NON-PUBLIC

MEMORANDUM

TO: Chairman Levitt

FROM: Brandon Becker BB
Director, Division of Market Regulation

Paul S. Maco
Director, Office of Municipal Securities

RE: Orange County

DATE: June 19, 1995

I. Executive Summary

During the next two months, approximately $1.6 billion of debt issued by Orange County, and towns and school districts located in the County, will mature. The County has developed a restructuring plan that would allow it to repay its current debtholders and emerge from bankruptcy without a payment default, although the plan will involve the deferral of principal repayments and a portion of the interest that will accrue over the next year. To date, the County has made all principal and interest payments on its outstanding notes and bonds when due. However, the County has reserved in the bankruptcy proceedings its rights to challenge the validity of certain of its obligations and to recharacterize and defer or avoid payment on others. We are concerned about the County's ability to implement that restructuring plan; a default on a County debt obligation this summer is possible.

Several events during the next two months will impact significantly Orange County's ability to meet its debt obligations and recover from bankruptcy without a payment default and, in turn, may affect the California and national municipal securities markets. These include: voter approval of a 1/2 cent sales tax increase on June 27; rulings in the bankruptcy proceeding on a proposed rollover of maturing County short-term debt; County payment, without the rollover, of note issues ranging from $31 million to $600 million due on six different maturity dates from June 28 to August 10; and recharacterization in the bankruptcy proceeding of certain County certificates of participation ("COPs").

It is difficult to predict with certainty the effects of an Orange County default on the municipal securities market or the financial markets generally. A default by the County likely would result in higher borrowing costs for municipalities, particularly in California. The County's bankruptcy filing and efforts to avoid timely payment of its debt obligations may prompt other financially distressed local governments to take similar measures. We are monitoring the possible systemic risks surrounding such a default, although at this time we do not believe a default by Orange County would pose significant risks to our financial markets generally.

The bankruptcy of Orange County highlights the importance of the effort the President's Working Group on Financial Markets began in December to promote sound investment guidelines for state and local governments. We believe that a joint effort by the Department of the Treasury and the Commission to promote sound investment policies and procedures by state and local governments could have a significant impact in preventing future municipal financial difficulties resulting from the mismanagement of public funds. We therefore recommend that the Department of the Treasury and the Commission begin a campaign to promote such an effort by the nation's leading financial regulators during the coming months.

II. Background - Orange County's Financial Situation and Bankruptcy Issues

A. Bankruptcy. Orange County and the Orange County Investment Pools ("Pools") filed for Chapter 9 bankruptcy following losses that were eventually realized at $1.7 billion. County funds and funds of more than 200 non-County governmental agencies and others were invested in the Pools. As of November 30, 1994, the Pools had assets of approximately $20.6 billion, of which $13 billion was borrowed through reverse repurchase agreements. The remaining $7.6 billion included $2.7 billion deposited by the County and $4.9 billion deposited by local agencies other than the County. In mid-December, the County commenced an orderly auction and sale of the existing portfolio, which was completed on January 20, 1995. On May 2, 1995, approximately $3.9 billion of pooled funds was distributed to local agency pool participants and $1.7 billion to the County.

B. Restructuring. The County's restructuring plan would permit the County to repay its current debtholders and emerge from bankruptcy without a payment default. The County has technically defaulted on certain notes with the approval of the bankruptcy court by not setting aside certain revenues in advance of their payment date. However, the County's ability to implement the restructuring plan is in doubt. Based primarily on press reports, we are concerned that one critical factor, a June 27 referendum (known as Measure R) on a proposed half cent increase in the sales tax rate, may not pass. If adopted, that sales tax increase would provide an additional $130 million to the County annually. Failure to adopt that measure could greatly harm the County's efforts to obtain revenues the County will need to provide essential services and emerge from bankruptcy.

