the common stock prospectus: "The water supply at any existing or future site must be of adequate quality and is always subject to the danger of drought and pollution."

**Conclusion**

The process by which industrial development revenue bonds are brought to the market place depends upon many persons, including the issuer, underwriter, fiscal agents, bond counsel, company executives and registered representatives. The antifraud provisions of the federal securities laws, while not imposing a structured form of disclosure as required for the offering of non-exempt securities pursuant to the Securities Act of 1933, do prohibit the deception of investors in connection with the offering of exempt securities. In preparing and disseminating the bond offering prospectus, the bond underwriter failed to include the material information referred to

above, and Marine failed to accept or assume any responsibility to insure that information being disseminated by bond underwriters in connection with the bond offering was complete and not false and misleading.

**Statement of Commissioner Karmel**

Commissioner Karmel, dissenting

I object to the issuance of this staff report because, as more fully explained in my dissent In the Matter of Spartek, Inc.,[n4] and my separate statement to the Commission's recent announcement relating to reports of investigations,[n5] I do not believe that publication based on Section 21(a) of the Securities Exchange Act of 1934 should be used as a sanction to dispose of investigated matters.

**Footnotes**

-[n1]-Commissioner Karmel dissented from this determination of the Commission for the reasons set forth in her statement which follows this release.

-[n2]-Industrial Development Revenue Bonds are popular financing vehicles because they are used by municipalities to attract new industry to their area. The proceeds of these industrial development revenue bonds are used by the issuing municipality to erect an industrial facility which is then leased to a private corporation for business use. The principal and interest on the bond issue is paid only from the revenues of the private corporation.

-[n3]-As the result of a civil injunctive action brought by the Commission, Paragon and its principals were enjoined by consent from further violations of the antifraud provisions of the federal securities laws. (Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Exchange Act of 1934 and Rule 10b-5 thereunder.) Paragon is no longer in business.

-[n4]-Securities Exchange Act Release No. 15567 (February 14, 1979).

-[n5]-Securities Exchange Act Release No. 15664 (March 21, 1979).

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**Injunctive Proceedings**

***Securities and Exchange Commission v. Lee F. Sutliffe***, Civ. Action No. 95-0867-CV-W-BD (W.D. Mo.), Litigation Release No. 14658 (September 28, 1995) (complaint).

The Securities and Exchange Commission today announced the filing of a Complaint on September 27, 1995, in the United States District Court for the Western District of Missouri, in Kansas City, seeking an order of permanent injunction against Lee F. Sutliffe (Sutliffe). The Commission's Complaint alleges that Sutliffe, by participating in the preparation of false and misleading municipal bond offering circulars, violated the antifraud

provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.

The Complaint alleges, among other things, that during the years 1984 through 1989, Sutliffe was the undisclosed promoter and control person of two not-for-profit corporations, First Humanics Corp. (First Humanics) and its successor, International Elderly Care, Inc. (IEC), which participated in 26 public offerings of municipal and corporate bonds raising over $107 million. The purpose of these offerings was to acquire, renovate and operate nursing homes.

The Complaint further alleges that, in connection with two such offerings, First Humanics' 1987 offering to acquire the Medicos Recovery Care Center nursing home in Detroit, Michigan (Medicos) and IEC's 1988 offering to acquire the Colonial Gardens Convalescent Center in Boonville, Missouri (Colonial Gardens), Sutliffe promoted the offerings and participated in the preparation of false and misleading offering circulars. Specifically, the Complaint alleges that the Medicos offering circular contained material misrepresentations and omissions concerning: Sutliffe's role as a promoter of the offering; Sutliffe's control over First Humanics as well as his regulatory history and numerous prior bond and business failures; the commingling of revenues from existing First Humanics nursing homes and the resulting financial interdependence of all First Humanics nursing homes; and First Humanics' ongoing ponzi scheme.

In addition, the Complaint alleges that the Colonial Gardens offering circular contained material misrepresentations and omissions concerning: Sutliffe's role in the offering and his control over IEC as well as his background; the nexus between IEC and First Humanics; and First Humanics' prior bond defaults.

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***Securities and Exchange Commission v. Lee F. Sutliffe***, Litigation Release No. 14707 (November 1, 1995) (settled final order).

The Securities and Exchange Commission today announced that on October 27, 1995 the United States District Court for the Western District of Missouri, in Kansas City, entered an Order of Permanent Injunction (Order) against Lee F. Sutliffe (Sutliffe). The Order enjoins Sutliffe from future violations of Sections 17(a)(1), 17(a)(2) and 17(a)(3) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Sutliffe consented to the entry of the Order without admitting or denying the allegations in the Commission's Complaint.

The Commission's Complaint, filed on September 27, 1995, alleged, among other things, that during the years 1984 through 1989, Sutliffe was the undisclosed promoter and control person of two not-for-profit corporations, First Humanics Corp. (First Humanics) and its successor, International Elderly Care, Inc. (IEC), which participated in 26 public offerings of municipal and corporate bonds raising over $107 million. The purpose of these offerings was to acquire, renovate and operate nursing homes.

The Complaint further alleged that, in connection with two such offerings, First Humanics' 1987 offering to acquire the Medicos Recovery Care Center nursing home in Detroit, Michigan (Medicos) and IEC's 1988 offering to acquire the Colonial Gardens Convalescent Center in Boonville, Missouri (Colonial Gardens), Sutliffe promoted the offerings and participated in the preparation of false and misleading offering circulars. Specifically, the Complaint alleged that the Medicos offering circular contained material misrepresentations and omissions concerning: Sutliffe's role as a promoter of the offering; Sutliffe's control over First Humanics as well as his regulatory history and numerous prior bond and business failures; the commingling of revenues from existing First Humanics nursing homes and the resulting financial interdependence of all First Humanics nursing homes; and First Humanics' ongoing ponzi scheme.

In addition, the Complaint alleged that the Colonial Gardens offering circular contained material misrepresentations and omissions concerning: Sutliffe's role in the offering and his control over IEC as well as his background; the nexus between IEC and First Humanics; and First Humanics' prior bond defaults.

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***SEC v. Calhoun County Medical Facility, Inc., et al.***, Civ. Action No. WC-81-61 WK-P (N.D. Miss.), Litigation Release No. 9366 (June 1, 1981) (settled final order).

Jule B. Greene, Regional Administrator of the Commission's Atlanta Regional Office, announced the filing of a Complaint, alleging violations of Sections 17(a)(2) and (3) of the Securities Act of 1933 against Calhoun County Medical Facility, Inc. ("the Issuer"), a Mississippi corporation; Bullington-Schas & Co., Inc. ("Bullington-Schas"), a Memphis, Tennessee broker-dealer; A. Dulaney Tipton ("Tipton") of Memphis, Tennessee, President of Bullington-Schas; Terry Allen Frost ("Frost") of Memphis, Tennessee, a registered representative associated with Bullington-Schas; and Jerald H. Sklar ("Sklar"), an attorney in Memphis, Tennessee.

The Commission's Complaint alleged that the Issuer offered and sold $1.8 million of its first mortgage revenue bonds to finance the acquisition of the Calhoun County Hospital in Calhoun County, Mississippi; that Bullington-Schas served as underwriter for the bond issue; that Tipton and Frost performed Bullington-Schas' underwriting duties and participated in the sale of the bonds; and that Sklar acted as bond counsel. The Complaint further alleges that annual financial statements concerning the past operations of the Hospital, which indicated an inability to defease the bond offering, were not included in the offering circular; rather, pro forma financials were included without discussion of the significantly divergent prior financial history.

The Commission's Complaint further alleged that defendants made untrue statements and omitted to state material facts concerning, among other things, the role, duties and responsibilities of counsel to the underwriter and bond counsel.

On May 28, 1981, the Honorable William C. Keady, Chief Judge of the

United States District Court for the Northern District of Mississippi, entered final judgments permanently enjoining the defendants from further violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act. The defendants consented to the relief without admitting or denying the allegations of the Commission's Complaint. Defendant Sklar was ordered also to comply with the undertakings contained in his Stipulation and Consent concerning procedures to be followed in connection with future bond issues.

