MUNICIPAL BOND MARKET

MUNICIPAL MARKET DISCLOSURES Q&A

August 30, 2010

Recently, the Securities and Exchange Commission (SEC) charged the state of New Jersey with securities fraud for failing to disclose to municipal bond investors that it had underfunded the state's two largest pension plans. In mid-August, New Jersey agreed to settle the case.

This case shines a spotlight on the sometimes lax disclosures from muni bond issuers. Below are some key questions and answers on Northern Trust's ongoing commitment to strong municipal credit research and the regulatory environment around muni bond disclosures.

What did the SEC allege New Jersey did wrong?

New Jersey settled claims that it misled investors regarding about $26 billion in 79 municipal bond offerings from 2001 to 2007 by not adequately disclosing underfundings of its two biggest pension funds. It was the first SEC case to target a state over its disclosure obligations.

The SEC claimed that the bond offerings "created the false impression" that the pension funds were adequately funded, hiding the fact that the state could not make contributions without raising taxes or cutting services. It claimed that the state concealed years of underfunding by not informing investors that amounts listed in bond documents as payments were in fact transfers of money already in the pension system. The state was also accused of not adequately informing investors about legislation adopted in 2001 that increased retirement benefits.

The state settled without admitting or denying the SEC's claims, consented to a cease-and-desist order, and was not required to pay any civil fines or penalties.

How did the market react?

The market has had no obvious reaction to the settlement, and the bonds in question have not appeared to trade any differently after the announcement. Informed investors had been well aware of the pension underfundings and other issues, but the SEC action has served notice to the issuers that full and complete disclosure is a baseline requirement, with significant potential penalties for failure.

Who oversees and regulates the municipal bond market?

The SEC regulates underwriters and broker/dealers but has limited oversight of issuers, focusing on disclosure of material information related to the issuance of municipal debt. The SEC does specify initial and ongoing disclosures for municipal securities, which it presents as rule 15c2-12. It can pursue situations where offering documents contain false or misleading information.

In 1975 Congress created the Municipal Securities Rulemaking Board (MSRB) as an industry self-regulatory organization. The MSRB was authorized to create rules to prevent fraud and manipulative acts and practices; to foster cooperation and coordination in municipal securities transactions; to promote mechanisms of a free and open market in these securities; and to generally protect investors and the public interest. The MSRB includes representatives of investors, underwriters and the public, and the recent financial regulation package did

CONTINUED

change the composition of the Board to make it more independent of the industry.

Also in 1975, Congress passed the Tower Amendment to the Securities Exchange Act of 1934, which prohibits the SEC and MSRB from requiring issuers to file securities documents with them before securities are sold – unlike corporate bonds, stocks and mutual funds.

Other influencers of the issuers include the Government Finance Officers Association (GFOA) and Governmental Accounting Standards Board (GASB). The GFOA publishes best practices for its members, and the GASB establishes state and local governmental accounting and financial reporting standards. GASB is similar to the Financial Accounting Standards Board for the corporate world, but the GASB often has different standards and practices for reporting similar financial metrics, such as pensions.

Have the efforts of the MSRB and the SEC to improve muni disclosure worked? Is it getting better?

Yes, our opinion is that disclosure and transparency have improved, but this was – and continues to be – a much less-efficient market than the taxable corporate bond market in terms of timeliness and completeness of information.

As an example, while corporate issuers are required to issue audited financials 45 days after the end of a fiscal quarter (90 days at fiscal year-end), the municipal market works with a 180-day lag. Furthermore, a "late notice" filing by a corporate issuer can be a significant event to many investors, whereas a late disclosure by a municipal issuer has traditionally drawn less scrutiny.

What does Northern Trust do to track updated financial information on municipal issuers?

The Northern Trust Municipal Fixed Income Research group has access to many information resources including electronic databases, online financial reporting systems and a broad array of contacts within the investment community.

Resources include Electronic Municipal Market Access (EMMA); access to rating agency research and analysts including Moody's Municipal Financial Ratio Analysis tool; issuers' Comprehensive Annual Financial Report; best practices published by the National Federation of Municipal Analysts; and public sources such as the Rockefeller Institute. Each analyst also has primary and back-up responsibility for issuers based on geography and/or sector and maintains a connection to those markets through industry- and state/local-specific media. Our proprietary Economic Research team also provides macroeconomic insights.

What does Northern Trust do to supplement the SEC's minimum disclosure requirements?

Beyond the offering documents and ongoing required disclosures, Northern Trust assesses the experience, reputation and reliability of the various parties – issuers, underwriters, bond counsel, advisors, auditors, etc., – on any particular issue and forms an opinion about their trustworthiness.

Given Northern Trust's size and scope of coverage, we have a high level of access to the management of relevant issuers in the marketplace. The Northern Trust Municipal Fixed Income Research analyst team has frequent contact with issuers. We access online sites of numerous issuers on an ongoing basis. We also participate in the pre-market investor teleconferences and investor presentations to address topics we believe are relevant in determining the ability and willingness of the issuer to remit the obligations in full and on time.

Our market presence also assures us of broad and direct access to the underwriter and broker/dealer community. Northern Trust has frequent conference calls with underwriters of municipal issues. Depending on market conditions and events, we can have several interactions on any given day. Specific new issue discussions as well as reviews or updates of issuer finances and prospective needs are an important part of assessing new and previously purchased issues. Many times the issuer's leadership and staff are also present, providing additional insight into the quality and attitude of that management team.

