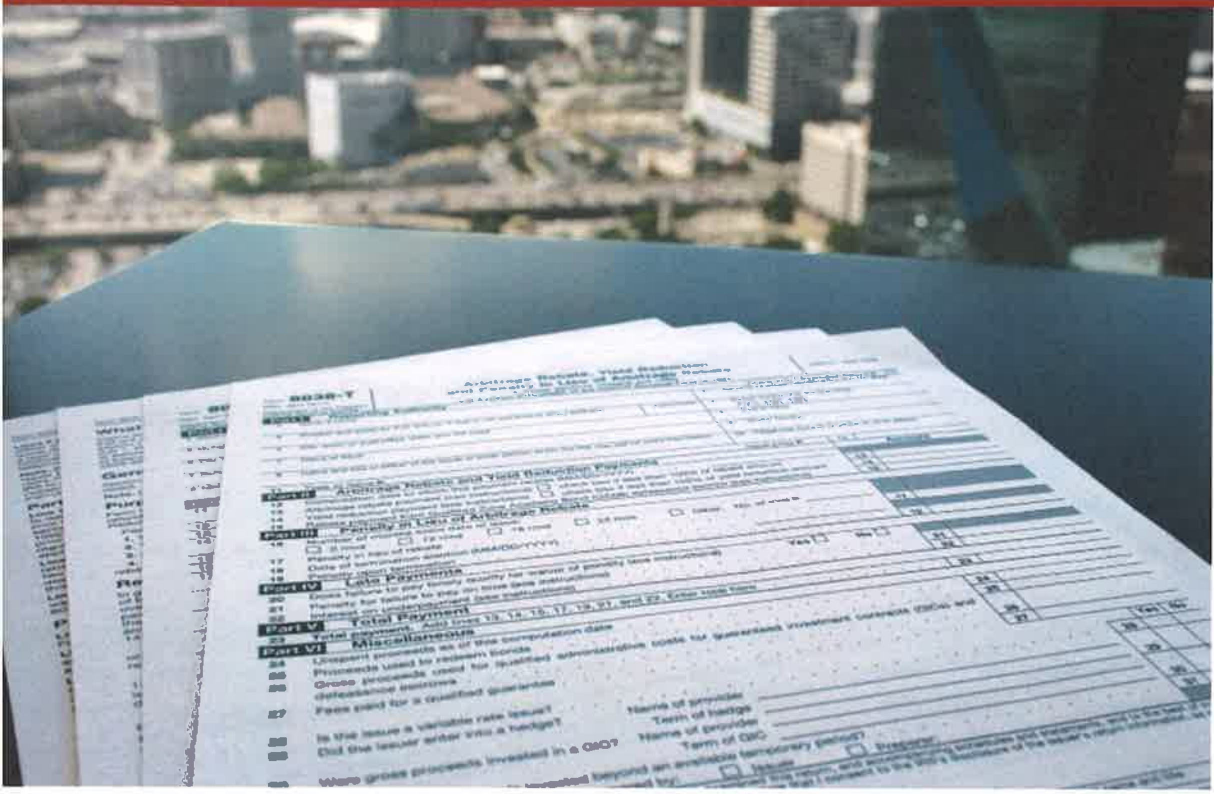
ARBITRAGE REBATE



FirstSouthwest Asset Management delivers individualized post issuance compliance services to issuers and borrowers nationwide.

FIRSTSOUTHWEST ASSET MANAGEMENT

FirstSouthwest AssetManagement
A Hilltop Holdings Company.

Our mission is to serve as a trusted advisor for our clients by providing the expert guidance, solutions and services that achieve their definition of success

The arbitrage rebate requirements have been in effect since 1986 and apply to any type of Tax-Exempt Obligations and Stimulus Act Taxable Obligations (BAB's, QSCB's, and QZAB's). The IRS rules related to these types of obligations are interrelated and very complex. The following is intended to provide a very high level overview of the rules. Issuers should seek assistance from a qualified post issuance compliance provider and work with their provider to develop and implement a post issuance compliance plan.

What is Arbitrage Rebate?