For further information concerning (i) a related administrative proceeding involving Bullington-Schas, Tipton and Frost, see Securities Exchange Act Release No. 17832; and (ii) a Section 21(a) Report involving the role of underwriter's counsel, see Securities Exchange Act Release No. 17831.

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***SEC v. San Antonio Municipal Utility District No. 1, et al.***, Civ. Action No. H-77-1868 (S.D. Tex.), Litigation Release No. 8195 (November 18, 1977) (settled final order).

***See "The Issuer" section.***

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***SEC v. Astro Products of Kansas, Inc., et al.***, Civ. Action No. 76-359-LG (D. C. Kans.), Litigation Release No. 7557 (September 13, 1976) (complaint).

Richard M. Hewitt, Administrator of the Fort Worth Regional Office of the Securities and Exchange Commission, announced today the filing on August 31, 1976 of a civil injunctive complaint in federal district court at Wichita, Kansas naming 19 corporate and individual defendants. The complaint charged violation of the securities registration and antifraud provisions of the federal securities laws and the Trust Indenture Act in connection with the offer and sale of industrial development revenue bonds issued by Astro Products of Kansas, Inc., Haysville, Kansas, and the City of Haysville.

The defendants were charged with violations of the following provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Trust Indenture Act of 1939:

Astro Products of Kansas, Inc., Los Angeles, California – antifraud; securities registration; trust indenture qualification.

Canter Line Tool Company, Inc., Los Angeles, California – antifraud.

The Vern Hunt Co., Los Angeles, California – antifraud.

The National Bank of Wichita, Wichita, Kansas – antifraud.

Sima Walding Supply Co., Inc., Los Angeles, California – antifraud.

Tower Brokerage, Inc., St. Petersburg, Florida – antifraud.

Hugh Bell, St. Petersburg, Florida – antifraud.

Bruce Bressman, Los Angeles, California – antifraud.

Roman A. Dimeo, Los Angeles, California – antifraud, securities registration; trust indenture qualifications.

Theodore F. Dubowik, Memphis, Tennessee – antifraud.

George B. Flowers, Los Angeles, California – antifraud.

Richard T. Heagy, Memphis, Tennessee – antifraud.

Vern Hunt, Los Angeles, California – antifraud.

Herbert M. Kohn, Kansas City, Missouri – antifraud; securities registration; trust indenture qualification.

Stephen A. Lancaster, Memphis, Tennessee – antifraud.

Ray W. Lipper, Los Angeles, California – antifraud.

James J. Russ, Memphis, Tennessee – antifraud; securities registration; trust indenture qualification.

Walter A. Sawhill, Wichita, Kansas – antifraud; securities registration; trust indenture qualification.

M. Kelley Sims, Los Angeles, California – antifraud.

The complaint charged the defendants with a scheme to violate the federal securities laws. The Commission alleged in the complaint that James J. Russ, Roman A. Dimeo and Walter A. Sawhill engaged in a scheme to promote an industrial development revenue project in Haysville, Kansas. The alleged scheme involved procuring the issuance by the City of Haysville of $2,200,000 industrial development revenue bonds of which the proceeds were to be used to acquire equipment for a plant to assemble vehicular wheel. As part of the alleged scheme, Russ misrepresented his background and the economic potential to Haysville of the proposed assembling plant and bond counsel, Herbert A. Kohn, by furnishing an opinion that the bonds were duty authorized made it possible for the issue to be marketed and issued and tax exempt.

Further, the complaint charged that following the issuance of the bonds, Russ, Dimeo and Sawhill arranged for the bonds to be sold to several underwriters, including Richard T. Heagy, Stephon A. Lancaster, Theodore F. Dubowik and Hugh Bell. The complaint further alleged that these underwriters than sold the bonds through misrepresentation to various broker-dealers, including Bruce Bressman, who ultimately sold the bonds to the public. In selling the bonds, the underwriters, relying ostensibly upon unverified information supplied by Russ, and without exercising due

diligence, misrepresented;

(1) The security behind the investment;

(2) The financial condition of the corporate issuer;

(3) The use of the project's proceeds;

(4) The background of those involved in the project;

(5) The likelihood of success for the project;

(6) The lead time necessary for beginning operations; and

(7) The tax exempt status of the bonds; and omitted to state:

(1) The high risk nature of the investment;

(2) The diversion of the project's proceeds; and

(3) The lack of security available to the bondholders.

Approximately $400,000 of the issue was sold to public investors and approximately $1,800,000 was used as part of an alleged scheme to defraud the First Federal Savings and Loan, Utica, New York.

During and after the issuance of the bonds (which were issued in five increments between December 21, 1973 and May 6, 1974), Russ and Dimeo allegedly in a scheme to misappropriate proceeds of the issue, or approximately $1,700,000, with four of the project's equipment suppliers, Ray W. Lipper, Center Line Tool Company, Inc., M. Kelley Sims, Sims Walding Supply Company, Vern Hunt, Vern Hunt Company, and George Flowers. The complaint alleges that each of these suppliers had done business with defendant Russ prior to the Haysville project and that through the suppliers submission of false invoices, many of which were allegedly prepared by or at the direction of Russ, in excess of $800,000 of the proceeds were diverted through fraud from the project.

According to the complaint this fraud was made possible because Haysville and the National Bank of Wichita, the fiscal agent, violated express duties which they had agreed to perform for the protection of the bondholders. The complaint charged that these breaches of duty occurred, in part, because Kohn gave incorrect advice to officials of both Haysville and the fiscal agent concerning their duties. In addition to this alleged scheme involving the four suppliers and their companies, Russ allegedly submitted a number of purportedly false and forged invoices to the National Bank of Wichita for which he paid over $200,000.

The complaint states that the project never began operation. Over a year and a half after the last closing in May 1974, a committee of the bondholders assumed control over the project and liquidated it. The liquidation value of the bonds has been set at $.037 on the dollar. The bondholders' committee is now distributing the liquidated proceeds to the

bondholders.

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***SEC v. Astro Products of Kansas, Inc., et al.***, Litigation Release No. 7774 (February 10, 1977) (settled final orders).

Richard M. Hewitt, Administrator of the Fort Worth Regional Office of the Securities and Exchange Commission, announced today that on January 19, 1977, Federal District Judge Frank G. Theis of Wichita, Kansas, granted the Commission's motion for preliminary injunction enjoining defendants Tower Brokerage, Inc.; Hugh Bell, both of St. Petersburg, Florida; Richard T. Heagy of Memphis, Tennessee; and Theodore DuBowik of Phoenix, Arizona, from future violations of the anti-fraud provisions of the federal securities laws. Judge Theis also granted the Commission's motion for preliminary injunction against Roman A. DiMeo of Santa Ana, California, enjoining him from future violations of the registration, anti-fraud, and trust indenture qualification provisions of the federal securities laws.

On January 18, 1977, Judge Theis issued a default order preliminary enjoining defendants Vern Hunt and the Vern Hunt Company, both of West Covina, California, from future violations of the anti-fraud provisions of the federal securities laws.

On November 29, 1976, defendants James J. Russ and Astro Products of Kansas, Inc., both of Memphis, Tennessee, consented, without admitting or denying the Commission's allegations, to the entry of a permanent injunction enjoining them from future violations of the registration, anti-fraud, and trust indenture qualification provisions of the federal securities laws. For further information, see Litigation Release No. 7557.

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***SEC v. Astro Products of Kansas, Inc., et al.***, Litigation Release No. 8613 (December 8, 1978) (defaults entered).

Michael J. Stewart, Administrator of the Fort Worth Regional Office, announced that on October 31, 1978, Federal District Judge Frank Theis, chief judge for the District of Kansas at Wichita, entered orders of permanent injunction by default against Theodore F. DuBowik, Phoenix, Arizona; Vern Hunt, and The Vern Hunt Company, both of Los Angeles, California. These orders enjoin the defendants from future violations of the anti-fraud provisions of the securities laws. For further information, see Litigation Release No. 8574.

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***SEC v. The Senex Corporation, et al.***, Civ. Action No. 74-53 (E.D. Ky.), Litigation Release No. 6451 (July 24, 1974) (complaint).

