

The Handbook of Municipal Bonds

SYLVAN G. FELDSTEIN
FRANK J. FABOZZI



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Foreword

Information is the lifeblood of markets. Indeed, economic theory tells us that the benefits of a free competitive market—an efficient and optimum allocation of resources—is only possible if all market participants have access to the same knowledge about a product and its price.

Without this information, buyers, sellers, dealers, and others have little way to determine whether to purchase or sell the product being traded. Market participants need to know what is being bought or sold and what value/price is being attached to the product. None of us would go into a food store to purchase food if everything were wrapped in brown paper with just the briefest description of the contents and prices only known when we reach the checkout counter. Everyone participating in a market needs to be informed so that rationale decisions can be made and resources allocated efficiently and optimally.

Over the years, I often heard people in the equity markets and in parts of fixed income markets talk about how “complex” they were. Market participants would talk about the large number of variables, alternatives, and such that they would have to consider. But, of all the financial markets, the municipal securities market has the greatest informational requirements.

One only needs to peruse the table of contents of this book to see the myriad types of municipal securities being offered in the market today. Multiply those different credit structures by the number of possible issuers (50,000+) and by the number of different possible maturities and one can understand easily why there are more than 1.5 million different securities outstanding in today’s municipal bond market. At one point in my career, a database provider informed me that it took more than 120 possible data fields just to describe the range of municipal securities then outstanding. Today it undoubtedly would require even more.

Compare these statistics with the U.S. equity markets, where there are less than 10,000 outstanding equity issues. Moreover, it is not difficult to understand what it means to buy or sell a share of a company. Or consider the market for U.S. Treasury securities, where the number of different securities that can be traded is less than 1,000 and the credit quality is known! Participants in the municipal securities market, even those operating in a

narrow segment of the market, are confronted with an almost overwhelming list of factors to be considered.

The Handbook of Municipal Bonds meets a critical need in filling the informational demands of this market. It provides a useful starting place for an issuer being presented with various financing alternatives, for an investor trying to choose among alternatives, and even for dealers and other professionals that wish to operate in segments of the market that are unfamiliar to them. It is the only comprehensive reference source for professionals in the municipal securities market—financial advisors, bond counsel, tax counsel, and trustees, to name a few. Reporters and other observers of the municipal securities market would be well advised to have *The Handbook* nearby.

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Preface

Since the mid-1980s, the municipal bond industry has undergone enormous growth and dramatic change. It is fair to describe the municipal debt market as continuing to evolve. As we go to press in early 2008, the municipal bond insurers, long a mainstay of the market with their triple A ratings and 50% market share, face significant financial and rating problems.

There are now more municipals outstanding than ever. According to the Securities Industry and Financial Markets Association (SIFMA), at the end of the third quarter of 2007, the par amount of municipals outstanding was \$2,570.6 billion. Because of the lower interest rate environment in the years immediately after the terrorist attacks of 9/11, many older high coupon bonds were refunded at lower interest rates. This resulted in annual new issue volume also reaching new highs. In 2005, \$408.3 billion was issued, an all time record. For calendar year 2006, the figure dropped slightly to \$383.4 billion, tying it with 2003's total. By comparison, in the calendar year before 9/11, total new issue municipal volume was \$200.88 billion. Trading in the secondary market has also become at times brisk, and "real time" trade transparency for investors and dealers has improved. Chapter 20 in this book describes this in more detail.

The industry also has many new buy-side participants. In addition to the traditional bank trust departments, mutual funds, property and casualty insurance companies, and high-net-worth individuals, buyers now include hedge funds, arbitrageurs, life insurance companies, cross-over buyers, and foreign banks, among other relative-value buyers. Even on the deal origination sell-side things are changing. While shrinkage among the dealer-brokers and investment bankers has occurred as Wall Street consolidated, the number of lawyers who represent themselves as "qualified experts" in the narrow legal specialty of municipal bond law has exploded as noted in Chapter 49 on analyzing revenue bonds. For all participants in this industry, greater scrutiny of qualifications and caution are in order. Because of the growth of the industry and the entry of so many new participants, in our opinion a handbook covering all aspects of the municipal bond market would be timely and useful.

In addition to the chapters on investment banking and trading that we cover in Parts One and Two, we have included chapters on municipal

bond analytics and modern municipal bond portfolio management in Part Four and Part Five, respectively, in the book. These areas have substantially changed since the 1990s as the buy side participants have become more familiar with modern portfolio theory and fixed income analytics. In our previous writings on municipal bonds prior to the mid 1990s, we introduced and applied to the municipal market some of the techniques and concepts that are now widely used in the industry on both the buy and sell sides, including the proprietary trading desks of brokerage and investment banking firms. Book reviewers at that time thought that such concepts were not applicable for municipal bonds and criticized our book for that reason. Today, however, they have become important tools in the industry.

Compliance has also become of critical concern for both the buy and sell sides. For this reason, Part Three has several chapters addressing some of the more importance compliance issues in the industry.

Also, particularly since 2002, new synthetic instruments such as derivatives, structured notes, rate locks, and swaps have been introduced into the industry. As this book went to press in the fall of 2007, it was announced that four fund companies filed with the Securities and Exchange Commission to launch a total of 15 municipal bond *exchange-traded funds* (ETFs). Going forward, we expect these new instruments to increase in importance and have included some of the latest innovations in these areas within this book.

The trading and pricing of municipal bonds has also become more transparent while adopting analytical and quantitative concepts and principles from the taxable fixed income asset classes. There are now four different sets of municipal bond indexes available to investors in gauging portfolio performance and the market's performance. They include:

- *Lehman Brothers Municipal Bond Index*, a total return index that is widely used by mutual funds and other large portfolio managers. Their municipal bond indexes are based upon a universe of bonds across yield curves and credit sectors. In mid-2007, it had approximately 41,563 issues.
- Standard & Poor's, in conjunction with Investortools, publishes various municipal indexes. There are over 50,000 bonds, priced historically, in the *Standard & Poor's Investortools Municipal Bond Index*.
- Merrill Lynch fixed income research publishes a number of municipal bond indexes. Their universe, as of mid-2007, included approximately 12,490 municipal bonds.
- *The Bond Buyer*, the trade daily newspaper, publishes weekly yield indexes.

As of 2007, there are two services that in the afternoon of each trading day make available generic scales for different maturities and different credit ratings. One is provided by Thomson Municipal Market Data, known in the industry as the MMD scale. The other is by Municipal Market Advisors (MMA).

The sale of bonds by issuers, both competitively and through negotiation, has also become more efficient and software based. Two companies offer this service for competitive bond sales. One is I-Deal/Ipree, which also provides a software platform for negotiated bond sales and is discussed in Chapter 21. The other is Grant Street Group, which focuses on competitive sales in the municipal market.

The pricing of municipals, marked to market at the end of the trading day, is now done daily. The two most widely used services are FT Interactive Data and J. J. Kenny (Standard & Poor's Securities Evaluations). Chapter 27 describes the methodology and process used by FT Interactive Data.

Disclosure has become more immediate and accessible. The Securities and Exchange Commission as of mid-2007 has designated four information firms as Nationally Recognized Municipal Securities Information Repositories (NRMSIRs). Official Statements from issuers and "material event notices" are available at the NRMSIRs. While this is not the final solution to ongoing disclosure because the definition of what is "material" is still open to disagreement between bondholders and underwriters, it is a step in the right direction.

In the 1980s, the credit quality of municipal bonds was of major concern coming on the heels of New York City's general obligation note default in the mid-1970s and the Washington State Public Power System revenue bond default in the early 1980s. By 2007, though many on the buy-side and the credit enhancers maintained credit research resources, credit research on the sell-side was largely nonexistent. Many buy-side firms have become complacent. An exception is in the analysis of high-yield, project-type start-up financings. We have included several chapters and case studies in this book that cover the high-yield, high-risk credit sectors as well as the traditional credit sectors.

Perhaps the reason for the complacency in credit analysis is due to the high ratings that had been assigned to the new municipal issues. Approximately 50% of all new municipals up to 2008 were insured and given a triple-A rating by the commercial rating companies. Chapter 68 covers the analysis of these insurers that have become so important in the municipal bond market. Possibly another reason for the credit complacency is because municipals are becoming more commoditized with investors, traders, and speculators from all over the world participating in this market. Many view municipal bonds as being almost as safe as U.S. Treasuries. We disagree with

this view despite the excellent track record of low municipal defaults and low yield spread volatility. In our view, the credit risk analysis component of the municipal industry is still important and in future economic down cycles will be very relevant. Accordingly, Parts Six and Seven of this book cover credit analyses written by recognized analysts in their sectors. The chapters in these two parts of the book cover most of the credit sectors.

We should also note that since the 1980s the “generally accepted accounting principles” of state and local governments have been set by the independent Government Accounting Standards Board (GASB). GASB has established uniform and more thorough reporting standards that municipal bond issuers and investors rely upon. GASB has helped improve the transparency of state and local government accounting. As this book goes to press, there is an assault on GASB by some issuers and politicians to weaken or eliminate its role. The result, if successful, in addition to introducing confusion to this area of the industry, would also allow issuers to obfuscate budget deficits and long-term liabilities. Years ago these practices resulted in budgetary disasters and bond defaults. We have included a chapter in this book by GASB to highlight its importance (Chapter 45) as well as one by the National Federation of Municipal Analysts, an organization of municipal bond credit analysts that has been in the forefront of fighting for more complete “material event” and financial disclosures (Chapter 43).

Finally, we note that many of our case studies provide the reader with detailed information on some of the more innovative financings and interesting problem bonds. The cases cover a wide range of topics arising from the 9/11 catastrophe, subprime loans, a major airline bankruptcy, and others. They are relevant for both buyers and issuers of municipals bonds.

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PART

One

The Sell Side: The Originators of Deals

The Central Place of States and Local Governments in American Federalism

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Writing in Federalist Number 45, James Madison predicted that the states would dominate the new federal union created by the Constitution. The powers of the federal government were “few and defined,” he pointed out, limited primarily to “external objects, as war, peace, negotiation, and foreign commerce.” By contrast, the states, he explained, would have authority over “all the objects which, in the ordinary course of affairs, concern the lives, liberties and properties of the people, and the internal order, improvement, and prosperity of the State.” As a result of their greater role in governance and their closer ties to the people, the states would also enjoy stronger popular support than the distant national government. Madison assumed the principal problem of federalism would be protecting a fragile federal government from the states, not protecting the states from the federal government.