Arbitrage is the Profit from Buying in one market and Selling in another. For issuers of tax-exempt obligations, Borrowing in the tax-exempt market and Investing in the taxable market. Rebate is the profit from taking Advantage of the Market differentials.

The Basics of Rebate Compliance

The arbitrage rebate requirements permit issuers to retain a rate of return on their unspent proceeds equal to the yield they are paying their bondholders. Issuers must rebate to the Treasury any investment rate earned above their bond yield.

Rebate and Yield Restriction liabilities must be paid to the Treasury every fifth Bond Year. A Bond Year is each one-year period ending on the date selected by the Issuer. Installment payments are due 60 days after either the fifth Bond Year or the Final Maturity of the issue.

Each issue's liability is determined separately. The IRS does not allow issuers to net negative and positive liabilities.

90% of the liability must be paid at each fifth bond year and 100% of the liability at the Final Maturity date.

Payments are made by filing Form 8038-T. The IRS only requires Issuers to file a Form 8038-T along with a check for the required payment. No supporting calculations are required. If no payment is due, there is no filing requirement.

If payments are not made timely, the IRS can assess a penalty of 50% of liability for governmental and 501(c)(3) issuers. 100% for other Private Activity Issuers. Interest is due on the underpayment and the penalty. Issuers not under IRS audit can request a waiver of the penalty.

Overpayments of prior liabilities can be requested on Form 8038-R. Refunds must be requested no later than 2 years after the final maturity date of the issue.

Allocation of Bond Proceeds to Expenditures

Contrary to what you might think, you do not spend bond proceeds. You allocate expenditures to them. An issuer can allocate proceeds to expenditures and investments based upon any reasonable, consistently applied accounting method. There must be a current outlay of cash to create an expenditure.

The IRS rules limit the time periods that expenditures can be re-allocated to proceeds. An issuer must account for the allocations of expenditures to proceeds not later than 18 months after the expenditure is paid, or if later, 18 months after the financed property is placed in service. Subject to a maximum time limit of 60 days after the fifth anniversary of the issue date or 60 days after the final maturity of the issue.

Expenditures prior to the issuance of the bonds can be reimbursed with bond proceeds as long as the issuer makes a Declaration of Official Intent to reimburse the expenditures before the expenditure is made or within 60 days after the expenditure has been made.

Official Intent does not apply to Preliminary Expenditures including Architectural, Engineering, Survey, and Soil-Testing costs. Preliminary expenditures do not include Land Acquisition, Site Preparation, or similar Commencement Costs. Preliminary Expenditures cannot exceed 20% of the Issue Price of the Issue(s).

Exceptions to Rebate

While there are exceptions to the arbitrage rebate requirements, the IRS has made these exceptions technically difficult to meet. Issuers should seek assistance in verifying compliance if they believe an issue may qualify for an exception.

Small Issuer Exception If a governmental entity with general taxing powers, on the date of issuance, reasonably expects not to issue more than an aggregate limit during the Calendar Year, they are exempt from the Rebate rules.

For municipal issuers, the aggregate limit of tax-exempt debt issued is $5-million. For School Districts (K – 12) the aggregate limit is $15-million as long as no more than $5-million is for non-construction. Taxable issues are not included in the aggregate limit.

The Small Issuer exception is an exception from the Rebate rules. If proceeds of the tax-exempt issue are not spent within 3 years of the date of issuance, they will be subject to the Yield Restriction rules (see Yield Restriction below).

Investing in Tax-Exempt Investments If the proceeds of a tax-exempt issue are invested in non-Alternative Minimum Tax tax-exempt obligations, the rebate rules do not apply to those investments. The issuer is Borrowing Tax-Exempt and Investing Tax-Exempt.

Spending Exceptions There are three spending exceptions that issuers can meet. The 6-month, 18-month, and the 24-month exceptions. There are interim semi-annual spending benchmarks that must be met. The cumulative expenditures for the benchmarks are calculated based upon the bond proceeds and the investment earnings on those proceeds. If any benchmark is not met, the exception is no longer available to the issuer.