The Securities and Exchange Commission today announced the filing of a

complaint in the U.S. District Court for the Eastern District of Kentucky seeking a preliminary and permanent injunction against The Senex Corporation, a Delaware corporation; Arthur Jay Tarley, Wyoming, Ohio; Mentor Corporation, a Kentucky corporation; A.J. Jolly, Alexandria, Kentucky; Alison, Jay, Malcolm & Company (formerly known as Stemac Management Corporation), a Delaware corporation; BFT, Inc., an Ohio corporation; and Thomas N. Street, Jr., Memphis, Tennessee, from engaging in further violations of certain anti-fraud provisions of the federal securities laws [Section 17(a) of the Securities Act of 1933 and Section 10 (b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder] in connection with the offer and sale of certain municipal revenue bonds.

The Commission's complaint alleges that the defendants engaged in a fraudulent scheme pursuant to which they promoted with officials of the City of Covington, Kentucky, the concept of building in Covington a nursing home to house the indigent, the infirm and the elderly and that they induced the City of Covington, Kentucky, to authorize the issuance of $4,415,000 City of Covington Health Care Project Revenue Bonds to provide funds to finance the construction of the proposed nursing home.

The complaint alleges that the defendants caused a corporation controlled by certain of the defendants to be appointed to construct the facility for a contract price of approximately $2.9 million and subsequently entered into a contract with a local contractor to construct the same facility for approximately $2.3 million; that when a question arose as to the need for such a facility in the Covington area, the defendants convinced City officials of the need for and the feasibility of the project by withholding and/or endeavoring to discredit two contemporaneous studies which reflected adversely on the need for such a nursing home in the Covington area. In this connection, the complaint alleged that the defendants refused to make available to the Northern Kentucky Health and Welfare Planning Council a copy of an adverse feasibility report stating that the report was "the private domain of the underwriter" when in fact no such underwriter was in existence at that time; and that certain of the defendants stated that the best indication of the project's feasibility was that a sophisticated investment banker was willing and anxious to invest in excess of $4,000,000 in the project when in fact that statement was untrue, and the defendants had been unable to locate any independent securities dealer to underwrite the proposed bond issue.

The complaint alleges that as a further part of the scheme, the defendants caused a purportedly independent feasibility consultant to render a report bearing favorably on the feasibility of the project when in fact the feasibility consultant was not independent but was a promoter and a developer of the nursing home project who expected to share in the developer's profits; and further that the defendants caused a broker-dealer controlled by certain of the defendants to be appointed as financial adviser for the project and as underwriter of the bond issue.

The complaint further alleges that as a further part of the scheme, an offering prospectus was prepared and distributed to investors which failed to disclose, among others, the above material facts, and that the misleading prospectus was used by the defendants in securing an "A" rating for the bonds, which rating was used along with the prospectus to facilitate the sale of the bonds to other dealers and ultimately to individual investors.

To Contents

***SEC v. The Senex Corporation, et al.***, Litigation Release No. 6769 (March 5, 1975) (settled final orders.)

The Securities and Exchange Commission announced the entry on March 3, 1975, of an order of preliminary injunction in the U.S. District Court for the Eastern District of Kentucky against A.J. Jolly, Mentor Corp. and Thomas N. Street, Jr. enjoining them from engaging in further violations of certain of the antifraud provisions of the federal securities laws (Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder) in connection with the offer, sale or purchase of City of Covington Health Care Project Revenue Bonds, Series 1972, or any other securities.

After an eleven day hearing on the Commission's motion for preliminary injunction, the Court in its opinion found that in connection with a new offering of municipal bonds issued to finance the construction of a health care facility in Covington, Kentucky, the defendants violated the antifraud provisions by, among other things, failing to disclose: (1) that the defendant Mentor Corporation which issued a consultant's report demonstrating the desirability of the proposed project would share in 50 percent of the developer's profit; (2) that there was a difference of opinion among experts concerning the need for the proposed project as evidenced by the existence of other feasibility reports bearing adversely on the proposed project; and (3) that the project's financial adviser and underwriter were owned and controlled by the developer.

The Court stated in its opinion that "Notwithstanding his biased position, Jolly prepared and permitted use of the Mentor report in the prospectus and as part of a 'package' designed to impress securities dealers" and that "At no time during the lengthy period involved in the promotion did the defendants make any effort to afford an accurate depiction of the experts' disagreements or the financial entanglement among involved entities."

Previously, Judgments of Permanent Injunction in this matter were entered by the U.S. District Court for the Eastern District of Kentucky against The Senex Corporation, Arthur Jay Tarley, Alison, Jay, Malcolm & Company formerly known as Stemac Management Corporation, and BFT, Inc., permanently enjoining them from further violations of Section 17(a) of the Securities Act of 1933 and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 in connection with the offer, sale or purchase of City of Covington Health Care Project Revenue Bonds, Series 1972 or any other securities. These defendants consented to the entry of permanent injunctions without admitting or denying the allegations of the Commission's complaint.

To Contents

***SEC v. The Senex Corporation, et al.***, Litigation Release No. 8651 (January 23, 1979) (settled final orders).

The Securities and Exchange Commission announced the entry on December 5, 1978, of a Judgment of Permanent Injunction upon consent in the United States District Court for the Eastern District of Kentucky against A J Jolly, and Mentor Corporation, enjoining them from engaging in further violations of certain of the anti-fraud provisions of the federal securities laws (Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder) in connection with the offer, sale or purchase of CITY OF COVINGTON HEALTH CARE PROJECT REVENUE BONDS, SERIES 1972, or any other securities.

The Commission charged that in connection with a new offering of municipal bonds in 1972 issued to finance the construction of a health care facility in Covington, Kentucky, the defendants violated the anti-fraud provisions by, among other things, failing to disclose: (1) that the defendant Mentor Corporation which issued a consultant's report demonstrating the desirability of the proposed project would share in 50 percent of the developer's profit; (2) that there was a difference of opinion among experts concerning the need for the proposed project as evidenced by the existence of other feasibility reports bearing adversely on the proposed project; and (3) that the project's financial adviser and underwriter were owned and controlled by the developer.

Previously, Judgments of Permanent Injunction in this matter were entered by the United States District Court for the Eastern District of Kentucky against Thomas N. Street, The Senex Corporation, Arthur Jay Tarley, Alison, Jay Malcolm & Company formerly known as Stemac Management Corporation, and BFT, Inc., permanently enjoining them from further violations of Section 17(a) of the Securities Act of 1933 and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 in connection with the offer, sale or purchase of CITY OF COVINGTON HEALTH CARE PROJECT REVENUE BONDS, SERIES 1972 or any other securities. All defendants consented to the entry of permanent injunctions without admitting or denying the allegations of the Commission's complaint.

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***SEC v. The Senex Corporation, et al.***, 399 F. Supp. 497 (E.D. Ky. 1975).

See Federal Reporter.

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**Commission Orders - Settled Administrative Proceedings**

***In re Joseph LeGrotte***, Securities Act Release No. 7200, Exchange Act Release No. 36036, A.P. File No. 3-8763 (July 31, 1995).

**I.** The Commission deems it appropriate and in the public interest that public administrative proceedings be instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 2IC of the Securities Exchange Act of 1934 ("Exchange Act") against Joseph LeGrotte ("LeGrotte").

In anticipation of the institution of these administrative proceedings, LeGrotte has submitted an Offer of Settlement which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceeding brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to jurisdiction, which is admitted, LeGrotte consents to the entry of this Order Instituting Proceedings pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Making Findings and Imposing a Cease and Desist Order.

Accordingly, it is ordered that proceedings pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act be, and hereby are, instituted.

**II.** On the basis of this Order and the Offer of Settlement submitted by LeGrotte, the Commission makes the following findings:

**ENTITY INVOLVED**

A. First Humanics Corp. ("First Humanics" or "the company"), a not-for-profit corporation, was in the business of acquiring, renovating and operating nursing homes. From 1984 through 1989, First Humanics renovated and operated 21 nursing homes acquired through 21 separate offerings totalling approximately $82 million in publicly sold municipal and corporate bonds. On October 15, 1987, the Economic Development Corporation of the City of Detroit, Michigan, for the benefit of First Humanics, acquired the Medicos Recovery Care Center (Medicos) through the issuance of $6,955,000 in tax-exempt bonds. This was First Humanics' last offering.

