

Conduit Bond Issuers

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

REPORT NUMBER 2011-118/2011-613, ISSUED AUGUST 2012

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

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

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

In the report, the California State Auditor (state auditor) made the following recommendations to California Communities, Municipal Finance, and the Health Financing Authority. The state auditor's determination regarding the current status of recommendations is based on these agencies' responses to the state auditor as of October 2012 and additional information California Communities and Municipal Finance provided in November 2012.

Recommendation 1.1—See pages 18—23 of the audit report for information on the related finding.

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

Legislative Action: Unknown.

The state auditor is not aware of any action taken by the Legislature as of December 18, 2012.

Recommendation 1.2—See pages 20—23 of the audit report for information on the related finding.

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

FPPC's Action: Fully implemented.

In October 2012 the FPPC informed the California State Treasurer that, pursuant to its *McEwen* advice letter and other advice letters it has issued in the past, the compensation models of the joint powers authorities included in the audit (California Communities and Municipal Finance) do not violate the political reform act.

Recommendation 1.3—See pages 18—23 of the audit report for information on the related finding.

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

California Communities' Action: Partially implemented.

California Communities indicated that its commission considered requiring HB Capital Resources, Ltd. (HB Capital) to disclose the amount of compensation paid to each of its employees. However, the commission concluded that it does not have discretion over such compensation. Instead, California Communities amended its contract with HB Capital in October 2012 to require HB Capital not to compensate its employees providing services directly or indirectly to the joint powers authority on a commission basis or pursuant to any other method of compensation that is based on the dollar amount or volume of bonds issued by the joint powers authority.

Municipal Finance's Action: Pending.

Municipal Finance stated that a subcommittee of its board members is reviewing proposed contract language that will prohibit its consultants from compensating their employees on a commission basis or any other method that is based on the volume of bonds sales. Municipal Finance indicated that the proposed contract language will also require all consultants to disclose the amount of compensation provided to individual employees.

Recommendation 1.4—See page 28 of the audit report for information on the related finding.

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

California Communities' Action: Pending.

California Communities stated that the term of its contract with HB Capital does not expire until June 2015, and that the contract automatically extends for another two years unless California Communities gives written notice to HB Capital prior to May 2013 that it does not desire to extend the contract. California Communities indicated that at the beginning of 2013, its commission will consider whether to provide such notice and conduct a competitive bid process for selecting a program manager for a term commencing in July 2015. California Communities added that at the beginning of 2013, its commission will be reviewing each of its other consultant contracts to determine whether it would be timely to conduct a competitive bid process for one or more of these contracts.

Recommendation 1.5—See pages 28 and 29 of the audit report for information on the related finding.

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

Municipal Finance's Action: Fully implemented.

In July 2012 Municipal Finance's board compared Sierra Management's services and prices to other conduit bond issuers and concluded that it is receiving the best value for the public funds it oversees. Municipal Finance also sought competitive bids for issuer/special counsel services in November 2012, which it stated was a result of its review of the services it was receiving. Municipal Finance affirmed that it will continue to follow its July 2012 policy, stating that for any engagement for professional services with a duration of at least one year, its board will conduct a review on a periodic basis to assess and evaluate the performance of the service provider. It added that it expects to conduct a review on an annual basis each January.

Recommendation 1.6—See pages 26 and 28 of the audit report for information on the related finding.

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

California Communities' Action: Fully implemented.

In October 2012 California Communities amended its contract with HB Capital to prohibit HB Capital from receiving any additional compensation, payment, or other financial benefit from any person in connection with the issuance of bonds by the joint powers authority, except for the compensation authorized by its contract.

Municipal Finance's Action: Pending.

Municipal Finance indicated that it is reviewing proposed contract language that would prohibit its consultants from engaging in activities on its behalf that produces a direct or indirect financial gain to the consultants without its informed consent. Municipal Finance added further that Sierra Management voluntarily restricts itself to serve Municipal Finance and no other financing authority.

Recommendation 1.7—See pages 30 and 31 of the audit report for information on the related finding.

Once the Securities and Exchange Commission (SEC) finalizes its definition of *municipal advisor*, California Communities should have its legal counsel review whether HB Capital should register with the Municipal Securities Rulemaking Board.

California Communities' Action: Pending.

California Communities noted that the SEC has not finalized the definition of municipal advisors, and has extended the temporary definition until September 2013. California Communities stated that its legal counsel will continue to monitor SEC communications for when the definition is finalized and conduct an independent review.

Recommendation 2.1—See pages 34 and 35 of the audit report for information on the related finding.

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

Health Financing Authority's Action: Fully implemented.

The Health Financing Authority indicated that it will now provide telephone access for all of its local approval hearings so members of the public may participate via a toll-free phone call. The Health Financing Authority demonstrated its new process using an October 2012 hearing for the city of Hope. The Health Financing Authority published notices for this hearing in both *The Sacramento Bee* and in the *Los Angeles Times*. These notices included the date and time of the hearing, an address for members of the public who wished to attend in person, and a toll-free number and participation code for members of the public who wished to participate remotely.

Recommendation 2.2—See page 39 of the audit report for information on the related finding.

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

Legislative Action: Unknown.

The state auditor is not aware of any action taken by the Legislature as of December 18, 2012.