For purposes of the 18 and 24-month exceptions, an issue can have unspent proceeds at the final benchmark equal to the lesser of 3% of the issue price or $250,000.00 and still meet the exception. If a Reasonable Retainage amount has been specified in the contract, the unspent amounts at the final benchmark is increased by an additional amount equal to a maximum 5% retainage amount. The retainage must be spent within one year of the final benchmark.

6-Month Exception All proceeds and investment earnings, except amounts in a Reserve or Debt Service Fund, are spent on any type of capital assets, within 6 months of the date of issuance. All types of issuers qualify.

18-Month Exception All proceeds and investment earnings, except amounts in a Reserve or Debt Service Fund, are spent on any type of capital assets with cumulative expenditures in the first six months of 15%, first twelve months of 60%, and the first 18 months of 100%. All types of issuers qualify.

24-Month Exception All proceeds and investment earnings, except amounts in a Reserve, Cost of Issuance, or Debt Service Fund, are spent with cumulative expenditures in the first six months of 10%, first twelve months of 45%, first 18 months of 75%, and 100% in first twenty four months. 75% of the expenditures have to be for Construction Expenditures. The exception only applies to Governmental and Section 501(c)(3) issuers.

Debt Service Funds Debt service funds are exempt from rebate if they meet both an annual Income and Depletion test.

Income Each issue's debt service fund is limited to $100,000.00 of investment income per year. Long-term, Fixed Rate Governmental issues are not subject to the earnings limitation. Issues with an average annual debt service not in excess of $2,500,000.00 are also not subject to the income limitation.

Depletion At some time during the year, an issue's debt service fund's invested balance must drop below a Reasonable Carryover Amount. The Reasonable Carryover Amount is typically 1/12th of the preceding year's debt service.

If both the Income and Depletions tests are met, the Debt Service fund is excluded from the rebate calculation.

Commingled Funds

A commingled fund contains Proceeds of a tax-exempt issue and more than $25,000.00 of amounts that are not proceeds of the issue. In addition, all of the amounts in the fund are invested and accounted for collectively. Allocations must be made to all of the participants in a commingled fund no less frequently than as of the close of each Fiscal Period. A Fiscal Period is defined as a period that does not exceed three months (e.g. daily, weekly, monthly, or quarterly).

Expenditures in a commingled fund can be allocated among the participants based upon any of the following "safe harbor" methods:

- Specific Tracing
- Pro-Rata
- First-In, First-Out
- Gross Proceeds Spent First

Income in a commingled fund can be allocated among the participants under one of the following safe harbor methods:

- The Average Daily Balances
- The Average of the Beginning and Ending Balances

Mark to Market accounting is required for commingled funds if the average investment maturity of the fund is more than eighteen-months. Mark to Market accounting treats all of the investments as sold for their Fair Market Value on the last day of each Fiscal Period.

Refundings and Transferred Proceeds

A Refunding Issue uses it proceeds to pay Principal, Interest, or a Redemption Price of a Refunded issue(s). A refunding is performed to Reduce Interest Costs or eliminate Restrictive Covenants.

There are two types of refundings:

- Current Refunding – Within 90 days of issuance.
- Advance – After 90 days of issuance

Per the IRS rules, the yield on an Advance Refunding Escrow cannot be more than .001% above the Refunding Issue bond yield.

Unspent proceeds of the Refunded issue transfer to the Refunding issue as the Refunding issue makes Principal payments on the Refunded issue.

Advance Refundings are only allowed for Governmental and Section 501(c)(3) issuers.

Bonds issued after 1985 may only be Advance Refunded once. There is no limit on Current refundings.

If the Advance Refunding produces an interest savings, the issuer must redeem the Refunded Bonds on the first optional call date.

Yield Restriction

Yield Restriction is a separate set of rules from the Rebate rules. Rebate is the excess earnings over the bond yield (Profit) on a cumulative basis from the inception of the issue. The Yield Restriction rules govern when an issuer can legally earn arbitrage without jeopardizing the tax-exempt status of the obligations.

Yield Restriction starts after a Temporary Period or is based upon a Size Limitation, and is calculated at a Materially Higher yield.