**RESPONDENT**

B. LeGrotte was an officer and director of First Humanics from 1986 to 1988. LeGrotte reviewed and signed the Medicos offering circular, participated in earlier First Humanics offerings and bond closings and was involved in the operations of First Humanics.

**BACKGROUND**

C. In connection with each offering, First Humanics contracted to purchase a particular nursing home. To finance the purchase, the Company arranged for a municipality to issue tax free municipal bonds. However, the Company remained liable for all payments to bondholders. To finance the issuance costs on certain of the above offerings, the Company, in some instances, also issued a modest amount of corporate bonds in conjunction with the tax exempt bonds. Again, the Company was liable for all payments to bondholders.

D. Each prospective nursing home was initially located by Lee F. Sutliffe ("Sutliffe"), the undisclosed control person of First Humanics and the undisclosed promoter of' First Humanics' offerings. If Sutliffe decided the nursing home was acceptable for acquisition, the First Humanics Board of Directors then voted to acquire the facility. Sutliffe received an acquisition fee of between $100,000 and $300,000 in connection with each nursing

home purchased by First Humanics.

E. Subsequent to the Board's approval, Sutliffe initiated the offering process, through which First Humanics obtained the funds necessary to purchase the nursing home. In connection therewith, Sutliffe assembled an offering "working group" which coordinated the offering process and was responsible for preparing the offering circulars. The activities of the First Humanics working group were largely directed by Sutliffe. In this manner, Sutliffe acted as the promoter of the offerings. LeGrotte also sometimes participated in working group meetings and reviewed offering materials prepared by the working group.

F. In connection with each offering, an offering circular was prepared. The offering circular typically contained sections describing First Humanics, the nursing home to be acquired, the bonds, sources and uses of bond proceeds, risk factors and, as appendices, a financial feasibility study and the Company's audited financial statements. The primary purpose of the offering circular was to provide the investing public with all material facts pertaining to the offering. LeGrotte reviewed offering circular drafts and executed numerous supporting documents which were used in connection with the drafting of the offering circular. In some instances, LeGrotte also signed the offering circulars on behalf of First Humanics. Thus, he participated in the preparation of the offering circulars.

G. Upon completion of the offering process, Sutliffe coordinated the bond closings. In connection therewith, Sutliffe prepared closing documents and directed the wiring and disbursement of bond proceeds from which were paid most of the issuance costs. At each bond closing, the municipal issuer sold the bonds to an underwriter who, in turn, resold them to the investing public through various retail broker dealers. Upon receiving the bond proceeds from the underwriter, the municipal issuer either lent such proceeds to First Humanics so that the Company could purchase the nursing home, or the issuer purchased the nursing home and leased it back to the Company. A certain amount of bond proceeds were also set aside as working capital for the benefit of First Humanics.

H. Immediately after closing, First Humanics assumed the municipal issuer's repayment obligation to the bondholders. Thereafter, the Company was required to make monthly bond payments to the indenture trustee sufficient for the trustee to meet semi-annual interest payments to the bondholders. At all times, effective control of the nursing homes remained with First Humanics. Pursuant to various bond and trust indentures, the Company was also required to allocate a certain amount of the offerings proceeds to a debt service reserve fund. The debt service reserve fund was used to offset any insufficiencies in funds available for the semi-annual interest payments to bondholders. However, the Company was required to pay back any monies withdrawn from this account.

I. Prior to promoting the First Humanics offerings, Sutliffe was involved in the promotion of numerous other bond issues. Most of these earlier offerings, however, had experienced financial problems and some eventually defaulted prior to the Medicos offering. Furthermore. in March 1985, the State of Missouri found that Sutliffe had participated in the making of false filings, and issued a cease and desist order against him. LeGrotte was aware of Sutliffe's business and regulatory history.

J. In addition to Sutliffe's promoting activities, he also controlled First Humanics. The First Humanics officers and Board of Directors, including LeGrotte, allowed Sutliffe to dictate virtually all significant First Humanics' decisions. Sutliffe even served on various First Humanics sub-committees, including a management sub-committee. As such, Sutliffe determined which nursing homes First Humanics would acquire and was involved in the day-to-day operations of the nursing homes. Sutliffe's control was openly displayed at Board of Directors meetings and reflected in the pertinent minutes and in First Humanics internal memoranda and correspondence. Thus, although LeGrotte was an officer and director of First Humanics and was actively involved in the management of the Company, he followed the directions of Sutliffe.

K. Revenues from First Humanics' nursing homes were generally paid directly to the company and, from 1984 on, First Humanics freely and openly commingled all such revenues in a central bank account located in Dixon, Illinois (Dixon account). First Humanics then used the revenues from any one nursing home to pay the expenses of other homes, as the need arose. When a nursing home's revenues were insufficient to meet a bond payment money was simply taken from available funds in the Dixon account, whatever the source. Each nursing home's expenses were paid according to the urgency of the bill and not limited by the amount of revenue generated by the particular nursing home. From 1986 onward, however, most of the nursing homes failed to generate an amount of revenues sufficient to meet their own expenses. As a result, commingling became essential to the operation and survival of First Humanics. The success or failure of any one nursing home was thereby dependent upon the success or failure of all the other nursing homes. Therefore, each municipal offering was, in fact, a de facto investment into First Humanics and its existing nursing homes. LeGrotte was, in fact, aware that the use of one nursing home's revenues to pay anothers expenses was essential to the operation of First Humanics. Thus, LeGrotte acknowledged that a problem in any one nursing home would have an effect on the other nursing homes.

L. In addition, the vast majority of First Humanics' nursing homes were located in Illinois and heavily dependent on Illinois' Medicaid reimbursements, which were often insufficient and continually late. Given the nursing homes interdependence, as the result of the commingling discussed above, such late and insufficient payments affected all nursing homes, even those located outside of Illinois. Thus, largely because of the medicaid problems in late 1985 First Humanics became late in its required monthly bond payments to the indenture trustees for certain bond issues. Therefore, First Humanics began using the funds from some of these delinquent nursing homes' debt service reserve accounts to offset the insufficiencies. Although First Humanics was required to pay back monies withdrawn from such accounts, these payments were often late and insufficient. LeGrotte was aware of both the Medicaid problems and the late and insufficient payments to the debt service reserve funds.

M. As a result of First Humanics' cash flow shortages, First Humanics also became reliant on the working capital generated from new bond offerings as a source of funds for current operations. Additionally, a procedure was developed whereby Sutliffe "kicked-back" a portion of his acquisition fee to First Humanics at or shortly after, each bond closing. Thus, the success of

existing nursing homes and the payments to existing bondholders became largely dependent on First Humanics' ability to obtain funds from future offerings. In this manner, First Humanics operated a Ponzi scheme in which LeGrotte participated.

N. Nonetheless, First Humanics continued to be late in its monthly bond payments to the trustees. As a result, First Humanics also continued to deplete certain bond issues' debt service reserve funds. In August 1986, one of the trustees, in fact, informed First Humanics that based on its continued failure to repay these funds it was in violation of four of its bond indentures and, therefore, in technical default. First Humanics experienced a $912,946 loss before depreciation for its fiscal year ended November 30, 1986, even including Sutliffe's kickbacks. Furthermore, none of the nursing homes had met their cash flow projections as stated in their offering circulars. In December 1986, one of the trustees again informed First Humanics that it was in technical default on two of its municipal bonds. However, Sutliffe caused six new bond issues to close on December 18, 1986. As a result, and in connection with the First Humanics Ponzi scheme, additional working capital was 7 generated and, undisclosed to investors, $500,000 of Sutliffe's acquisition fee was kicked-back to First Humanics. These funds were immediately applied to cure First Humanics' monthly bond payment deficits and to pay its pact due bills. Nonetheless, First Humanics' cash flow problems continued.