For more than a century, American federalism developed largely as Madison forecast, with the federal government exercising a limited role in peacetime domestic life, and most government power wielded at the state and local levels. On the eve of the Great Depression, federal spending accounted for barely one-sixth of total domestic government—federal, state, and local—spending. The federal government provided few services directly to the people and only a modest amount of financial assistance to state and local governments.¹

¹ J. Richard Aronson and John L. Hilley, *Financing State and Local Governments: Fourth Edition* (Washington, DC: Brookings Institute Press, 1986), p. 17.

Over the course of the twentieth century, this situation changed dramatically. The emergence of a national—and increasingly global—economy, two world wars, the rise of the United States to superpower status, and the ongoing cultural and technological transformations of our society have been accompanied by a tectonic shift in power to the federal government. The federal government now plays an enormous role in regulating the economy, promoting social welfare, enforcing political and civil rights, and protecting the environment.

Yet states and local governments remain central to American governance. As in Madison's day, "the ordinary course of affairs" is dominated by state and local governments. The rules that structure civil society—contract law, tort law, property and land use law, criminal law, family law, the incorporation of businesses, the regulation of the professions—are developed, implemented, and enforced primarily at the state and local levels. So, too, most public services that affect people in their homes and families—public schools, policing, incarceration of offenders, fire safety, clean water, removal of solid wastes and sewage, maintenance of roads and streets, public parks, public hospitals and emergency medical services—are provided by states and localities, not the federal government. The vast majority of the opportunities for participation in political life—such as running for office, campaigning for or against a ballot proposition, or appearing before such critical governing institutions as the school board, the planning and zoning commission or a town meeting—are at the state and local level, too.

The centrality of states and local governments to our federal system was dramatically underscored by three recent events: the 2000 Presidential election and the bitter postelection battle over Florida's 25 electoral votes; the terrorist attacks on the World Trade Center and the Pentagon on September 11, 2001; and Hurricane Katrina's devastation of New Orleans and the Gulf Coast in 2005.

The 2000 election reminded us that there is no national presidential election. Instead we undertake 50—actually, 51 including the District of Columbia—separate state elections. The winner is determined not by the national popular vote, but by the states' electoral votes, which are based in part on state population but also provide representation for the states as states. The collection, tabulation, and recounting of presidential votes is conducted by state officials, pursuant to state rules. Moreover, the states often delegate critical issues—selection of voting machinery, ballot design, whether to undertake a manual recount, whether to accept a technically flawed absentee ballot, whether dangling or dimpled chad is sufficient to mark the intent of a voter—to local officials. To be sure, as the Supreme Court's *Bush v. Gore*, 525 U.S. 98 (2000), decision indicates, the federal constitution constrains state and local decision making. And Congress

reacted to the events of 2000 with new legislation increasing the federal role in the mechanics of voting. But the 2000 election remains a stunning reminder of how even with respect to our most important national office, states and local governments play a vital role.

September 11, 2001—9/11—demonstrated the crucial role of the states and especially local governments in dealing with issues of public safety and security. Although the terrorist attacks were an assault on our nation, most of the domestic response involved local governments. New York City police, firefighters, and emergency medical personnel responded to the attacks on the World Trade Center. Local public health and safety workers from the District of Columbia and various Virginia and Maryland counties battled the consequences of the terrorist attack on our most important federal military installation, the Pentagon. The vast bulk of the subsequent public effort to increase the security of public buildings, public spaces, and vulnerable infrastructure facilities has involved state and local security officers, not the federal government. More generally, in detecting and pursuing terrorists and preventing future terrorist attacks, the 600,000 local police officers are likely to play at least as great a role as the FBI and its 11,000 agents. This is not simply a matter of numbers—although the enormous difference in the magnitude of the local versus federal police forces is surely relevant. Local police forces are likely to have far greater knowledge of local conditions and dangers, including access to informants and awareness of unusual or suspicious incidents.²

The central role of states and local governments was underscored again in the aftermath of Hurricane Katrina. Once again, states and local governments were called upon to make critical decisions concerning evacuations, public safety, emergency health and medical assistance, and the provision of basic services. State and local actions directly affected the lives and property of hundreds of thousands, if not millions, of people. State and local governments are also continuing to play a key role in aiding victims of the disaster, rebuilding stricken areas, and planning future development in light of the needs of disaster prevention and preparedness.

The centrality of the states and local government is not simply a lingering aftermath of an earlier era. In recent years, the federalizing trend that marked the middle decades of the twentieth century has flattened, and the federal system has witnessed a modest tilt away from the federal government and back to the states and localities. This can be seen in the enhanced state and local share of public employment and public spending; in the greater discretion accorded to states and local governments in the manage-

² See generally Richard Briffault, "Facing the Urban Future After September 11, 2001," *The Urban Lawyer* 34 (Summer 2002), pp. 563–582.

ment of federally funded programs; and in the many policy initiatives that have sprung from the states and localities.

In 2002, the federal government civilian workforce was 2,690,000—down 13% from nearly 3.1 million federal employees 15 years earlier, and 170,000 workers smaller than the federal civilian workforce of 1966. By contrast, the combined state and local workforce in 2002 was 15,602,000—or nearly six times the federal. And while the federal workforce has been stagnating, the state and local workforce has been growing. The number of state and local employees in 2002 was 11% higher than in 1990—and roughly double the state and local workforce of 1966.

The state and local share of total government spending is also on the rise. In 1980, federal spending was 87% greater than state and local spending. In 2003, federal spending was just 48% greater than state and local spending. If federal spending on defense and foreign affairs, interest on the national debt, and the two major social insurance programs—Medicare and Social Security—are subtracted from the federal total, so that the focus is on domestic regulation and public services, then state and local spending actually dominates federal spending—by roughly 2:1. Moreover, although the federal government provides significant financial assistance to local governments, the federal aid share of state and local funds has been dropping. Federal aid amounted to 23% of state and local spending in 1980, and was slightly less than that in 2003. States and localities have not only expanded their programs but have also become more successful at cultivating their own resources.

Moreover, in recent years the federal government has given the states greater flexibility in spending federal dollars. The most famous instance of this is the 1996 welfare reform law, which gave the states broad new authority over federally funded welfare programs. Other federal aid programs in such areas as transportation and pollution control have been revised to reduce federal regulatory controls. This trend, however, is not unmixed, as the federal role has also increased in some areas, like primary and secondary education, that have traditionally been reserved to the states and localities.

States and localities have also been more aggressive in addressing a wide range of domestic policy issues. This is reflected in the unprecedented leadership role assumed by the state attorneys general in shaping national policy on tobacco; the initiatives underway in nearly a dozen states to tackle the sprawling pattern of urban growth; the states' exploration of new forms of school finance, HMO regulation, income assistance, and health insurance for the uninsured; the combination of voter-initiated and legislatively adopted measures to promote campaign finance reform; and the state and local legislative and judicial decisions reexamining family and marriage relationships. These developments demonstrate that states and localities are important, independent policymakers within the federal system.

THE STATES

The 50 states are the basic components of the United States. Although not all American land or residents are found within the states—the District of Columbia, the Commonwealth of Puerto Rico, and territories such as American Samoa, Guam, the Northern Marianas Islands, and the Virgin Islands are also parts of the United States—the federal government is structurally constituted out of the United States. As the Supreme Court has observed, “[t]he Constitution, in all its provisions, looks to an indestructible Union, composed of indestructible States.” (*Texas v. White*, 74 U.S. 700, 725 (1869)).

The U.S. Constitution and the States

The Constitution includes multiple protections of the autonomy and equality of the states. The Constitution guarantees the territorial integrity of the states. No state may be created out of the territory of another state without its consent. So, too, no state may be deprived of its equal suffrage in the Senate. Under the Guarantee Clause, the United States is committed to protecting the states from invasion and domestic violence.

The states are in no sense arms of the federal government. They are not like federal administrative agencies or regional offices; the federal government does not appoint state officers. The states can legislate without having to demonstrate any authorization from the federal Constitution or by the federal government. Under the Tenth Amendment, the states have residual power over all aspects of government not granted to the federal government or not constrained by the Constitution or by the federal government acting pursuant to the Constitution. To be sure, the federal Constitution does impose significant restrictions on the scope of state law-making authority, and Congress acting pursuant to the Constitution’s grant of power to the federal government can impose further limitations on the states. Nonetheless, the states continue to possess and exercise broad police power authority over their territory and their citizens.

Several recent Supreme Court decisions have underscored the protections that the Constitution provides for the autonomy of the states and their localities. Under *New York v. United States*, 505 U.S. 144 (1992) and *Printz v. United States*, 521 U.S. 898 (1997), Congress cannot “commandeer” states and localities to serve federal ends; that is, they cannot require the states to pass certain laws or enforce a federal regulatory program. Under the Court’s recent Eleventh Amendment cases, Congress lacks the power to subject nonconsenting states to private damages actions in either federal, *Seminole Tribe of Florida v. Florida*, 517 U.S. 44 (1996), or state, *Alden*

v. Maine, 527 U.S. 706 (1999), courts. Principles of federalism also limit the ability of Congress to enact legislation intended to remedy state and local violations of constitutional rights; such measures must be “congruent” with and “proportional” to the scope of state violations (see *City of Boerne v. Flores*, 521 U.S. 507 (1997), *Board of Trustees v. Garrett*, 531 U.S. 356 (2001)). Of course, Congress has broad powers under the Commerce Clause and other provisions of the Constitution to adopt economic and social legislation, preempt inconsistent state laws (see, e.g., *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525 (2001)), regulate state and local activity that affects commerce or constitutional rights (see e.g., *Garcia v. San Antonio Metropolitan Transit Auth.*, 469 U.S. 528 (1985), *Nevada Dep’t of Human Resources v. Hibbs*, 538 U.S. 721 (2003)), and use conditions attached to federal grants to influence state and local actions (see *South Dakota v. Dole*, 483 U.S. 203 (1987)).

The inherent law-making power of the states includes fiscal affairs. Although the Constitution prohibits certain specific forms of state taxation and imposes other more general rules, such as nondiscrimination against interstate commerce, the states have enormous autonomy with respect to taxation, borrowing, spending, and lending money. They may innovate new forms of revenue-raising and new types of debt instruments, they may adopt new taxes and raise tax rates, and they may incur debt to raise the funds they need to pay for the programs they prefer. To be sure, state resources may be limited in practice, and interstate competition may constrain state activities. But the states’ formal legal authority with respect to state fiscal matters is significant.