During the coming months, over $1.35 billion of short-term Orange County debt will mature (See Appendix I). An additional $217 million of debt issued by towns and school districts located in the County also matures this summer. Release of pooled funds pursuant to the comprehensive settlement agreement, together with proceeds of the recent $295 million Orange County Recovery Bond issue may avoid default on local agency debt. The County also intends to issue long-term "Teeter Bonds" (which are secured by future revenues from delinquent property tax payments) to repay shorter-term Teeter Notes which mature on June 30.

The County has reached an agreement with its Official Creditors Committee to rollover $975 million of short-term debt obligations until June 30, 1996. That agreement must be approved by more than half of the noteholders to be adopted. At this time, there is significant opposition to the agreement by noteholders, making adoption in its current form unlikely. (See Appendix II for a description of the Financial Restructuring Plan).

C. Lawsuit Against Merrill Lynch. Merrill Lynch was one of the largest sellers of securities to the Pools. Merrill Lynch also loaned over $2.4 billion to the Pools pursuant to reverse repurchase agreements, and underwrote securities offerings by Orange County and other participants in the Pools.

The County has filed a lawsuit against Merrill Lynch & Co., Inc., and certain of its subsidiaries, in connection with these activities, seeking in excess of $2 billion from the broker-dealer. An adverse court ruling might lead to a judgement or settlement at great cost to Merrill Lynch. The market effect of any settlement will likely depend upon its terms.

Other broker-dealer firms sold securities to the Pools and loaned funds to the Pools pursuant to reverse repurchase agreements; the County initiated proceedings against one, which it later withdrew. As of this date, the County has not initiated proceedings against any other broker-dealer.

III. Likely Impact of A Default by Orange County

A payment default by the County with respect to the principal or interest that is due potentially could have a damaging effect on the nation's public finance markets. The extent of such damage, if any, is uncertain. If the County were to default on its obligations, we believe the County would find borrowing more expensive in the future, and it is likely that local governments throughout the County, and perhaps the entire state of California, would be affected as well.[1] We are far less certain about the likely impact of such a default on municipal debt

---

[1] A County default during the next two months would occur during the short-term borrowing season for California local governments. This year, California local governments are expected to borrow $8 billion in short-term notes. The state has postponed its annual short-term borrowing until the spring in order to avoid the possibility of higher borrowing costs due to events surrounding the Orange County bankruptcy.

In general, the State of California has approximately $9 billion in short term debt outstanding; $19 billion in long term general obligation debt; and $5.5 billion in lease purchase debt (including certificates of participation) as of May 1, 1995; and $24 billion in agency and authority bonds and notes outstanding as of December 1, 1994. Local California issuers had approximately $ 4.1 billion in long term general obligation debt and $ 13 billion in lease purchase debt as of June 30, 1993.

generally. Such a default could harm investor confidence in the intention and ability of municipalities generally to repay their debts when due and affect both the secondary market for existing debt as well as costs of issuing new debt.

The impact of a County default on state and local government borrowing costs will depend largely on whether investors view an Orange County default as a unique event or as an event that is likely to be repeated elsewhere. California issuers may be distinguished from issuers in other states on the basis of the unique state constitutional limitations on California local government debt. We believe that institutional investors, such as money market funds, who generally dominate the short-term municipal debt market, are highly capable of differentiating credit among municipal issuers. Those institutional investors therefore are likely to play a critical role in determining the impact of an Orange County default on municipal markets generally.

There has been extensive press discussion of the possibility that Orange County may default on its debt obligations, reducing the risk that the market will be unprepared for such a default, if it occurs. It is difficult to predict, however, how the markets will react to an actual County default; the market reaction to press discussions of a contingent default may not provide reliable indications of market reactions to an actual default.

The Division of Investment Management is aware that money market funds hold large amounts of Orange County notes, but the exact amount is uncertain. Last December, the Division permitted 38 money market funds to engage in transactions with affiliates, (e.g., the funds' advisers) designed to prevent the funds from "breaking the dollar." Nineteen of these funds continue to hold Orange County notes (approximately $412 million par value) subject to some type of credit support arrangement. Of these 19 funds, 6 are holding the notes subject to "puts" issued by affiliates of the funds. Each put provides that the affiliate will buy notes at par in the event Orange County defaults. An unknown number of funds own Orange County paper in small enough amounts that support was unnecessary to maintain their price at $1.00.