**MEDICOS OFFERING**

O. Despite First Humanics' financial problems, in 1987 Sutliffe directed First Humanics to acquire Medicos. Connection therewith, Sutliffe arranged to have the City of Detroit issue $6,955,000 in tax-exempt bonds. Sutliffe directed LeGrotte and other First Humanics board members to issue $530,000 in taxable bonds to cover the issuance expenses; series of bonds were issued pursuant to one offering circular.

P. Sutliffe, acting as the promoter, then began the offering process by assembling the working group which provided the Medicos offering circular. LeGrotte attended these group meetings. Again, Sutliffe largely directed the women group's activities as the undisclosed promoter for Medicos. Although LeGrotte was not primarily responsible for drafting Medicos offering circular, he assisted with its preparation. Furthermore, LeGrotte signed the offering circular on behalf of First Humanics.

Q. Upon completion of the offering process, Sutliffe coordinated the Medicos bond closing. The Medicos offering closed on October 15, 1987 and the municipal and corporate bonds were sold to the public through underwriters and various broker-dealers. Upon receiving the proceeds from the underwriters, municipal issuer purchased Medicos and thereafter leased the facility back to First Humanics. At closing, LeGrotte signed pertinent acquisition and closing documents. In addition, LeGrotte signed certifications stating that the Medicos offering circular did not misrepresent or omit to state any material facts. Finally, Sutliffe kicked-back approximately $200.00 of his Medicos acquisition fee to First Humanics as part of Humanics' ongoing Ponzi scheme.

R. The Medicos offering circular omitted to disclose numerous material facts. For instance, the Medicos offering circular failed to adequately

disclose Sutliffe's promotion of the Medicos offering, his control over First Humanics, his bond failures and his past securities law sanctions. Additionally, the Medicos offering circular portrayed Medicos as a "stand alone" nursing home. Thus, the Medicos offering was simply presented as an investment into Medicos. In connection therewith, the offering circular stated that the bondholders' ability to receive interest and principal payments was dependent on the revenues derived from the operation of Medicos, not First Humanics' other nursing homes. As a result, nothing adequately describing the commingling of nursing home revenues or resulting financial interdependence among First Humanics' homes was disclosed. Thus, Medicos bondholders were also not informed that Medicos revenues would be used to pay Humanics existing nursing homes' expenses. Consequently, bondholders were not informed that, in fact, their investments constituted de facto investments into First Humanics and its existing nursing homes and not merely Medicos.

S. Similarly, the serious Illinois Medicaid problem which at the time was adversely affecting all First Humanics' nursing homes was not disclosed. Thus, Medicos bondholders were not informed that, given the nursing homes' financial interdependence, their future bond payments were largely dependent on First Humanics' ability to secure the late Medicaid payments from the State of Illinois. The offering circular also failed to disclose both the August and December 1986 defaults which related directly to First Humanics' ability to pay bondholders.

T. Finally, neither Sutliffe's $200,000 kick-back nor first Humanics' dependence on the capital generated from future offerings to finance its existing nursing homes, as part of its ongoing ponzi scheme, were disclosed. Thus, Medicos bondholders were not informed that their ability to receive payments was also dependent on First Humanics' ability to secure funds from, future offerings.

U. Through LeGrotte's role as an officer and director and his participation in the Medicos offering process LeGrotte was aware of the above material facts. In addition, through his participation in the drafting of the Medicos offering circular LeGrotte knew or should have known that the Medicos offering circular omitted these facts. However, despite this knowledge, LeGrotte actively encouraged the sale of the Medicos bonds to the public by voting to approve the acquisition, signing the offering circular, signing pertinent bond closing documents and certifying that the offering circular contained no material misrepresentations or omissions.

V. Respondent LeGrotte caused violations of Section 17(a) of the Securities Act in that he, in the offer or sale of certain securities, namely Medicos municipal bonds and First Humanics corporate bonds described in paragraphs II. A. and O. above, by use of the means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly, caused the: employing of devices, schemes or artifices to defraud; obtaining of money or property by means of untrue statements of material facts or omissions to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or engaging in transactions, practices or courses of business which operated as a fraud or deceit upon purchasers or prospective purchasers. As part of the aforesaid conduct, Respondent caused misrepresentations and omissions of material fact to be

made to purchasers and prospective purchasers regulatory history and numerous prior bond and business failures; First Humanics' prevalent commingling of revenues from past nursing home projects and the resulting financial interdependence of all First Humanics nursing homes; the Illinois Medicaid problem; and First Humanics' on-going ponzi scheme.

W. Respondent LeGrotte caused violations of Section 10(b) of the Exchange Act and, Rule 10b-5 promulgated thereunder in that he, in connection with the purchase or sale of certain securities, namely Medicos municipal bonds and First Humanics corporate bonds described in paragraphs II. A. and O above. by use of the means or instrumentalities of interstate commerce or by the use of the mails. directly or indirectly, caused the: employing of devices, schemes or artifices to defraud; making of untrue statements of material facts or omissions to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made not misleading or engaging in acts, practices or courses of business which operated as a fraud or deceit. As part of the aforesaid conduct. Respondent caused misrepresentations and omissions of material fact to be made to purchasers and sellers concerning, among other things, Sutliffe's role in promoting the offering. his control over First Humanics as well as his regulatory history and numerous prior bond and business failures; First Humanics' prevalent commingling of revenues from past nursing home projects and the resulting financial interdependence of all First Humanics nursing homes; the Illinois Medicaid problem; and, First Humanics' on-going ponzi scheme.

**III.** In view of the foregoing, it is in the public interest to impose the sanctions agreed to in the Offer of Settlement.

Accordingly, IT IS HEREBY ORDERED THAT, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Joseph LeGrotte cease and desist from committing or causing any violation, and committing or causing any future violation, of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10-b promulgated thereunder.

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***In re Sidney Gould***, Securities Act Release No. 7201, Exchange Act Release No. 36037, A.P. File No. 3-8764 (July 31, 1995).

**I.** The Commission deems it appropriate and in the public interest that public administrative proceedings be instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Sidney Gould ("Gould").

In anticipation of the institution of these administrative proceedings, Gould has submitted an Offer of Settlement which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceeding brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to jurisdiction, which is admitted, Gould consents to the entry of this Order Instituting Proceedings pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Making Findings and

Imposing a Cease and Desist Order.

Accordingly, it is ordered that proceedings pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act be, and hereby are, instituted.

**II.** On the basis of this Order and the Offer of Settlement submitted by Gould, the Commission makes the following findings:[n1]

**ENTITY INVOLVED**

A. First Humanics Corp. ("First Humanics" or "the company"), a not-for-profit corporation, was in the business of acquiring, renovating and operating nursing homes. From 1984 through 1989, First Humanics renovated and operated 21 nursing homes acquired through 21 separate offerings totalling approximately $82 million in publicly sold municipal and corporate bonds. On October 15, 1987, the Economic Development Corporation of the City of Detroit, Michigan, for the benefit of First Humanics, acquired the Medicos Recovery Care Center (Medicos) through the issuance of $6,955,000 in tax-exempt bonds. This was First Humanics' last offering.

**RESPONDENT**

B. Gould was an officer and director of First Humanics from 1986 to 1989. Gould reviewed the Medicos offering circular, participated in earlier First Humanics offerings and bond closings and was involved in the operations of First Humanics.

**BACKGROUND**

C. In connection with each offering, First Humanics contracted to purchase a particular nursing home. To finance the purchase, the Company arranged for a municipality to issue tax-free municipal bonds. However, the Company remained liable for all payments to bondholders. To finance the issuance costs on certain of the above offerings, the Company, in some instances, also issued a modest amount of corporate bonds in conjunction with the tax-exempt bonds. Again, the Company was liable for all payments to bondholders.

D. Each prospective nursing home was initially located by Lee F. Sutliffe ("Sutliffe"), the undisclosed control person of First Humanics and the undisclosed promoter of First Humanics' offerings. If Sutliffe decided the nursing home was acceptable for acquisition, the First Humanics Board of Directors then voted to acquire the facility. Sutliffe received an acquisition fee of between $100,000 and $300,000 in connection with each nursing home purchased by First Humanics.