State Constitutions

Each state has its own constitution that establishes the basic structural framework for its state government. The federal constitution does not create the states or design their governments. Rather, a state’s constitution provides for the basic component parts of state government, allocates powers among these components, and determines how these parts interact. So, too, like the federal constitution, most state constitutions impose limits on the scope of governmental authority. Many state constitutions contain limits similar to those in the federal constitution like the due process and equal protection clauses and the Bill of Rights. But state constitutions also differ from the federal in significant ways.

As a matter of theory, the federal constitution provides a *grant of enumerated powers* to the federal government. In other words, the federal government enjoys only those powers actually granted to it by the federal constitution. To be sure, expansive judicial interpretations of such open-

ended constitutional provisions as the necessary and proper clause, the commerce clause, and the spending power have given the federal government broad authority; but still, in theory, all federal powers must be expressly or impliedly granted by the federal constitution. By contrast, state governments acting through their state legislatures are presumed to have broad, residual, plenary governmental powers. State constitutions are seen not as granting powers to state governments but, instead, as limiting the powers the states inherently possess.

A second major distinction between the federal and state constitutions is one of form. State constitutions tend to be longer and more detailed than the federal. This may be, in part, a reflection of the greater domestic responsibilities of state governments. Many state constitutions deal with the substantive responsibilities of state government, like public education. It may also reflect the relative frequency with which state constitutions have been revised or amended. The United States has operated under the same constitution since 1787. It has been amended 27 times. By contrast, the 50 states have had 147 constitutions, or nearly three per state. Nine states have had five or more constitutions. Only 19 states have operated under just one constitution. Moreover, not only do states frequently change their constitutions, but they even more frequently amend the ones they have. At the start of 2003, the states' current constitutions had been amended nearly 6,800 times, or approximately 136 amendments per state. As a result, many state constitutions include considerable statutory-like details.

To be sure, despite these differences most state constitutions produce state governments that look a lot like the federal government and the governments of their sister states. Thus, all 50 states have adopted the separation of powers, with three separate branches of government. All 50 states have an independently elected governor and an independently elected legislature; no state employs a parliamentary system in which the state legislature chooses the chief executive. In 49 states the legislature, like the federal Congress, is bicameral; and in most states the members of the upper house of the legislature serve for longer terms than members of the lower house. All 50 states also have an independent judiciary, and in all 50 states the courts engage in judicial review of state legislation. State bill of rights provisions frequently resemble those of the federal constitution, too.

Yet, in the areas of governmental structure and fundamental rights, many state constitutions include provisions that differ significantly from those in the federal constitution, or have no federal constitutional counterpart at all. Whereas federal judges are appointed by the executive, and, once confirmed by the Senate, enjoy life tenure, most state constitutions provide that most state judges are elected and serve for terms, rather than for life. Similarly, although the federal constitution places no limits on the number

of terms federal legislators may serve, 18 states limit the number of terms state legislators can serve. Moreover, while the federal constitution creates only two executive branch officers—the president and the vice president—most states provide for numerous independently elected state officials who may exercise executive functions independently of the governor. In all but seven states, for example, the voters elect the attorney general, and in two of the other states, the attorney general is selected by an institution other than the governor.³ The governor and attorney general may be of different parties and may clash over questions of legal policy. In addition to the independent attorney general, 38 states have an independently elected treasurer or comptroller, while in another four the official with these functions is elected by the legislature. Other officials who in some states are elected independently include the secretary of state, the commissioner of education, the commissioner of insurance, and the commissioner of agriculture.

Other structural innovations found in many state constitutions include the item veto and direct democracy. With respect to the former, the federal constitution enables the president to veto proposed legislation, but the president must veto an entire bill if he is to veto it at all. The constitutions of 43 states, however, allow the governor to veto “items” or “parts” of bills, although in every state but one that provides for this power the item veto is limited to appropriation bills.

The federal constitution makes no provision for direct democracy. The federal government is entirely representative: The people elect representatives to office who then do the governing. Apart from voting for candidates, citizens have no direct role in the ongoing processes of government. Most state constitutions, however, provide for some direct role for the people in governing. In every state but one, popular approval in a referendum is necessary to ratify changes to the constitution. Many state constitutions also condition the issuance of state or local debt on voter approval. Some state constitutions permit the voters to use referenda to block new legislation, while others authorize voter initiation of new legislation or amendments to the state constitution. In other words, in nearly half the states the voters can make or amend the constitution, without any action by the state legislature or the governor.

Direct democracy, particularly voter-initiated legislation and constitutional amendments, has had an enormous impact on the states that provide for it, particularly since California’s adoption of Proposition 13 in the late 1970s. Today, in states like California, Colorado, Washington, and Oregon it is a central part of the political process. The voter initiative played a critical role in the adoption and spread of legislative term limits and in the imposition of limits on state and local taxation and spending.

³ The attorney general is elected by the state legislature in Maine, and appointed by the judges of the state supreme court in Tennessee.

The State Fiscal Constitution

State constitutions pay considerable attention to state and local finances. The federal constitution says next to nothing about public finance, doing little more than authorizing federal taxation and borrowing,⁴ and setting out the basic procedures for raising and spending money.⁵ It places just a handful of substantive constraints on federal taxation,⁶ and no restrictions on federal borrowing at all. By contrast, state constitutions accord extensive consideration to state and local spending, borrowing, and taxing.

State constitutions limit the purposes for which states and localities can spend or lend their funds and expressly address specific spending techniques.⁷ These “public purpose” provisions narrow the range of government action and limit public sector support for private sector activities, although, in practice, judicial interpretations make these constraints far less binding than the constitutional texts might suggest.⁸

Nearly all state constitutions impose significant substantive or procedural restrictions on state and local borrowing. Some bar state debt outright or impose very low limits on the amount of debt a state may incur. Some cap state or local debt at a specified fraction of state or local taxable wealth or revenues. Many require a supermajority in the legislature, or of voters in a referendum, or of both before debt may be incurred.⁹

Many state constitutions also constrain state and local taxation. These provisions include prohibitions on certain types of taxes, such as the income

⁴ See U.S. Const., art. I, § 8, cl. 1 (authorizing Congress to “lay and collect Taxes, Imposts and Excises”); *id.* at Amend. XVI (authorizing imposition of income tax); *id.* at § 8, cl. 2 (authorizing Congress “[t]o borrow Money on the credit of the United States”).

⁵ See U.S. Const., art. I, § 7, cl. (providing that “[a]ll bills for raising revenue shall originate in the House of Representatives”); *id.* at § 9, cl. 7 (providing that “[n]o Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law”).

⁶ See U.S. Const., art. I, § 8, cl. (providing that “[a]ll Duties, Imposts and Excises shall be uniform throughout the United States”); *id.* at § 9, cl. 4 (providing that “[n]o Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken”); *id.* at § 9, cl. 5 (“No Tax or Duty shall be laid on Articles exported from any State”).

⁷ See, for example, Dale F. Rubin, “Constitutional Aid Limitation Provisions and the Public Purpose Doctrine,” *St. Louis University Public Law Review* 12, No. (1993), pp. 143–148. Rubin finds that 46 out of 50 state constitutions contain some limits on spending.

⁸ See, for example, Richard Briffault, “The Disfavored Constitution: State Fiscal Limits and State Constitutional Law,” *Rutgers Law Review* 34 (Summer 2003), pp. 907, 910–915.

⁹ *Id.*, pp. 915–916.

tax; caps on the rates of certain taxes, such as the sales tax; and a variety of limits on the property tax, including the tax rate and annual increases in assessed valuation, as well as special procedural rules for new taxes or tax increases, including legislative supermajorities or voter approval requirements, some times with popular supermajorities.¹⁰

THE COMPLEX STRUCTURE OF AMERICAN LOCAL GOVERNMENT

Although American federalism can pose difficult questions concerning the allocation of governing authority between the federal government and the states, the position of the states in American government is reasonably familiar to most people. There are only 50 states, and many of us can name them all. The number of states is quite stable, as are state boundary lines. All but five states were admitted to the union before the start of the twentieth century, and the last two states, Alaska and Hawaii, were admitted in 1959, or nearly a half-century ago. The states are comparable to each other in powers, constitutional status, internal organization, and authority over their citizens even if they differ significantly in territorial size and population.

Local governments are quite a different story. There are nearly 90,000 of them and they differ dramatically in powers, status, organization, function, authority, and mode of creation across the country and, indeed, within a particular state. There is not even a consistent terminology for local governments; different states include such diverse local units as parishes, boroughs, townships, as well as the more common forms of local government such as county or city. Unlike the states, local governments may—and frequently do—overlap each other's territory. Unlike the states, local governments are frequently created, modified territorially, or abolished. Unlike the states, local governments lack inherent law-making authority. So, too, while the federal Constitution makes frequent reference to the states, the federal Constitution is entirely silent on the subject of local governments.

Local governments are crucial to American federalism. Approximately three-quarters of the aggregate total of state and local employees are actually employed by local governments. So, too, the overwhelming majority of state and local elected officials serve at the local level. The states may be formally responsible for the provision of most domestic public services, but local governments play the key role in actually delivering such basic services as education, policing, fire prevention, street and road maintenance, mass transit, and sewage and solid waste removal. Local governments are also the dominant actors in our intergovernmental system in regulating land use and in community development. A considerable portion of state spending is

¹⁰ *Id.*, pp. 927–929.

used not for the provision of state programs but consists, instead, of grants to local governments to help them finance local services and activities.

Part of the complexity of American local government derives from the fact that most localities are agents with two principals—their state government and their local constituents. On the one hand, local governments are creatures of their states, established by the states to discharge state functions locally. On the other hand, local governments are more than simply administrative arms of the state government. Local constituents play a critical role in directing local government activities and shaping their performance. This may involve local popular election of local government officials; appointment of some local officials by other, locally elected officials; or a requirement that the state appoint only local residents to the governance of the local unit. Local autonomy may also result from the powers and discretion accorded to the local government. Local governments, thus, have a bottom-up, that is, a local control aspect, as well as a top-down or state-control aspect.

Another part of the complexity of our local arrangements derives from the sheer variety of types of local governments. There are multiple forms of local government, and they often have overlapping territorial scopes and responsibilities. Most people in the United States live in at least two different local governments. Many are within the jurisdiction of multiple localities.