We monitor the disclosures of ongoing events by the participants themselves and gather supplemental information from independent sources and overseers, such as rating agencies, public interest groups and local media.

Is there a committee, department, or individual who reviews the financial information of the municipal issuer?

The Northern Trust Municipal Fixed Income Research team has research analysts who are fully dedicated to municipal research, and those results are reviewed with the manager of that team and credit committees, with oversight from Northern Trust's Risk Management Group. Importantly, we also have dedicated credit research staff, and risk management assessments are conducted separately on the liquidity providers, insurers and various financial guarantors used in parts of the municipal market. In conjunction with our Fixed Income Portfolio Management and Research teams, our in-house Economic Research team conducts extensive fundamental analysis of the domestic and international macroeconomic environments, which is a direct input into our interest rate model and is also used in our determination of value at the sector and security level.

Is the disclosure on the sectors/issuers where we tend to buy better than the riskier sectors and smaller authorities?

We believe that our long-standing investment process leads to a higher percentage of investments in well-established, regular capital market issuers in essential services sectors that, on average, tend to have better disclosure than smaller, less-frequent capital market participants. Our credit review process does identify and negatively incorporate poor disclosure practices for those issuers who are known to be or become less timely than the norm. Issuers who have an ongoing and routine need for market access have typically exhibited superior disclosure practices. Project-specific and particularly smaller or insured deals (and thus, often unrated at the underlying issuer level) are more likely to have less-comprehensive and timely disclosure practices.

Has Northern Trust not approved many issuers because of poor disclosure – not up to date, not timely, missing data, unwillingness to discuss items not in the documents, etc.?

Yes, there have been instances where poor disclosure practices contributed to the declining or retracting of approval for an investment. Those examples typically also have other contributing factors which form part of a pattern that we would describe as an overall assessment of “poor management.”

Describe the steps that are taken in the event of negative financial information.

New issues and issuers, as well as those to which we already have exposure, are regularly evaluated by analysts to uncover emerging risk factors that may negatively (or positively) affect credit quality. When an analyst identifies a negative credit situation, there is expedited communication to portfolio managers through various communication channels. The analyst may recommend a complete or partial reduction in holdings and also offer a timeline of the developing credit situation.

Describe the process for the implementation of a sell order, or a workout, if negative information is received.

Sell discipline is stressed from both a portfolio and credit management perspective. On the credit side, our analysts act independently to identify both positive and negative trends. When an analyst identifies a negative credit situation, there is expedited communication to portfolio managers. Portfolio managers then work within the recommendation to facilitate best execution on the behalf of clients.

Rating agencies used to claim that poor disclosure was one reason muni credits were rated lower than “comparable” corporate issuers. Since the agencies have now recalibrated muni ratings, does that mean they no longer worry about poor disclosure?

Poor disclosure remains a concern of the rating agencies. The change to global ratings scales moves muni and corporate ratings opinions to the same metrics: the probability of default combined with loss due to default.

What steps are taken when your credit analysis of a municipal issue differs from those by the credit rating agencies?

Rating agency opinions are important, as they assess the whole rated market and underwriter universe. Their ratings and opinions can and do move the market and control the ability or willingness of many market participants to use or avoid issues and issuers based on those ratings. On the other hand, they are obviously stretched to provide focused and timely coverage on all of those issues and issuers. Northern Trust operates on a “trust but verify” status with the rating agency opinions and devotes significant personnel, management attention, oversight and financial resources to coming to our independent and proprietary opinions on the issues we choose to approve for use by our managers.

For an approved issuer, when our internal credit view of an issuer materially differs from the rating agencies, portfolio managers incorporate these opinions in the evaluation of relative value for inclusion of an investment in portfolios. Clearly, when our internal credit opinion is significantly less positive versus the

CONTINUED

rating agencies, that issuer may be deemed unsuitable for investment due to our credit standards, despite the potential presence of high ratings from the agencies.

How are unfunded pension liabilities factored into the credit analysis of the municipal issuer?
Pension liabilities are very relevant, depending on the issue and issuer (for example, they tend to be less critical for a short-duration issue or a many project-specific or dedicated source revenue bond). Funding levels versus actuarial liabilities are key, but so are the assumptions – actuarial as well as assumed market returns – that go into calculating those reported funding levels. Ability and willingness to fund the regular employer contributions are assessed, as is the presence or level of Other Post-Employment Benefits commitments by the issuer.

What efforts are made by Northern Trust to determine whether there are swap contracts associated with the municipal issues?
Swap exposure is a required disclosure in the footnotes of financial reports of issuers. The fact that they exist, plus the ratings of the counterparties, are noted although specific identification of those counterparties is often excluded. Our analysts work to identify those counterparties, if possible, as well as to assess what the cost or benefit to termination events may be in place. Because swaps can be put in place after the actual issuance of a bond or can be entered into by an issuer who is guaranteed by a different legal entity, this ongoing due diligence and research on both issuers and their obligors is an important effort.

Conclusion: The municipal bond market is fragmented, diverse and opaque: more than 50,000 issuers, more than 1.1 million individual issues and $2.8 trillion in outstanding obligations. This market lags the general economy in realizing the impact of financial stress, and both headline and real credit risk is likely to increase in the near- to medium-term. Compliance and disclosure risk have been heightened by the recent SEC settlement with New Jersey.

Northern Trust has devoted resources – technology, staff, oversight, risk management – to providing independent proprietary review and analysis of the assets managed in these strategies on behalf of our clients.

Northern Trust

Q28795 (9/10)