E. Subsequent to the Board's approval, Sutliffe initiated the offering process, through which First Humanics obtained the funds necessary to purchase the nursing home. In connection therewith, Sutliffe assembled an offering "working group" which coordinated the offering process and was responsible for preparing the offering circulars. The activities of the First Humanics working group were largely directed by Sutliffe. In this manner,

Sutliffe acted as the promoter of the offerings. Gould sometimes participated in working group meetings and also reviewed offering materials prepared by the working group.

F. In connection with each offering, an offering circular was prepared. The offering circular typically contained sections describing First Humanics, the nursing home to be acquired, the bonds, sources and uses of bond proceeds, risk factors and, as appendices, a financial feasibility study and the Company's audited financial statements. The primary purpose of the offering circular was to provide the investing public with all material facts pertaining to the offering. Gould reviewed offering circular drafts, commented on certain drafts, and executed numerous supporting documents which were used in connection with the drafting of the offering circular. Thus, he was involved in the process of preparing offering circulars.

G. Upon completion of the offering process, Sutliffe coordinated the bond closings. At each bond closing, the municipal issuer sold the bonds to an underwriter who, in turn, re-sold them to the investing public through various retail broker-dealers. Upon receiving the bond proceeds from the underwriter, the municipal issuer either lent such proceeds to First Humanics so that the Company could purchase the nursing home and leased it back to the Company. A certain amount of bond proceeds were also set aside as working capital for the benefit of First Humanics.

H. Immediately after closing, First Humanics assumed the municipal issuer's repayment obligation to the bondholders. Thereafter, the Company was required to make monthly bond payments to the indenture trustee sufficient for the trustee to meet semi-annual interest payments to the bondholders. At all times, effective control of the nursing homes remained with First Humanics. In addition, pursuant to various bond and trust indentures, the Company was required to allocate a certain amount of each offering's proceeds to a debt service reserve fund. The debt service reserve fund was used to offset any insufficiencies in funds available for the semi-annual interest payments to bondholders. However, the Company was required to pay back any monies withdrawn from this account.

I. Prior to promoting the First Humanics offerings, Sutliffe was involved in the promotion of numerous other bond issues. Most of these earlier offerings, however, had experienced financial problems and some eventually defaulted prior to the Medicos offering. Furthermore, in March 1985, the State of Missouri found that Sutliffe had participated in the making of false filings, and issued a cease and desist order against him. Gould was aware of Sutliffe's business and regulatory history.

J. In addition to Sutliffe's promoting activities, he also controlled First Humanics. The First Humanics officers and Board of Directors, including Gould, allowed Sutliffe to dictate virtually all significant First Humanics' decisions. Sutliffe even served on various First Humanics' Board sub-committees, including a management sub-committee. As such, Sutliffe determined which nursing homes First Humanics would acquire and was involved in the day-to-day operations of the nursing homes. Sutliffe's control was openly displayed at Board of Directors meetings and reflected in the pertinent minutes and in First Humanics internal memoranda and correspondence. Thus, although Gould was an officer and director of First

Humanics and was involved in the management of the Company, he followed the directions of Sutliffe.

K. Revenues from First Humanics' nursing homes were generally paid directly to the company and, from 1984 on, First Humanics freely and openly commingled all such revenues in a central bank account located in Dixon, Illinois (Dixon account). First Humanics then used the revenues from any one nursing home to pay the expenses of other nursing homes, as the need arose. When a nursing home's revenues were insufficient to meet a bond payment, money was simply taken from available funds in the Dixon account, whatever the source. Thus, each nursing home's expenses were paid according to the urgency of the bill and not limited by the amount of revenue generated by the particular nursing home. From 1986 on, however, most of the nursing homes failed to generate an amount of revenues sufficient to meet their own expenses. As a result, commingling became essential to the operation and survival of First Humanics. The success or failure of any one nursing home was thereby dependent upon the success or failure of all the other nursing homes. Therefore, each municipal offering was, in fact, a de facto investment into First Humanics and its existing nursing homes. Gould was, in fact, aware that the use of one nursing home's revenues to pay another's expenses was essential to the operation of First Humanics.

L. In addition, the vast majority of First Humanics' nursing homes were located in Illinois and heavily dependent on Illinois' Medicaid reimbursements, which were often insufficient and continually late. Given the nursing homes interdependence, as the result of the commingling discussed above, such late and insufficient payments affected all nursing homes, even those located outside of Illinois. Thus, largely because of the Medicaid problems, in late 1985 First Humanics became late in its required monthly bond payments to the indenture trustees for certain bond issues. Therefore, First Humanics began using the funds from some of these delinquent nursing homes' debt service reserve accounts to offset the insufficiencies. Although First Humanics was required to pay back monies withdrawn from such accounts, these payments were often late and insufficient. Gould was aware of both the Medicaid problems and the late and insufficient payments to the debt service reserve funds.

M. As a result of First Humanics' cash flow shortages, First Humanics also became reliant on the working capital generated from new bond offerings as a source of funds for current operations. Additionally, a procedure was developed, of which Gould was aware, whereby Sutliffe "kicked-back" a portion of his acquisition fee to First Humanics at, or shortly after, each bond closing. Thus, the success of existing nursing homes and the payments to existing bondholders became largely dependent on First Humanics' ability to obtain funds from future offerings. In this manner, First Humanics operated a Ponzi scheme in which Gould participated.

N. Nonetheless, First Humanics continued to be late in its monthly bond payments to the trustees. As a result, First Humanics also continued to deplete certain bond issues' debt service reserve funds. In August 1986, one of the trustees, in fact, informed First Humanics that based on its continued failure to repay these funds it was in violation of four of its bond indentures and, therefore, in technical default. First Humanics experienced a $912,946 loss before depreciation for its fiscal year ended November 30,

1986, even including Sutliffe's kick-backs. Furthermore, none of the nursing homes had met their cash flow projections as stated in their offering circulars. In December 1986, one of the trustees again informed First Humanics that it was in technical default on two of its municipal bonds. However, Sutliffe caused six new bond issues to close on December 18, 1986. As a result, and in connection with the First Humanics Ponzi scheme, additional working capital was generated and, undisclosed to investors, $500,000 of Sutliffe's acquisition fee was kicked-back to First Humanics. These funds were immediately applied to cure First Humanics' monthly bond payment deficits and to pay its past due bills. Nonetheless, First Humanics' cash flow problems continued.

**MEDICOS OFFERING**

O. Despite First Humanics' financial problems, in early 1987 Sutliffe directed First Humanics to acquire Medicos. In connection therewith, Sutliffe arranged to have the City of Detroit issue $6,955,000 in tax-exempt bonds. Sutliffe also directed Gould and other First Humanics board members to issue $530,000 in taxable bonds to cover the issuance expenses. Both series of bonds were issued pursuant to one offering circular.

P. Sutliffe, acting as the promoter, then began the offering process by assembling the working group which prepared the Medicos offering circular. Again, Sutliffe largely directed the working group's activities as the undisclosed promoter for Medicos. Gould reviewed the Medicos offering circular and the related offering documents. Although Gould was not primarily responsible for drafting the Medicos offering circular, as an officer he was involved in its preparation.

Q. Upon completion of the offering process, Sutliffe then coordinated the Medicos bond closing. The Medicos offering closed on October 15, 1987 and the municipal and corporate bonds were sold to the public through underwriters and various broker-dealers. Upon receiving the proceeds from the underwriters, the municipal issuer purchased Medicos and thereafter leased the facility back to First Humanics. At closing, Gould, signed pertinent acquisition and closing documents necessary for the offering to close. In addition, Gould signed certifications stating that the Medicos offering circular did not misrepresent or omit to state any material facts. Finally, Sutliffe kicked-back approximately $200,000 of his Medicos acquisition fee to First Humanics as part of First Humanics' ongoing Ponzi scheme.