The County

One basic form of local government is the county. Descended from the old English shire, the county traditionally provided basic state services at the local level. Thus, the county was responsible for public prosecutions, recording deeds, keeping birth, death, and other public records, assessing property for tax purposes, registering voters, maintaining public roads, and providing poor relief and health care for the indigent. Most states are entirely divided up into counties. (Alaska uses the term *borough* for its counties; Louisiana uses the term *parish*.) There are exceptions: In Virginia, most of the cities are outside the jurisdiction of a county; in Connecticut and Rhode Island the county exists as a territorial unit but there are no county governments; and in a number of major cities—such as Boston, Denver, Honolulu, New York, Philadelphia, and San Francisco—city and county governments are combined. These and a few other exceptions aside, most of the land in most of the states lies within a county. A state's arrangement of counties is also usually quite stable, with counties only rarely created or destroyed, and county borders rarely changed. Indeed, in many states, the current county

structure dates back to the state's entry into the Union. In 2002, there were 3,034 counties, or virtually the same as the 3,052 a half century earlier.¹¹

Traditionally, the county was a regulatory and service-providing body, not a law- or policy-making one. Indeed, often there was neither a county executive nor a county legislature; instead the county government may have consisted of a group of independent officials, such as the Assessor, the Coroner or Medical Examiner, the Register of Deeds, the Board of Elections, the Sheriff, and the District Attorney. Although locally elected and thus to a considerable extent locally accountable, their function was to discharge state services locally. Counties were particularly important in providing basic services in rural and small town areas.

Beginning in the mid-twentieth century, however, counties, particularly those in urban areas, began to take on broader responsibilities and to assume a policy-making role. Frequently encompassing central cities, smaller outlying cities, and suburbs, counties are often well-situated to provide area-wide services in metropolitan regions. Many states have provided for stronger county governments, including elected executives and legislatures, and they have increased county functions to include such area-wide activities as housing, mass transit, airports, parks and recreation, water supply and sewage, planning, zoning, and regional governance.

Counties differ dramatically in population, ranging from under 100 people to nearly 10 million (Los Angeles County, California). At the start of the new millennium, the 671 counties that each had fewer than 10,000 inhabitants together had just 3.7 million people. But the 201 counties that each had more than 250,000 inhabitants together had 159 million people, or 56.5% of the total population in all the counties in the United States.¹² In 2001, county governments across the country raised and spent in the aggregate approximately \$250 billion.¹³

The City

The city—or the municipality or the municipal corporation—is another basic unit of local governance. Here, too, terminology varies from state to state, so that municipalities may include the borough in some states (but not the Alaskan “borough,” which is really a county), the town (but not the New England town), and the village. The city is closely associated with the idea of urbanness, that is, with greater population and greater population density, and the resulting need for more government regulation and public services. The city also relies on the concept of incorporation, that is, like a

¹¹ See U.S. Bureau of the Census, 1997 Census of Governments, p. 4.

¹² See U.S. Bureau of the Census, 2002 Census of Governments.

¹³ *Id.*

private business corporation or a not-for-profit corporation, a municipality is incorporated when local people seek a new local entity to provide the services and undertake the functions they believe are necessary to deal with the consequences of population growth and density. Typically, the municipal government includes an elected legislative or policy-making body and an elected executive or appointed manager.

The number of municipal corporations is far more fluid than the number of counties. There were 19,431 municipal corporations in 2002—a 2,624 (or 16%) increase over the 16,807 municipal corporations in 1952. This increase reflects both population growth and dramatic population movements over the last half century. Some municipal corporations are also able to change their boundaries and increase their population through the annexation of unincorporated land. Although municipal corporations account for only a tiny portion of the United States' total land area, in 2002, nearly 174 million Americans, or almost 62% of the population, lived in cities. Like counties, cities vary widely in their population. Slightly less than one-half of all municipalities have fewer than 1,000 inhabitants each. The total population of these 9,361 small municipalities came to only 3.7 million people, or just 2.2% of the total municipal population. Conversely, there were just 241 cities with populations of 100,000 or more, but the total population of these larger cities was 76 million. Most cities—with the exception of many of the cities in Virginia—are located territorially within counties and are subject to county jurisdiction. So too, as previously noted, for a number of major cities, the city and county have been effectively fused.

The Township

A third form of local governance is what the United States Census Bureau calls *town* or *township governments*. These entities are located in just 20 states, concentrated in New England, the Middle Atlantic region, and the Midwest. (The New England states, New York, and Wisconsin use the term *town* while the other states use the term *township*.) Typically in these states, all or most of the counties or the parts of counties outside of incorporated municipalities are subdivided into towns or townships, much as the state is divided into counties. In New England and in the Middle Atlantic states, they are frequently found in densely populated urban areas and perform many municipal-type regulatory and service functions. By contrast, in the Midwest, many township governments perform only a very limited range of services for predominantly rural areas. There they resemble old-fashioned counties. There were 16,504 town or township governments in 2002, and, like the number of counties, the number of towns and townships is relatively stable, dropping only modestly from the total of 17,202 in 1952. With an

aggregate population of 57 million, or around 20% of the total population of the United States, town and township governments play only a modest role in local governance in the United States as a whole. But they are significant in some states, including Connecticut, Illinois, Indiana, Kansas, Maine, Massachusetts, Michigan, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, Vermont, and Wisconsin.

Special Districts

Although no local government has the full range of powers of a state, counties, cities and townships are all considered to be general purpose governments in that they have relatively broad responsibilities over a significant number of areas—public safety, public health, land use, streets, highways, and transportation. However, a significant number of local governments are given very narrowly defined authority and are authorized to undertake only one or a very limited number of functions. These are known as special purpose local governments, and they are actually the most common form of local government in the United States today. The most common form of special purpose government is the school district. In 2002, there were 13,522 school districts in the United States. The Census Bureau lumps all other forms of special purpose government into the category of *special district governments*. There were 35,356 special districts in 2002, or nearly as many as the total number of municipal governments and towns and townships combined—and far more than the total number of municipal governments and counties. The special district has also been the most rapidly growing form of local government in the United States over the last half-century. The number of special districts in 2002 was nearly triple the 12,340 counted in 1952.

The vast majority—nearly 32,000—of the special district governments in 2002 were single-function districts, with responsibilities ranging from fire protection (5,725 districts), water supply (3,405), housing and community development (3,399), drainage and flood control (3,247), soil and water conservation (2,506), sewerage (2,004), cemeteries (1,666), libraries (1,580), health and hospitals (1,464), parks and recreation (1,287), highways (743), air transportation (510), and solid waste management (455). Other districts provide parking facilities, public utility services, industrial development, and financial assistance to other local governments. The remaining roughly 3,000 districts are multifunction districts that engage in two or more activities, particularly involving sewerage, water supply, and natural resources. Special districts other than school districts raised and spent approximately \$90 billion in 1996–1997. That represented a 25% increase in special dis-

strict expenditures over 1991–1992, which was itself a 35% increase over special district expenditures in 1986–1987.¹⁴

Special districts may be created for a variety of reasons. These include giving them independence from general purpose cities or counties; tailoring the territorial scope of the government to the proper dimensions of its function or activity; avoiding certain state constitutional restrictions that apply to cities or counties; obtaining some of the infrastructure and service benefits of local government without having to incur the full costs of general purpose local government.

Like general purpose governments, special districts combine top-down and bottom-up elements. They may be created by the state, by local constituents pursuant to state enabling legislation, or by other local governments. Those with locally elected or appointed governing bodies have a stronger bottom-up aspect. Unlike general purpose local governments, some special purpose districts, particularly those that are regional in scope, may be governed by state-appointed boards of directors, which reinforces their top-down element. Moreover, unlike general purpose governments, many bottom-up special districts are designed to be accountable to and controlled not by the local population generally but by discrete local groups, such as local landowners or users of the service provided by the special district. In these districts, representation in district governance may be tied to land values or assessment payments.

FROM DILLON'S RULE TO HOME RULE

The source and scope of local government powers has long been controversial. As a matter of federal constitutional law, local governments are creatures of the states. The states enjoy broad powers to create, alter, or abolish their local governments, change their boundaries, and modify or eliminate their powers, largely unconstrained by the United States Constitution. (See *Hunter v. City of Pittsburgh*, 207 U.S. 161 (1907).) Indeed, as a background legal principle in our system, a local government is a delegate or agent of its state, enjoying only the powers the state has delegated to it.¹⁵ The scope of a locality's state-granted powers was traditionally further constrained by *Dillon's Rule*. Named after Judge John F. Dillon of the Iowa Supreme Court,

¹⁴ See U.S. Census Bureau, 1997 Census of Government, Finances of Special District Governments 1 (September 2000). Because school districts are heavily funded by state aid and appropriations from general purpose local governments, school district expenditures may not be an appropriate measure of the importance of school districts in the state and local government system.

¹⁵ See Richard Briffault, "Our Localism: Part I: The Structure of Local Government Law," *Columbia Law Review* 90, no. 1 (January 1990), pp. 7–8.

who first authored the rule in his Commentaries on the Law of Municipal Corporations shortly after the Civil War, Dillon's Rule provides that local governments may exercise only those powers granted in express words, or *necessarily or fairly implied* in the expressly granted powers, or essential to the accomplishment of the objects and purposes of the locality.

Protecting Local Governments

Dillon's Rule's crabbed approach to local power has long been criticized, and many states have taken steps to empower their localities. Two older limits on state power in order to strengthen their localities are state constitutional prohibitions on special state commissions that perform municipal functions and on special or local legislation. The special commission bans, many of which date back to the nineteenth century, were intended to protect the integrity of local governments by curbing the ability of the states to take important local functions and vest them in special bodies unaccountable to the local electorate.¹⁶ The more widespread special legislation prohibitions were intended to limit the ability of state legislatures to target specific local governments.¹⁷ Both types of provisions have had mixed success. In the middle and late twentieth centuries, a number of states added a new type of provision to their constitutions with the goal of protecting local governments from state legislative imposition—restrictions on unfunded mandates. Some of these measures are procedural, requiring the disclosure of the costs that state mandates impose on localities, but others are substantive, prohibiting certain categories of cost-imposing requirements unless the state provides the funds to offset the new costs.¹⁸

Home Rule

Restrictions on special commissions, special laws, and unfunded mandates may limit the ability of state governments to disrupt or impose upon local governments, but they do not empower local governments to act on their own. That has been the role of "home rule." The first home rule amendments to state constitutions date back to the late nineteenth century. The initial home rule measures often empowered just a single large city—St. Louis in Missouri, San Francisco in California—or a small number of very big cities. Today, most states accord home rule to most municipalities, and some states even make home rule available to counties, or at least some counties, too.