Unlike rebate liability payments, 100% of the Yield Restriction liability is due at any required payment date.

Temporary Period During the Temporary Period an issuer can earn a yield on their investments in excess of the bond yield. However, the investments are still subject to the rebate rules during the Temporary Period.

Project Funds typically have a 3-Year Temporary Period. In order to receive a 3-year Temporary Period, an issue must reasonably expect as of the date of issuance:

- That 85% of the Project Proceeds will be spent within 3–years after the date of issuance.
- The Issuer will Contract for at least 5% of the Project Proceeds within six months after the date of issuance.
- That the Issuer will proceed with Due Diligence to complete the Project.

Replacement Proceeds have a 30 day Temporary Period. Replacement Proceeds are monies that bond holders are legally entitled to in the case of financial difficulties of the issuer. Replacement Proceeds include non bona fide debt service funds, non-bond proceeds assets pledged for the benefit of the bond holders, or reserve funds funded with non-bond proceeds issuer contributions.

Size Limitations Reserve Funds are subject to a size limitation. This size limitation is referred to as the Reasonably Required Reserve amount. If the reserve fund balance is less than the size limitation, it will not be subject to yield restriction. Any excess above the size limitation will be yield restricted.

The IRS size limitation is based upon the lesser of a three prong test. The Reasonably Required Reserve amount is the lesser of:

- 10% of the par amount
- Maximum Annual Debt Service
- 125% of Average Annual debt service

Materially Higher Amount The Yield Restriction calculation takes all of the Yield Restricted assets and compares their investment yield to the bond yield plus an adder. The adder is either .125% or .001%.

The adder depends upon the type of yield restricted assets.

For bond proceeds funded Project, Cost of Issuance, Capitalized Interest, and Reserve Funds, the Materially Higher adder is .125%.

For Advance refunding escrows and Replacement Proceeds, the Materially Higher amount is .001%.

If you have both types of assets in the calculation, the lowest adder is used for all of the Yield Restricted assets.

The IRS Yield Restriction rules permits an issuer to exclude amounts invested in higher yielding investments equal to the lesser of $100,000.00 or 5% of the Sales Proceeds of the issue.

Post Issuance Compliance

The IRS believes that issuers with written post issuance policies and procedures are more likely to be in Compliance with their Post Issuance responsibilities and Document Retention requirements. Post Issuance Policies and Procedures should include:

- Assignment of Responsibilities for Who is responsible for What functions.
- Document Retention Policies and Procedures
- Arbitrage and Yield Restriction Calculation Requirements
- Procedures for Monitoring Private Business Use
- A Training Plan that avoids the Turn Over Factor

Document Retention Closing Documents, Investment Support, Expenditure Support, and any other documents material to the issue must be maintained for the life of the issue plus three years. If the issue is refunded, the documents must be maintained for the life of the refunding issue plus three years.

Monitoring Private Business Use The IRS limits the amount of Private Use on tax-exempt financed property. Governmental issues are allowed 10% private use. Private Active issuers, including Section 501(c)(3) issuers, are only allowed 5% private use. Issuers are required to track and maintain records documenting any private business use and the fact that it does not exceed the allowable limits.

An issue can lose its tax-exempt status if the Private Activity tests are not met. These tests include:

- Ownership
- Private Use and Private Security/Payment
- Private Loan Financing

These rules encompass the following items that may generate private use:

- Transfer of Ownership
- Management or Service Contracts
- Advertising or Naming Rights
- Lease or Rental by an External Party

FirstSouthwest Asset Management Can Help

FirstSouthwest Asset Management's (FSAM) Arbitrage Rebate Compliance Services Group was established in 1987. Since the inception of the group, FSAM has performed more than 40,500 calculations for more than 1,800 issuers on more than 7,800 bond issues. Our practice today consists of a diverse client base of approximately 380 issuers, across 22 states, with 2,875 bond issues and an aggregate par value of approximately $166 billion. FSAM's senior rebate staff has on average more than 21 years of rebate compliance experience. 58% of our calculations contain commingled construction, debt service, or reserve funds.