R. However, the Medicos offering circular omitted to disclose numerous material facts. For instance, the Medicos offering circular failed to adequately disclose Sutliffe's promotion of the Medicos offering, his control over First Humanics, his prior bond failures and his past securities law sanction. Additionally, the Medicos offering circular portrayed Medicos as a "stand alone" nursing home. Thus, the Medicos offering was simply presented as an investment into Medicos. In connection therewith, the offering circular stated that the bondholders' ability to receive interest and principal payments was dependent on the revenues derived from the operation of Medicos, not First Humanics' other nursing homes. As a result, nothing adequately describing the commingling of nursing home revenues or the resulting financial interdependence among First Humanics' nursing

homes was disclosed. Thus, Medicos bondholders were also not informed that Medicos revenues would be used to pay First Humanics existing nursing homes' expenses. Consequently, bondholders were not informed that, in fact, their investments constituted de facto investments into First Humanics and its existing nursing homes and not merely Medicos.

S. Similarly, the serious Illinois Medicaid problem which at the time was adversely affecting all First Humanics' nursing homes was not disclosed. Thus, Medicos bondholders were not informed that, given the nursing homes' financial interdependence, their future bond payments were largely dependent on First Humanics' ability to secure the late Medicaid payments from the State of Illinois. The offering circular also failed to disclose both the August and December 1986 defaults which related directly to First Humanics' ability to pay bondholders.

T. Finally, neither Sutliffe's $200,000 kick-back nor First Humanics' dependence on the capital generated from future offerings to finance its existing nursing homes, as part of its ongoing ponzi scheme, were disclosed. Thus, Medicos bondholders were not informed that their ability to receive payments was also dependent on First Humanics' ability to secure funds from future offerings.

U. Through Gould's role as an officer and director and his participation in the Medicos offering process Gould was aware of the above material facts. In addition, through his participation in the Medicos offering process, Gould knew or should have known that the Medicos offering circular omitted these facts. However, despite this knowledge, Gould actively encouraged the sale of the Medicos bonds to the public by voting to approve the acquisition, signing pertinent bond closing documents and certifying that the offering circular contained no misrepresentations or omissions of material fact.

V. Respondent Gould caused violations of Section 17(a) of the Securities Act in that he, in the offer or sale of certain securities, namely Medicos municipal bonds and First Humanics corporate bonds described in paragraphs II. A. and O. above, by use of the means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly, caused the employing of devices, schemes or artifices to defraud; obtaining of money or property by means of untrue statements of material facts or omissions to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or engaging in transactions, practices or courses of business which operated as a fraud or deceit upon purchasers or prospective purchasers. As part of the aforesaid conduct, Respondent caused misrepresentations and omissions of material fact to be made to purchasers and prospective purchasers concerning, among other things, Sutliffe's role in promoting the offering, his control over First Humanics as well as his regulatory history and numerous prior bond and business failures; First Humanics' prevalent commingling of revenues from past nursing home projects and the resulting financial interdependence of all First Humanics nursing homes; the Illinois Medicaid problem; and, First Humanics' on-going ponzi scheme.

W. Respondent Gould caused violations of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder in that he, in connection with the purchase or sale of certain securities, namely Medicos municipal bonds

and First Humanics corporate bonds described in paragraphs II. A. and O. above, by use of the means or instrumentalities of interstate commerce or by the use of the mails, directly or indirectly, caused the: employing of devices, schemes or artifices to defraud; making of untrue statements of material facts or omissions to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or engaging in acts, practices or courses of business which operated as a fraud or deceit. As part of the aforesaid conduct, Respondent caused misrepresentations and omissions of material fact to be made to purchasers and sellers concerning, among other things, Sutliffe's role in promoting the offering, his control over First Humanics as well as his regulatory history and numerous prior bond and business failures; First Humanics' prevalent commingling of revenues from past nursing home projects and the resulting financial interdependence of all First Humanics nursing homes; the Illinois Medicaid problem; and, First Humanics' on-going ponzi scheme.

**III.** In view of the foregoing, it is in the public interest to impose the sanctions agreed to in the Offer of Settlement.

Accordingly, IT IS HEREBY ORDERED THAT, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Sidney Gould cease and desist from committing or causing any violation, and committing or causing any future violation, of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.

**Footnotes**

-[n1]- The findings herein are made pursuant to Gould's offer of settlement and are not binding on any other person or entity named as a respondent in this or any other proceeding.

To Contents

*http://www.sec.gov/info/municipal/mbonds/publicof.htm*

# EXHIBIT NO. 46

ATTORNEY TO CLIENT
CORRESPONDENCE
FOR CONFIDENTIAL USE ONLY

**Office of**
**The City Attorney**
**City of San Diego**

**MEMORANDUM**
**MS 59**

**(619) 236-6220**

**DATE:** November 6, 2001

**TO:** Honorable Mayor and Members of the City Council

**FROM:** Leslie J. Girard, Assistant City Attorney

**SUBJECT:** Furgatch v. San Diego Unified Port District, et al., Court of Appeal D035842; City, et al. v. All Persons Interested, et al., San Diego Superior GIC 763487; Dunkl v. City, et al., U.S. Supreme Court No. 01-136; Skane v. City, et al., San Diego Superior GIC 752505; and anticipated litigation matter: Henderson v. City

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In closed session we will be discussing with you your responsibilities regarding the consideration of the Preliminary Official Statement for the City's ballpark bonds. Our outside counsel, Gerald Boltz and Matt Anhut of Bryan Cave LLP, along with the City's bond counsel, Paul Webber of Orrick Herrington & Sutcliffe LLP, will be discussing these matters with you. Enclosed, for your review prior to the closed session, is a memorandum from Mr. Boltz and Mr. Anhut that generally outlines federal securities laws on this subject.

Enclosure

BRYAN CAVE LLP

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October 29, 2001

Leslie J. Girard, Esq.
Assistant City Attorney
City of San Diego
Civil Division - Special Projects
1200 Third Avenue, Suite 1620
San Diego, CA 92101

**Privileged and Confidential**
**Attorney-Client Communication**

Re: Review of Disclosure Documents as to Lease Revenue Bonds 2001

Dear Les:

We are writing this letter to provide an overview of the applicable federal securities laws and to provide a framework against which the City Council for the City of San Diego ("City Council") and the Board of Commissioners of the Public Facility Financing Authority of the City of San Diego ("Board of Commissioners") must review and evaluate the Preliminary Official Statement ("POS"), and the Official Statement when completed, prepared in anticipation of the offering of the Lease Revenue Bonds 2001 ("2001 Bonds"). As noted in the POS, the purpose of the bond offering is to finance the construction of a major league baseball park in San Diego, as well as other uses (as described in the POS) relating to the ballpark project (the "Ballpark Project"). In this letter we will not recount the lengthy history relating to the Ballpark Project and the numerous related legal challenges and actions, except to note, however, that in a letter dated September 20, 2001, to the City Attorney, the lawyer who has been the driving force behind various pieces of litigation relating to the Ballpark Project has contended that, because of various changes and alterations, the Ballpark Project should be re-submitted to the voters of San Diego for approval (the "September Letter").

In light of the application of provisions of the federal securities laws, and in particular the obligations imposed on issuers in connection the offering and sale of securities (as described below), and the allegations made in the September Letter, each member of the City Council and the Board of Commissioners must read the POS (and when completed the Official Statement), ask questions as to any area or matter that may seem unclear or need clarification, actively seek

information from the officials of the City or Authority and professionals retained in connection with the proposed offering, and conduct follow-up as to the information supplied.

Overview of the Applicable Federal Securities Laws

While Congress exempted offerings of municipal securities, such as the 2001 Bonds, from the registration requirements of the Securities Act of 1933, and the system of periodic reporting under the Securities Exchange Act of 1934, it did not exempt transactions in municipal securities from the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder. These provisions prohibit any person, including municipal issuers, from making a false or misleading statement of material fact, or omitting any material facts necessary to make statements made by that person not misleading, in connection with the offer, purchase or sale of any security. In the event of a violation of the securities provisions, the SEC has a range of remedies at its disposal, including the authority to seek injunctive relief to stop (in extraordinary circumstances) the offer or sale of securities and the imposition of penalties (which include monetary fines and the placement of limitations on securities related activities). In addition, there is typically a substantial amount of negative publicity that arises in connection with an SEC proceeding.