¹⁶ See Richard Briffault and Laurie Reynolds, *Cases and Materials on State and Local Government Law: Sixth Edition* (St. Paul, MN: Thomson West, 2004), pp. 238–244.

¹⁷ *Id.*, pp. 244–259.

¹⁸ *Id.*, pp. 259–266.

Early versions of home rule sought to provide local governments with two powers—initiative and immunity.¹⁹ The initiative power would enable local governments to undertake actions over a range of important issues without having to go to the state for specific authorization. In other words, home rule as initiative would undo Dillon’s Rule and give local governments power to engage in policy-making concerning local matters. The immunity power would go further and protect local actions from displacement by state law. The combination of initiative and immunity powers would make a home rule city an “imperium in imperio,” *St. Louis v. Western Union Tel. Co.*, 149 U.S. 465, 468 (1893), that is, a state within a state.

In practice, however, so-called “imperio” home rule often did not work out well for the cities. In many state courts, the Dillon’s Rule philosophy lingered, leading to narrow interpretations of basic concepts such as “local” or “municipal.” State courts were particularly reluctant to recognize claims that home rule immunized local actions from state regulation. Yet, with the same language used to establish both local initiative and local immunity, narrow judicial interpretations in immunity cases often led to equally narrow readings in initiative cases. In 1953, the American Municipal Association (later the National League of Cities), sought to remedy the deficiencies of the traditional imperio model by proposing a new approach under which all legislative powers that could be delegated to a locality were deemed to have been delegated to the locality, subject to the legislature’s power to deny local authority by state statute. In other words, immunity was sacrificed to strengthen initiative. Later versions of the AMA/NLC model sought to provide a measure of immunity as well by requiring that state legislation limiting or denying local power do so expressly. This so-called “legislative” home rule approach influenced many home rule provisions in the second half of the twentieth century. In practice, however, many state home rule provisions blur these theoretically sharp distinctions and combine both imperio and “legislative” models. Moreover, the scope of home rule in any given state is inevitably influenced by both the constitutional or statutory text and the course of judicial interpretation. As a result, home rule powers and protections vary considerably from state to state, and from subject to subject.

FORMS OF LOCAL GOVERNMENT

There are three principal forms of local government in the United States: mayor-council, commission, and council-manager.

¹⁹ See Gordon L. Clark, *Judges and the Cities: Interpreting Local Autonomy* (Chicago, IL: University of Chicago Press, 1985), p. 7.

Mayor-Council

Most of the largest cities in the United States use the mayor-council form, which tracks the traditional separation of powers between executive and legislative functions. Many cities have embraced the “strong mayor” form of mayor-council, with the mayor authorized to appoint and remove most city commissioners, propose the budget, and enter into contracts on behalf of the city. Other large cities, concerned about the power of the mayor and the potential for corruption and abuse in the strong mayor system, embraced a “weak mayor” model, with municipal functions splintered among multiple independent boards and commissions. In recent years, there has been something of a turn back to the strong mayor model, in the belief that government accountability can be promoted when the voters have one person whom they can hold accountable for government performance. Thus, in a number of large cities, such as New York, Chicago, and Boston, already strong mayors have been given greater responsibility for the public schools, which were traditionally the domain of independent boards of education.

Commission

The commission form of city government vests both legislative and executive powers in a single body—the commission—usually composed of five members. The commission model emerged in Galveston, Texas in 1901 in response to a tidal wave that devastated the city. The Galveston commission, initially composed of local business leaders, helped the city get back on its feet and by 1915 about 500 communities had adopted the commission form. One of the commission members may be designated the mayor, but he has no more formal powers than his colleagues. Individual commission members may also be given administrative responsibilities for different city services. Although the commission system was popular in the early decades of the twentieth century, there have been virtually no new adoptions since 1930, and only about 5% of cities use this form today.

Council-Manager

The council-manager system also arose in the early twentieth century as an alternative to the mayoral system. Here the innovator was Dayton, Ohio, which hired a city manager in 1914 to help recover from bankruptcy. After World War II, the council-manager system spread widely, particularly in medium-sized cities and suburbs, although a few large cities rely on managers as well.

The council-manager form draws on the model of the business corporation. The council as the elected representative body hires the manager as

the chief administrative officer, who sits at the pleasure of the council. The manager has broad authority to hire and fire staff, administer the budget, and run day-to-day city operations. The council, which may be part time, sets overall policy. Although the manager works for the council, in many cities the city manager may actually take the initiative and emerge as the city's de facto leader.

Cutting across the issue of city form is the nature of city elections. Traditionally, most cities, including all but the largest, elected their councils or commissions in at-large elections, with all members of the body elected from the city as a whole. In the 1970s and 1980s, concerns grew that such electoral systems disadvantaged racial minorities, and especially following the 1982 amendments to the federal Voting Rights Act many at-large electoral systems in cities with large minority populations were challenged in court. In response to such suits as well as the greater political salience of minority representation, many local governments have shifted from at-large to district elections of their legislative bodies.

METROPOLITAN GOVERNANCE

Most Americans today live in large metropolitan areas, which may contain hundreds of thousands if not millions of people and sprawl across hundreds if not thousands of square miles, and include dozens if not hundreds of local governments. Some metropolitan areas cross state lines. Metropolitan area residents do not concentrate their activities within their home localities, but can live in one locality, work in a second, shop in a third, go to entertainment events in a fourth, and travel through multiple others in the course of these activities. So, too, metropolitan area businesses typically draw most of their workers or customers from outside their home localities. While the metropolitan area as an economic or social region has grown, only rarely is there a single local government with broad jurisdiction over such a region. Instead, most metropolitan areas are composed of large numbers of relatively small, some times overlapping, local governments.²⁰

At one time, scholars and policy analysts sought the creation of large metropolitan area governments that would provide a legal and political structure congruent with the economic and social region. Much as many large cities had expanded territorially by annexation and consolidation with smaller outlying localities in order to follow population growth in the nineteenth and early twentieth centuries, they hoped that central city boundaries could be extended regionally. Widespread opposition from people in the

²⁰ See generally Richard Briffault, "The Local Government Boundary Problem in Metropolitan Areas," *Stanford Law Review* 48, no. 5 (May 1996), pp. 1115–1171.

outlying areas often precluded such expansion. Moreover, many scholars also came to oppose centralized regional governments, claiming that there are benefits from the competition of large numbers of relatively small localities as well as costs to very large local units.

The large number of metropolitan area governments creates numerous possibilities for interlocal conflicts and raises issues concerning efficient service delivery, interlocal inequalities, and the financing and maintenance of regional infrastructure. Many states and localities have sought to address some of these problems by developing new modes of interlocal cooperation and interlocal agreements. These can include contracts for services, whereby one government pays another to provide a service; joint services agreements, in which two or more governments provide a service jointly; or regional collaborative efforts to create new governmental entities that can provide government services.²¹

Many states also create, or authorize local creation, of regional special service districts. These are particularly important for building and operating infrastructure services, such as transit, airports, water supply, or wastewater treatment. Such arrangements enable people to maintain small local governments for services such as policing or land use regulation that people like to keep close to home, while taking advantages of the economies of scale for certain kinds of high-cost physical infrastructure. These districts or authorities are typically governed by appointees and financed by user charges, tolls, or special taxes. In a few areas—Seattle, Washington; Portland, Oregon; the Twin Cities region—there are multiple-purpose regional governments that handle a number of functions together.²²

Only a handful of metropolitan areas have something that approaches a metropolitan area government. In smaller areas that fall entirely within a single county, the county may be given broader governing powers that make it effectively a regional government, or the central city and the county may be consolidated. Some prominent city-county consolidations, involving

larger areas, in the late twentieth century include Miami and Dade County, Florida; Nashville and Davidson County, Tennessee; Indianapolis and Marion County, Indiana; and Jacksonville and Duval County, Florida. Typically in these so-called “two tier” consolidations, only the central city is consolidated with the county. Smaller cities within the county may remain. These consolidations strengthen the county government but also maintain possibilities of conflict between local and regional units.²³

State governments have also been called upon to do more to address interlocal inequalities and the external consequences of local regulation.

²¹ See Briffault and Reynolds, *supra*, pp. 449–472.

²² See *id.*, pp. 472–495.

²³ See *id.*, pp. 496–507.

The school finance reform movement, which has led to often-protracted litigations in a majority of states, seeks to force the states to address the impact of interlocal tax base disparities on the funds available for the number one local expense, public education. In response, many states have determined to mitigate interlocal differences by supplementing locally generated revenues with more state aid, as well as by more actively overseeing locally provided education. A prime source of conflict over the external effects of local decisions is land use.

Zoning, subdivision controls, and other forms of land use regulation are important areas of local decision making. But with so many metropolitan area localities in close proximity to each other, local land use decisions will often affect neighboring communities. Local approvals of new development can create traffic, congestion, and pollution problems for nearby places. Conversely, local growth controls and zoning restrictions may either force unwanted development on other communities, or lead to the adoption of similar restrictions by adjacent localities, thereby contributing to the further movement of new development to outlying areas or the exclusion of certain land uses from a region. Some states have begun to take on a larger role in setting standards for and supervising local land use regulation to deal with these issues.

SUMMARY

State and local management of the problems of metropolitan development is an important example of the way American federalism works in practice. These issues of metropolitan organization, land use regulation, education finance, the cost and quality of local services, the construction and maintenance of basic infrastructure, and the like directly affect the economic well-being and quality of life of tens of millions of Americans, but they are addressed primarily by states and local governments. Different states and local governments come up with different approaches, with some taking these matters more seriously, or making greater progress, or engaging in more creative experiments, than others. The federal government almost certainly has the power to address many of these issues, and often provides some money or gets peripherally involved. But, much as Madison predicted in 1787, these and other key matters of domestic governance are the province of the states and local governments.

An Overview of Investment Banking

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This chapter provides an overview of investment banking from the perspective of the senior managing underwriter. The principles are basically the same for the large national broker-dealer as well as the smaller regional broker-dealer. This chapter also defines regional investment banking firms, and their share of the overall public finance market, and identifies the services that these firms offer to state-level and local government bond issuers. The competitive advantages and disadvantages of regional firms, vis-à-vis the national market leaders, are also discussed. The chapter concludes with a discussion of some of the challenges currently faced by regional public finance bankers as they seek to maintain and expand their market share.