In addition to the standard rebate compliance functions, FSAM provides Issuers with service after the calculation, this includes:

- Annual Post Issuance Compliance Training.
- Unlimited Consultation.
- Process Improvement Suggestions.
- Post Issuance Compliance and Document Retention Monitoring and Feedback.

FSAM prides itself in its commitment to post issuance compliance education. Since 1993, FSAM has sponsored annual "Post Issuance Compliance Seminars" devoted solely to the topic of IRS and SEC compliance. To date, the seminars have been held in fourteen states and have had more than 4,500 attendees.

FSAM takes great pride in that approximately 70% of its rebate compliance clients have been with us for 10 years or more. This retention history demonstrates not only FSAM's technical abilities, but our ability to continue to maintain a high level of client satisfaction over time.

When the IRS wants advice on tax-exempt obligations, they ask FSAM. From 2015 to 2018, Bill Johnson will be an advisor to the IRS as part of the IRS Advisory Committee on Tax-Exempt/Governmental Entities or "ACT" on the Tax-Exempt Bond subcommittee.

In order not to limit FSAM's pre-issuance tax advisory services to its clients, or run afoul of the FINRA rules on Municipal Advisory Representatives, each member of the senior management team of FSAM's Arbitrage Rebate Compliance Services Group will become certified as Municipal Advisory Representatives by obtaining his or her Series 50 securities license.

FirstSouthwest also provides the following Post Issuance Compliance Services:

- SEC Continuing Disclosure
- Investment Advisory Services
- Structured Products (Swaps, Investment Contracts)
- GASB and FASB reporting for Financial Statement valuation

Post Issuance Compliance Quiz

What is your Post Issuance Compliance Score? Answer each of the questions Yes or No. For each Yes answer you will receive 5 points. If the question does not apply, consider it a Yes.

1. Do you have formal written Post Issuance Policies and Procedures ("PIPP")?
2. Do you have Detailed Procedures in place for each of the Functional Areas responsible for Post Issuance Compliance?
3. Have you Followed Up to ensure that the people Assigned with Responsibilities are Performing those Functions?
4. Do you Review your PIPP Annually for Compliance and make Necessary Revisions?
5. Do you Segregate bond related legal documents, requisitions/invoices, and investment support?
6. Are you maintaining records related to your bond issues for the life of the issue plus three years? Or, in the issue is refunded, the life of the refunding issue plus three years?
7. Have you recently audited your document retention procedures to determine they are being followed?
8. At a minimum, are you having Rebate calculations performed at IRS Computation Dates?
9. Do you Review and Adjust Expenditure Allocations within 18 Months of the project being Placed in Service?
10. If you are trying to take advantage of the Small Issuer, Spending, or Debt Service Fund Exceptions, do you have Documentation that Supports meeting the Exception?
11. At a minimum, are you spending at least 85% of your project proceeds in the First Five Years?
12. If the issue is a Refunding issue, did you have a Final Calculation performed on the Refunded Issue?
13. Do you have procedures in place to Monitor that necessary Zero SLGS Rolls are being made by your Escrow Agent?
14. Are you having Yield Restriction calculations performed?
15. Do you have Policies and Procedures in place to monitor Private Business Use?
16. Have you entered into any Leases, Management Contracts, or Naming Rights with private parties?
17. Do you have documentation to support the Amount of Private Use?
18. Have you recently audited your Private Business Use procedures to determine if they are being followed?
19. Do you provide annual Post Issuance Compliance training for anyone responsible for a Post Issuance Compliance Function?
20. For any new Post Issuance Compliance Responsible Person, have you confirmed that they understand their responsibilities and they have been properly Trained to perform them?

Compare your scores to the following table:

Score	Ranking	Action
0 - 25	Needs Improvement	Seek Assistance
26 - 50	Work in Process	Formulate a Plan
51-75	Getting There	Focus on Non-Compliance
76 - 100	Looking Good	Continue to Refine the Process

Contact Us

Call us, we are happy to work with you to develop a plan to get your post issuance compliance house in order. It is less expensive than you think.

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