Although as to certain antifraud provisions, the SEC must show that the person acted with "scienter" -- that is recklessness or an intent to deceive, manipulate, or defraud -- the SEC need only demonstrate that the person acted negligently to establish a violation of other antifraud provisions. To establish negligence, the SEC must show that the defendants failed to conform with the standard of care that a reasonable person would have exercised in like circumstances and position. Of course, there must first be a misstatement or omission of a material fact; however, the lower threshold of negligence provides greater enforcement flexibility to the SEC.

In light of the foregoing, it is critical that the City Council and the Board of Commissioners exercise all due care in reviewing and evaluating the information contained in the POS. As to that information, the statements in the POS "must be viewed as part of a 'mosaic' to see if those statements, in the aggregate, created a misleading impression. . . . The proper test is not the literal truth or the materiality of each positive statement, but the overall misleading impression that it combines to create." *In re Genentech, Inc., Securities Litigation*, 1989, Fed. Sec. L. Rep. (CCH) ¶94, 544 (N.D. Cal. 1989). Moreover, a fact is deemed "material" if there is a " ... substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable [investor]. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

Unfortunately, in the event that there is a challenge to the adequacy of a disclosure document, such challenge occurs with the benefit of hindsight. While it is not appropriate to apply hindsight, as a practical matter it is sometimes difficult to disregard subsequent events, and the impact of those events, in placing the disclosure in the proper context of what had occurred as of the time that the document was created.

The importance of the review of municipal securities disclosure documents was highlighted in connection with an SEC report that was critical of the supervisors of Orange County, California for shortcomings relating to their review of such documents. *Report of Investigation in the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors*, Exchange Act Release No. 36761 (January 24, 1996). As stated by the SEC in the Orange County matter:

> In authorizing the issuance of securities and related disclosure documents, a public official may not authorize disclosure that the official knows to be false; nor may a public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading. When, for example, a public official has knowledge of facts bringing into question the issuer's ability to repay the securities, it is reckless for that official to approve disclosure to investors without taking steps appropriate under the circumstances to prevent the dissemination of materially false or misleading information regarding those facts. **In this matter, such steps could have included becoming familiar with the disclosure documents and questioning the issuer's officials, employees or other agents about the disclosure of those facts.**

*Id.* (emphasis added).

The message communicated by the statements of the SEC in the foregoing report is that members of the body approving disclosure documents cannot simply "rubber-stamp" the document. Rather, each member has the responsibility to demonstrate that he or she was actively involved in the process -- that is, each person must review the disclosure document, inquire as to the source of the information, ask questions of the City officials and other professionals who provided information (as well as ask if there are other sources of information that should be reviewed), and follow-up to ascertain whether the information makes sense in the circumstances. In short, the members of the City Council and the Board of Commissioners must demonstrate that they have satisfied themselves, after diligent inquiry that all material facts have been accurately disclosed, that the POS is not misleading.

Application of the Provisions of Federal Securities Laws to the POS

As discussed above, the primary consideration in regard to the POS is that it not contain a misstatement as to a material fact or omit to state any fact that is necessary so as to make the

statements contained therein not misleading. This standard does not mean that the members of the City Council and the Board of Commissioners cannot rely on the professionals and City officials who have supplied information to be included in the POS. What it does mean, however, is that the members of the City Council and the Board of Commissioners act with reasonable care. This includes, at a minimum: (1) reviewing the entire POS; (2) asking for clarification as to material parts of the POS that a member may need additional guidance; (3) seeking information and asking questions of the officials, employees, and professionals who supplied information to be included in the POS; and (4) asking follow up questions to determine the reasonableness of any assumptions or estimates that were used in the POS. Although significant efforts have been expended to make the information in the POS accurate and understandable, the members of the City Council and the Board of Commissioners should not be hesitant to inquire as to any area that might not be entirely clear.

Also, in light of prior challenges to the Ballpark Project, it is prudent that the City Council make certain that there are no additional disclosure issues that need to be addressed. In particular, the City Council should document whether there is any potential conflict of interest -- whether through a business or financial relationship or transaction -- that might need to be disclosed. In this regard, we recommend that the City Council document that each member has not received anything of value from the Padres, any affiliate of the Padres, or any other person or entity that has a material interest in either the Ballpark Project or the proposed offering of the 2001 Bonds. (Such persons include: Padres, L.P.; Padres Construction, L.P.; Mr. John Moores; JMI Realty, Inc.; JMIR - Downtown Acquisition, LLC; San Diego Ballpark Builders; Clark Construction Group, Inc.; Nielsen Dillingham Builders; Douglas E. Barnhart, Inc.; Hines Interests Limited Partnership; Major League Baseball; Ambac Assurance Corporation; Wells Fargo Corporate Trust; HOK Sports; Merrill Lynch & Co., Inc.; Morgan Stanley & Co., Inc.; I.C. Rideau Lyons & Co.; Redwood Securities Group.)

From the perspective of the securities laws, no precise criteria can be established as to the level or range of financial and business relationships, arrangements and practices that might be problematic. The better practice is to ensure that there is no potential conflict in the first instance by requesting and obtaining written confirmation from each member that he or she did not have any business or financial dealings with any person who might be interested in the Ballpark Project or the 2001 Bond offering.

Finally, the City Council should, as part of its review, address the allegations made in the September Letter. In particular, in the September Letter, the lawyer asserts that changes in the financing and revenue assumptions relating to the Ballpark Project and the ancillary development; the increase in the financial participation by the Redevelopment Agency, the reliance by the City on other revenue sources for the Ballpark Project, any amendments to the MOU, and the change in the scope of the ancillary development mandate that the project again be submitted to the voters of the City for approval. Further, and notwithstanding that the POS had

not been completed or released prior to the date of his letter, the lawyer stated that matters might be "omitted or misstated in the [POS]."

In regard to the allegations made by in the September Letter, portions of the POS relating to the Plan of Financing, the Redevelopment Project, the Risk Factors and Litigation should receive additional attention on review by the City Council and the Board of Commissioners. In particular, the lawyer asserts that the transient occupancy tax and tax increment to be generated from the hotels, office space and other development around the Ballpark Project will not be sufficient to pay for the City's contribution to the Ballpark Project. While the assertion rests upon the assumption that specific revenues were pledged for the project, the allegations highlight the importance of reviewing the financial projections and assumptions underlying the City's commitment and resources available to repay the bonds. In that regard, the members of the City Council and the Board of Commissioners should make use of the resources available through City officials in determining whether any of the assertions warrant further attention.

Although there can be no prediction of what future actions might be brought relating to the Ballpark Project or the offering of the 2001 Bonds, a thorough and careful review of the POS by the members of the City Council and the Board of Commissioners will provide a solid foundation to support any response to -- and hopefully summarily conclude -- potential, future challenges.

Very truly yours,

Gerald E. Boltz

Matthew D. Anhut

# EXHIBIT NO. 47

ATTORNEY TO CLIENT
CORRESPONDENCE
FOR CONFIDENTIAL USE ONLY

**Office of**
**The City Attorney**
**City of San Diego**

**MEMORANDUM**
**MS 59**

**(619) 236-6220**

**DATE:** November 6, 2001

**TO:** Honorable Mayor and Members of the City Council

**FROM:** Leslie J. Girard, Assistant City Attorney

**SUBJECT:** Furgatch v. San Diego Unified Port District, et al., Court of Appeal D035842; City, et al. v. All Persons Interested, et al., San Diego Superior GIC 763487; Dunkl v. City, et al., U.S. Supreme Court No. 01-136; Skane v. City, et al., San Diego Superior GIC 752505; and anticipated litigation matter: Henderson v. City

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October 29, 2001

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**Privileged and Confidential**
**Attorney-Client Communication**

Re: Review of Disclosure Documents as to Lease Revenue Bonds 2001

Dear Les:

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Very truly yours,

Gerald E. Boltz

Matthew D. Anhut

# EXHIBIT NO. 48

NO EXHIBIT WITH THIS FOOTNOTE

# EXHIBIT NO. 49

NO EXHIBIT WITH THIS FOOTNOTE