OVERVIEW OF PUBLIC FINANCE BANKING

Public finance is the business of originating, structuring, and underwriting new municipal bond issues that are sold via a negotiated process. The business also encompasses financial advisory assignments, not entailing underwriting, for new issues. Public finance has grown rapidly over the past two decades as negotiated finance came to dominate the market.

Note: Quantitative data appearing in this chapter regarding municipal bond issuance volume, revenue bond issuance volume, and negotiated and competitive bond issuance volume were taken from *The Bond Buyer/Thomson Financial 2006 Yearbook* (New York, SourceMedia, Inc., 2006), and from prior annual editions of the *Yearbook* dating back to 1984. All data regarding the market shares and volumes for regional firms and national market firms were computed by the author from data appearing in the *Yearbook*, and the author takes sole responsibility for the computed data.

Role of Investment Banking In State and Local Capital Finance

Municipal bond issues may be sold either by competitive bidding, or by negotiation. In the former case, the issuer publishes a *notice of sale*, which establishes a time and place for submission of bids. Competing dealers submit bids at the appointed hour, and the bond issue is awarded to the bidder specifying the lowest cost to the issuer. In the latter case, the issuer engages a specific broker-dealer (or at times, a group of such firms) to act as investment banker for the transaction. The firm so engaged may be expected to perform a variety of services, including:

1. Assisting in the development of an appropriate credit structure for the bond issue.
2. Assisting in the development of the documentation embodying that structure.
3. Performing the quantitative analysis necessary to support and justify the structure.
4. Creating the maturity structure, preredemption or “call” features, and other technical aspects of the bonds.
5. Participating in presentations to the rating agencies.
6. Developing a comprehensive marketing plan for the bonds, and executing that plan.
7. Developing and justifying the final pricing for the issue.
8. Underwriting the issue, including any balances that remain unsold at the end of the marketing process.
9. Assisting in all of the technical aspects of closing the sale.

Not all of the services will be required on every transaction, but the marketing, pricing, underwriting and closing activities will be at the core of every investment banking engagement.

Dealer firms may also act as financial advisor to issuers of both negotiated and competitively sold securities. A dealer firm acting as financial advisor will supply independent advice to the issuer on many key aspects of the transaction, including the credit and security aspects of the issue, and the detailed technical features of the bonds. However, as financial advisor, the broker-dealer will not participate in the pricing, underwriting, and distribution of negotiated bond issues. Regulations of the Municipal Securities Rulemaking Board (MSRB) specifically prohibit a broker dealer from simultaneously acting as the financial advisor and underwriter for a negotiated sale. The advisor may, however, bid on a client’s issue that is competitively sold providing it obtains the permission of the issuer.

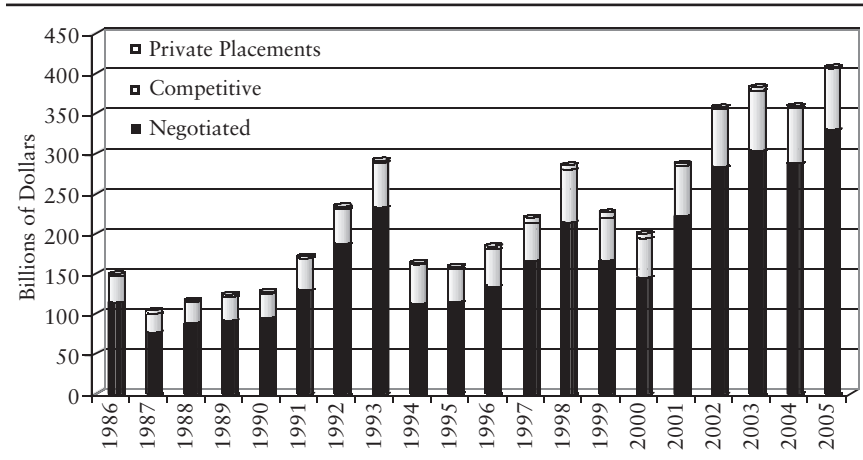
Dealer firms that are active in the public sector may be able to act as either financial advisor or investment banker, but they clearly focus the preponderance of their efforts on the latter field. Broker-dealers acted as investment banker on over \$330 billion of new municipal securities issues in 2005, but provided financial advisory services on only approximately \$80 billion. Independent financial advisors, that are not affiliated with any underwriting firm compete actively with broker-dealers for advisory work, and have a very significant market share. Dealer concentration on investment banking assignments, as opposed to financial advisory work, rests on the relative profitability of the two segments. Underwriting negotiated transactions generally offers higher profits than fee-based advisory engagements.

Growth of Negotiated Public Sector Financing

The importance of public sector investment banking in the securities industry can be measured by the sharp rise over the past thirty years in the volume of negotiated municipal finance. Municipal issuers sold a total of \$29.3 billion bonds in 1975, and only 40% of that total was negotiated. The total volume of municipal new issues rose to \$408 billion in 2005, and slightly less than 81% of that amount was sold by negotiated, rather than competitive, means. Exhibit 2.1 shows the growth in negotiated finance over the past two decades.

Municipal industry professionals work today in a market that is essentially dominated by negotiated issuance, and the profitability of their munic-

EXHIBIT 2.1 Long-Term Volume by Type of Bid, 1988–2006



Source: Thomson Financial.

ipal operations pivots on their ability to obtain and sustain a viable share of that business. This is true for both national market and regional firms. The competitive method of bond issuance continues to be important in certain regional markets such as New England and the Middle Atlantic states, and it is also employed by a number of major State issuers of general obligation bonds. The real growth in volume and profitability has, however, been concentrated in the negotiated sector. Competition amongst broker-dealers for negotiated business is intense, particularly in periods when the overall growth rate for municipal securities issuance is constrained. Municipal issuers contemplating a negotiated sale frequently employ a formal *request for proposals* for investment banking services, and encourage the development of alternative ideas and approaches as part of that process.

Factors Driving Negotiated Volume

Negotiated volume has expanded rapidly for several reasons. First, municipal bond issuance has become more complex from a credit perspective, largely because of the increasing importance of revenue bond structures. Revenue bonds represented less than half of total issuance in 1975, but had grown to 65% of 2005's much larger total. Revenue bonds can be more difficult to structure and to market than general obligation securities, and negotiation permits the underwriter to devote more time and skill to the structuring, and eases the marketing process because the underwriter can search more thoroughly for appropriate buyers. These two factors may contribute to lowering borrowing costs. Second, periods of market volatility may also encourage negotiated sales of all kinds, since the underwriter and the issuer have more opportunity to optimize the timing of the sale, and so minimize borrowing costs. Third, the development of certain synthetic and derivative products has encouraged negotiation. Variable Rate Demand Bonds (VRDBs), Auction Rate Securities (ARS) and transactions based on interest rate swaps and other derivatives are frequently best done through negotiation because of their intrinsic complexity. Finally, many refunding transactions can be most efficiently accomplished via a negotiated sale, both because of their complexity and because of the need to carefully time these interest-rate sensitive transactions. Other factors have also contributed to the rising volume of negotiated sales, but the four outlined above account for much of the increase.

Role of National-Market Firms

Large national-market firms enjoy an exceptionally strong position in the market for public sector investment banking services. One method for de-

fining national-market firms is to identify primary reporting government dealers that are also active in the primary market for municipal bonds. This definition currently encompasses nine firms. The best measure of their influence is to compute the volume of new negotiated issues on which these firms act as lead or *book-running* manager. These nine firms lead managed \$218.2 billion of the \$330.3 billion of negotiated issues sold in 2005. Their dominance is founded on a number of characteristics. First, the capital resources of each of these firms permit them to underwrite the largest municipal issues with no significant stress. Second, they have developed large and highly skilled staff capable of offering comprehensive services in all sectors of the market. Typically, these firms operate in almost all sectors, including among them health care, higher education, utility finance, and asset backed finance, and have developed a strong track record in all these areas. Third, these firms offer an array of services that goes well beyond traditional municipal finance. Within their organizations, they can call on resources in interest rate swaps and other derivatives and investment products that may prove to be very helpful to municipal issuers. Finally, they have developed marketing approaches that capitalize on all their varied resources and abilities.

REGIONAL BROKER-DEALER FIRMS

Regional firms active in municipal investment bank display wide range of characteristics. Their banking skills, staff, distribution capabilities, capital resources and sponsorship are quite varied. A significant number of participants in this market are owned by commercial banks. A number of these commercial bank owners have national stature or are international operations, but most are regional institutions. The majority of regional firms, however, are independent broker-dealers.

Regional dealers usually distribute the bonds they originate through their public finance operations to both institutional investors and retail sector buyers. Institutional coverage is national in scope for the larger regionals, but covers a more limited range for smaller firms. Retail distribution patterns are also varied. Some smaller firms and firms with a highly specialized public finance focus concentrate entirely on institutional buyers and forego retail distribution. The largest regionals have an extensive network of marketing branches, with a large numbers of sales representatives, and their coverage may be national in scope. Medium and smaller firms, however, tend to focus their retail sales efforts on a well defined regional area. Investment banking for state and local governments and authorities is regarded by most regional firms as an essential element of their business. Most regional firms, whether bank-owned or independent, use public finance as a means

of originating financial products that can be profitably distributed through their retail and institutional marketing system. They act as well-integrated intermediaries between bond issuers, on the one hand, and final investors on the other. In this capacity, they originate municipal securities, structure and underwrite them, and then market the resulting products to final investors. There are some smaller firms that function primarily as originators; these entities rely on relationships with other regional dealers to distribute their products. However, firms employing this business model are a relatively small part of the industry.

Number of Regional Participants

National-market firms were defined above as institutions that function as primary reporting government dealers who are also active in the primary or new issue market for municipal securities. By exclusion, all other firms not falling into this category constitute the body of regional firms. The Bond Market Association (BMA), the trade group for dealers in all major categories of debt instruments, lists 75 members who are classed as regional dealers under this definition. Of these, some 47 are active in the municipal new-issue market. This number, however, somewhat understates the total, since it excludes firms that are not members of the BMA. Over 90 firms generate at least some new issue underwritings in the municipal market, but the top 41 handle most of the underwritings not controlled by national market firms. Regional dealers, as here defined, senior managed a total of \$112 billion of new negotiated issues in 2005, but the top 41 firms captured slightly over 85% of the available amount.

Capitalization of Regional Firms

The capital resources of regional firms cover a very wide range. The largest firms in this category will have equity capital approaching \$3 billion, while the smallest firms will have total resources that fall into \$1 million to \$5 million category. It is important to note that these gross measures of capital resources do not define the effective amount of capital allocated to a regional firm's public finance operation. A very large firm may have extraordinary amounts of capital on a firmwide basis. However, the amount allocated internally to the municipal securities business may be only a fraction of that total, and the amount allocated to a specific geographic area within the municipal market may be smaller still. A regional firm with \$25 million in capital that is focused entirely on the municipal market in a limited geographic area of four to six states may well mobilize more "effective" capital to support its underwriting efforts than a much larger firm. The

regional dealer may well have capital resources that are more relevant to the needs of its clients than does a much larger firm. Nonetheless, this relevance is only a tactical advantage in pursuing certain types of business. Regionals still tend to be capital-constrained in a strategic sense, in that they may lack the resources needed to develop a broad public finance capability spanning a large number of different product specialties.

Geographic Distribution

Regional dealer firms are headquartered in roughly half of the states. The largest concentrations are in the Middle Atlantic region, from Maryland north to New York, with over 25 firms. Other large concentrations are found in Texas, Missouri, Minnesota, Florida, and southern New England. A large proportion of regional firms have a public finance footprint that extends over many states and regions. It is not unusual for even smaller firms to have multiple origination offices in several states. A number of firms maintain a presence in disparate markets, such as the Midwest, the West Coast, and the Northeast. One large regional, for example, supports no less than fifteen regional offices located in all parts of the continental United States. Dealers that are positioned in this way treat each of these markets as a distinct region, and tend to target their services at a carefully defined population of issuers in each region.

Share of the Negotiated Market

Regional dealer firms have not been able to substantially increase their share of the negotiated bond market in recent years. Regional's share of the market stood at 37% in 2001, declined to a little less than 33% in 2002, and has fluctuated in a narrow band around 33% since then. The dollar volume of securities underwritten by regionals has risen over the last five years as the overall municipal market has grown. In 2001, regionals underwrote \$81.7 billion. The total regional volume in 2005 was \$112 billion, a sharp increase. However, this represented only 33.9% of the total market. The regional dealer community, absent an increase in market share, is vulnerable to the financial effects of a slow rate of growth in volume, or to an absolute decline.

STRATEGIC ADVANTAGES FOR THE REGIONAL FIRM

Regional underwriters have many advantages in building their business in their local niche. They know the local market for public finance investment banking products, and many can be very effective in marketing bonds to re-

tail investors in their region. They also have access to governmental decision makers, a cost structure that is lower than that for national market firms, and the flexibility that goes with small size.

Knowledge of the Local Market

Regional firms frequently have more detailed knowledge about the local public finance markets in which they operate than do large national-market firms. They benefit from fairly intense interaction with local and state government officials and representatives of not-for-profit organization that sell tax-exempt bonds through conduit issuers. Regional firms monitor all local information sources carefully, and cultivate contacts with influential members of their communities. This interaction may provide early knowledge of developing projects that will require bond financing, and may also create opportunities to generate ideas that help shape and define the those projects. This is particularly true for small- to medium-sized projects that attract strong interest from the regionals, but less from the national-market firms. In any event, the better information flow received by regional public finance operations translates into a real competitive edge, and creates opportunities for business development.

Access to Local Decision Makers

Regional dealers may have frequent business, community service, and social interaction with the political and administrative decision makers for local governments and authorities. They are also usually a visible and significant force in the local economy, and have a well established identity. Local officials may well have a positive image of a regional firm with a significant presence, and they may develop real confidence in that firm and its representatives based on past service to community financing needs. That confidence, in conjunction with solid local contacts may translate into a moderate business advantage for the regional. The regional dealer will be able to exploit that advantage if it offers first-rate service at competitive fees; without the ability to deliver quality products, it will mean little.

Ability to Distribute Product Locally

The ability to market locally originated bonds to investors in the immediate area is a key competitive advantage for many regional dealers. Issuers generally respect a firm's ability to distribute their bonds to local accounts. The firm itself may also embrace local distribution as an effective means for maximizing profits.

Regional firms pursue varied approaches to marketing municipal securities. In general, there are four basic models:

1. Concentration on retail or household sector investors (including those buying through trust accounts and investment advisors) who are located in the geographic area of concentration for the firm.
2. Focus on institutional marketing, to national-level property and casualty insurance companies, managed mutual funds, major non-financial corporations, hedge funds, offshore banks, and similar institutions.
3. A balanced approach, combining a retail and institutional effort.
4. Foregoing an in-house marketing effort in favor of utilizing industry relationships with other firms to effect the sale of securities.

Firms using the approaches described in (1) and (3) have a clear advantage in local distribution. The emphasis on retail sales usually delivers financial benefits for the firm. The cost of maintaining a substantial retail sales force may be large, but in today's market the firm with this capability is able to obtain easier access to bonds, particularly those of an issuer employing a retail presale order period. Dealers capable of executing substantial retail business are frequently able to capture a larger portion of the profits on many underwritings.

The retail capabilities of regional firms may vary widely. The largest retail-oriented enterprises may have as many as 700 regional distribution offices, staffed by over 6,000 representatives. Smaller operations may make do with 10 to 25 retail sales representatives concentrated in one or two locations. However, a relatively substantial retail marketing strategy is a definite advantage to a public finance effort, no matter what the scale.

Cost Structure Supporting Profitable Small Transactions

Regional dealers may enjoy some cost advantages over national-market firms. The cost of local office space may be lower than in major financial centers, and lower living costs may facilitate marginally lower staff compensation. Regional public finance firms may also be able to size their staff in a more efficient way than national firms. The latter have to maintain large analytical and support establishments in order to accommodate wide fluctuations in their transactions volume. The regional firm may be able to operate with a leaner staff that is basically sized to handle average volume. Work surges can be handled with longer hours and a more intense work effort, and some of the technical work may be outsourced. Regional firms with a low cost structure can profitably handle a flow of smaller deals that might not be attractive to national-level operations.

DISADVANTAGES FACED BY THE REGIONAL FIRM

Disadvantages faced by regionals include a somewhat limited national distribution capability, especially to retail accounts, and constricted access to the staffing and capital needed to build a broadly based multiline public finance presence. These constraints impel regionals in the direction of smaller bond underwritings in certain well-defined product specialties. That, in turn, contributes to a stagnant share of the overall market for negotiated municipal issues.

Narrower Skill Base and Restricted Product Line

Regional firms have significantly smaller staff levels than national-market firms. They generally pursue public finance business in restricted range of product lines. Some firms have very narrowly defined business development efforts. For example, there are dealers that specialize entirely in areas such as health care finance, higher education, and housing. Other concentrate entirely on general and infrastructure finance for municipal and state governments.

The larger the firm, the more likely it is to pursue multiple product lines. However, even in the largest firms, four or five disciplines are likely to encompass the public finance effort. A larger firm, for example, might concentrate on general and infrastructure finance, and at the same time maintain specialties in higher education, housing, and education. Even the largest regionals will not approach the breadth of services offered by national-market firms; specialties such as resource-recovery financing, asset-backed securities, and specialized municipal derivative products departments are beyond the reach of most of these operations.

Decisions on product line concentration tend to be based on considerations of capital, staffing requirements, and the likely contribution of a given specialty to overall profitability. Capital considerations are always important. While a firm may have a sufficient concentration of capital to underwrite the larger issues in its geographic area of concentration, it must face the reality that the volume of business in certain specialty lines in that area is not enough to justify committing capital and personnel to those lines. Firms may also decide to opt out of certain lines of business because of difficulties in hiring the bankers and technicians needed to enter those specialties.

Regional investment banking is essentially a business of niches. Firms tend to focus on identifiable products that present significant product opportunities. The products might be selected because (1) volume in that specialty is high in the region the firm focuses on; (2) there is less competition in the specialty; and (3) available personnel have expertise in that area. Large firms may pursue several lines, though not as many as the national-market enterprises. Smaller players may have to make do with one.

Confined Scope for Distribution

Regional firms may have a significant advantage in distributing bonds to local retail investors. However, their overall distribution mechanism is weaker than that of the national-market firms. Some large regionals may have the branch structure and staffing required to market tax-exempt securities to retail accounts on a national basis, but the vast majority of firms in this classification confine their household sector sales to limited and well defined regions. This implies that they will turn in a relatively strong sales performance on small- and medium-sized financings (\$5 million to \$150 million), but will be only supporting players on large financings of up to \$800 million.

National marketing to institutions can also be a problem for regional firms. The major national-market buyers receive intense coverage from the largest dealer firms, and get access to a major flow of new bonds through those same firms. Regionals, on the other hand, produce a more uneven supply of new issues for these buyers, and that supply tends to be concentrated in smaller bond sales. National-market firms also serve the needs of fund and insurance company buyers with a wide range of specialties, such as derivative products. Thus, regional firms may not be positioned to always extract the best possible terms from large institutional investors and indeed, may not be familiar with all of those buyers.

The net outcome of all these limitations is that regionals become biased towards smaller issues in their base areas, and in well defined product lines. They face many challenges in underwriting and distributing bond issues in the mid- to upper-end of the current size range.

IMPORTANCE OF A WELL-DEFINED PLAN

The success of a regional public finance effort rests on careful planning and disciplined execution. The business model chosen needs to achieve the most efficient matching of the firm's strengths to the characteristics of the local market in order to maximize profits and return on capital. Planning must be realistic, the goals must be achievable, and the implementation process must move forward on a reasonable time scale. Overall, good management is the essential ingredient for success. A regional firm must have a well-thought-out vision of where it wants to position itself in the public finance industry, and it has to create and implement a practical, step-by-step process for reaching that goal. Management also has to recognize that public finance does not exist in a vacuum. A successful public finance effort needs solid support from the firm's underwriting, trading, and marketing arms. Meshing these other aspects of the firm with carefully constructed investment banking departments is the hallmark of outstanding regional firms.

Public Finance Product Line

Regional firms can opt to concentrate their public finance efforts on obtaining comanagementships, or they can focus on obtaining appointments as sole or senior manager on new issues. Comanagementships do not involve an extensive investment banking effort, since firms in this role are not expected to make many substantive contributions to the planning and structuring aspects of a transaction. However, profit margins are also low, since the firm's ability to directly market the securities to customers may be limited. Most regionals, as a practical matter, focus primarily on senior management appointments on new negotiated sales, but do devote some effort to obtaining comanagementships, particularly on larger transactions. The senior management role offers profit potential that is a significant multiple of the financial opportunities in comanagement appointments.

A firm focused primarily on the senior management role must decide where to concentrate its efforts. This requires:

1. A careful review of the pattern of bond issuance in the firm's geographic target area.
2. A review of the competitive situation in each major product line or type of issuance found in the area.
3. Estimating unit profit margins in each product sector.
4. A search for any unusual barriers to entry into specific market sectors.
5. The practicality and cost of acquiring the personnel and other assets needed to compete in each sector.

The analysis also has to take into account the existing business and assets of the firm. For example, a dealer with a very strong competitive bidding record in its home market, coupled with strong local retail distribution, has a real advantage in some specialties, such as general and infrastructure finance and utility bonds.

Regional dealers face varied challenges in their differing areas of geographic concentration. In New York, for example, where many local governments face credit quality problems and all have to deal with legal obstacles to revenue bond issuance, a dealer might elect to concentrate on refundings of all types. In order to mitigate the cyclical nature of the business, this same dealer might develop secondary lines such as financings for troubled credits, and conduit financings for independent schools, smaller colleges and universities, and other traditional and nontraditional not-for-profits. A New England dealer, on the other hand, might elect to place its main efforts squarely in the field of not-for-profit financing. Firms in rapidly growing areas of the South and Southwest might emphasize issues for infrastructure,

utility, and education bonds. Some smaller firms have adopted themselves to highly specialized niches, such as tax increment financing, Qualified Zone Academy Bonds (QZABs), charter schools, and financing for Native American projects.

The product lines and specialties adopted will, in all cases, be the ones that offer the best return on capital to the firm over some reasonable period of time.

Target Audience

Once the firm has defined its preferred business lines, it needs to carefully research every potential user of its services, and identify those who make or influence the decisions on underwriter selection. Some elected officials and the staff of key governmental units will clearly be targets, as will board members and staff of any independent agencies or not-for-profits that have been targeted. Those who influence underwriter selection may include other professionals, such as accountants, law firms, and independent financial advisors. The firm needs to strive to understand the decision-making process for each and every key issuer. It needs to know how those decisions are made, who makes them, and who influences them.

Marketing Plan

Public finance marketing plans are, in the best sense, a well-coordinated effort to establish the credibility of the firm as a provider of quality investment banking services. The regional banker has a specific message to deliver to the key decision makers for his chosen lines of business, the message that his or her firm can deliver effective financing concepts and bring them down to reality on a reasonable time frame. The regional firm needs to inspire trust in its professionalism, and confidence in its ability to bring in a bond issue at the lowest possible cost to the tax payers or fee payers. The popular press sometimes portrays public finance as a business dependent on political favoritism. No realist would deny that politics has been and will continue to be an influence on the public finance business. However, the most successful firms in the business cultivate real and substantive skills, and offer services of the highest quality. They also pursue the development of their business with careful attention to the ethical constraints that govern the interface between the public and private sectors.

Marketing plans can include an aggressive schedule of calls on all targeted potential clients. They can also call for indirect efforts, such as active support for and involvement with organizations such as the Government Finance Officers Association, the National League of Cities, and many oth-

ers. Advertising rarely plays a significant role in public finance marketing, since it is not likely to be effective with the relatively small and sophisticated target audience. The heart of any successful plan is really the effort to develop new ideas that help the issuer accomplish its stated goals, and the ongoing campaign to articulate those ideas to the targeted decision makers.

Staffing Requirements

Staffing public finance departments is one of the most challenging tasks facing management of the regional firm. Skilled and dedicated professionals are the key to success, yet recruitment can be very difficult. Factors impeding hiring may include:

1. Reluctance of some individuals to working outside of major financial centers.
2. Concern about the volatility of future compensation, based on a perception that the narrower market faced by regional firms will lead to greater earnings variability.
3. A general perception that regional firms will have difficulty paying top compensation in good years.
4. A view on the part of some highly specialized bankers that regional firms will have difficulty generating a consistent and high level of activity in their sector.

Regionals have to work to hard to overcome these perceptions and to build around them. Firms with longstanding public finance operations normally recruit at least a portion of their staff locally and then train and develop these individuals until they can fill the senior banker role. Regional dealers may also offer creative—and generous—compensation packages that assure job security and high levels of average compensation over a number of years. Regional dealers have also been successful at hiring public sector and not-for-profit officials and guiding them through the potentially difficult transition to a successful investment banking career. .

Regional firms have a special need to emphasize and develop the technical skills of their staff. A national-market firm may be able to sustain its reputation despite occasional internal errors and problems. Regionals, with their lower transactions volume, are effectively held to a higher standard—one significant problem can seriously damage both the firm's reputation and its business development prospects. Successful regional firms have very high standards for the technical skills and performance of their professional staff, because their reputation and success depend on it.

Underwriting, Marketing and Sales Support

Many regional firms need to develop and enhance their skills in underwriting and sales and marketing to achieve real success in public finance. Credibility in public finance depends to a considerable extent on the firm's ability to price bonds at aggressive but realistic levels, and then market them effectively to final investors. The firm also needs to demonstrate an ability to underwrite unsold balances when that is appropriate. Unaggressive pricing, weak sales, and ineffective marketing will quickly undermine even the best-staffed public finance department. Regional firms achieve real success when they effectively integrate all their activities into their public finance effort, and seek to maintain uniformly high standards across all of their activities.

A successful underwriting effort in the market for competitively sold bond issues can also help to develop public finance business. A strong track record in buying competitively sold issues raises the firm's profile amongst government officials, demonstrates its willingness to take risk and underwrite bonds, and underscores the dealer's sales and distribution capabilities.

Administrative Support

Administrative support, particularly in the areas of compliance, accounting, and clearance, is an important element in the success of the regional firm. Compliance can be an especially critical factor. Failure to meet all of the mandates imposed by the regulations of the Securities and Exchange Commission, the National Association of Securities Dealers, the Municipal Securities Rulemaking Board, and the various state regulatory agencies can lead to substantial penalties, and those penalties will create reputational risk for the firm. Slipshod clearance and accounting can also create regulatory and public relations risks that can impact public finance. Strong administrative support is the mark of every successful regional firm.

RECENT CHALLENGES

The municipal securities market has undergone many changes over the past decade. Many new products, such as interest rate swaps, have assumed importance. Older products such as variable rate financing have assumed new forms, such as auction rate securities. The regulatory environment has also grown more intense and demanding. All these developments have represented significant new challenges for regional firms.

New Products

Interest rate swaps have become a very important product in the municipal market over the past decade. Swaps (and related options) have been used to create synthetic fixed rate and floating rate securities, to lock in favorable interest rates in a volatile market, and for synthetic-based refundings. Interest rate swaps have been utilized by the largest and most sophisticated issuers, and they have also been employed by a great many medium and small governmental units. They thus impinge directly on the business of regional public finance firms. The swap business, as it exists today, is dominated by large financial institutions. Large national and international commercial banks and the national market dealer firms offer swaps as a proprietary product and act as the counterparty on the vast majority of swap transactions involving municipal issuers. These swap dealers benefit from a large capital base, from their pool of highly skilled transactors and analysts, and from their investment-grade credit ratings. Most regional firms have few or none of these advantages, and have thus not been able to participate fully in this developing market. Regionals have typically participated in the swap market in more restricted ways. They have acted as swap advisors, charging a fee to the issuer for reviewing all documentation, arranging the terms of the swap, and locating a suitable counterparty. They have also played, at times, a more restricted role, blocking out the general terms of the transaction (for a fee or as part compensation for the overall engagement) and then bringing an independent swap advisor to arrange the detailed terms. Finally, regionals have formed ad hoc partnerships with national broker-dealers, with the latter acting as sole-source swap providers and the regional handling the issuer contact aspects of the transaction. These forms of involvement can be profitable, but to a much lesser extent than acting as a principal and counterparty. Regional firms will need to continue to probe for a more meaningful involvement in swap and similar derivative transactions. That involvement may be important both to insure that the public finance client gets the best possible terms and to convey reasonable compensation to the regional dealer.

Variable rate finance remains a very important product line for municipal dealers. Total sales of this type of bond were over \$95 billion in 2005, including \$62 billion of variable rate demand bonds and \$33 billion of auction rate securities. Regional dealers have captured a significant share of the more traditional variable rate demand bond business, acting as senior manager on about one-third of the 2005 volume. However, they have only a very small share of the auction rate market, which is dominated by the large national-market firms.

Regional dealers need to devote considerable energy and thought to the problems created for them by the emergence of new products. In general, these new products demand scale and thus require large capital resources. They also demand relatively high and stable credit standing. These are resources that can be in short supply at many regional operations.

The Regulatory Environment

The regulatory environment has certainly become more complex and demanding over the past decade. In general, this complexity has emerged from a drive by regulators to achieve greater “transparency” in the market. *Transparency* means, on the marketing and sales side, a much better flow of information on trade volume and pricing. On the origination or public finance side it implies improved information flow from the issuer through the dealer regarding all material credit and other considerations impacting an issue. These requirements have laid additional burdens on public sector investment bankers, and those burdens can lay more heavily on smaller firms than on larger ones.

Restrictions on political contribution to officials of issuers, imposed both by Rule G-37 of the Municipal Securities Rulemaking Board and by certain states, have also had an impact. The regulatory environment today requires a regional firm to have both a technically proficient regulatory compliance program and a broad set of ethical guidelines and standards for its staff. The latter has to be woven into the culture of the dealer firm, and actively promoted and monitored by senior management.

THE OUTCOME OF REGIONAL BANKING EFFORTS

Regional dealer firms that are active in the public finance market provide a valuable service. They senior manage almost one-third of the total annual bond volume, and also provide advisory services to a wide array of local governments. Local governments, agencies and authorities, particularly smaller issuers, and not-for profit entities selling bonds though public-sector conduits benefit from these efforts. For many of these issuers the regional dealer community makes the difference between limited or no market access, on the one hand, and financings that move quickly and efficiently into the hands of investors. Regional dealers work in a difficult and demanding competitive environment in which success depends on good management and planning, and near flawless execution. Regional dealers have successfully surmounted these challenges in the past, and will undoubtedly continue to effectively serve their communities in the future.