A County default on its $1.374 billion of maturing short-term debt is unlikely to impact bond insurers because Orange County's short-term debt is not insured. Additionally, no more than 25% of Orange County long-term debt is insured.

IV. Recommendation.

Responsibility for prudent investment of public funds by state and local officials ultimately rests at the state and local levels. The ability of state and local governments to have continued low cost access to the debt markets, however, is an important matter of federal concern. The federal government should assist state and local governments in developing the skills necessary to manage risk in today's markets and in educating state and local finance officers about risk in today's financial markets. For example, we should educate state and local officials about the importance of written risk management procedures, and promote awareness of modern risk management tools, including analyses of how investment portfolios would behave under adverse market conditions. We also should stress the recent work of The Group of 30, the Derivatives Policy Group, and IOSCO, whose recent recommendations offer the means for state and local governments to modernize their risk management tools.

The Commission should work jointly with other federal regulators, such as the Department of the Treasury, to educate local finance officers and to encourage those officers to use proper risk management tools. The Commission also should work with the various associations to obtain these objectives. For example, the Government Finance Officers Association approved policy statements and practice recommendations to modernize risk management tools at its annual meeting this week. Additionally, the National Association of State Treasurers recently completed a survey of the fifty states and soon may revise its existing policy recommendations on local investment pools. We should work with Treasury to promote implementation of these state and local organization policies to the extent they promote sound investment strategies and modern risk management procedures.

The annual meetings of national and regional organizations of state and local finance officers occurring this fall present an opportune forum to address these issues. A program of appearances, following this past Tuesday's address to the Government Finance Officers' Association may include:

July 29- August 1:	National Governors' Association 87th Annual Meeting in Burlington, VT.
August 13-16:	The Municipal Treasurers Association of the United States and Canada - 30th Annual Conference in Spokane, Washington. (You are already scheduled as the keynote speaker).
October 14-18:	State Debt Management Network and National Association of State Treasurers 20th Annual Conference, Lake Tahoe, NV.

The invitation from the National League of Cities to submit a letter or article to their newsletter could address this subject. Text of remarks, together with reports of GFOA and NAST committees could be distributed through the membership organizations. Additionally, open letters in each organization's newsletter to membership stressing the program's message could be prepared.

The Commission, as well as other federal regulators, should continue to monitor the Orange County bankruptcy, remaining alert to systemic concerns raised by a default on County obligations. We do not believe a default by the County would pose systemic risks at this time, although significant market disruptions, including increased borrowing costs for state and local governments, may occur due to such a default. The Commission also should continue to monitor the proceedings involving Merrill Lynch and other broker-dealers.

APPENDIX I

Issue Maturity Dates

During the next eight to ten weeks, over $1.5 billion of short-term Orange County debt will mature. That debt is being extended by the rollover agreement. Listed below are the significant maturity dates and exposures to County or other issuer default.

Friday, June 30. $175 million in short-term Teeter Notes due. The bankruptcy court approved the payment in full on the due date from the proceeds of new long-term Teeters to be issued in June.

Monday, July 10. $600 million short-term taxable TRANs due.

Wednesday, July 19. $169 million short-term Series A Tax Exempt TRANs due.

Friday, July 28. $299.6 million Pooled TRANs due. The Pooled TRANs are part of the Comprehensive Settlement Agreement with Pool participants.

Tuesday, August 1. $100 million Orange County Flood Control District Taxable Notes due.

Thursday, August 10. $31 million short-term Series B Tax Exempt TRANs due.

OUTSTANDING ORANGE COUNTY DEBT

Short-Term Obligations

Issuance	Par Amount	Maturity
TRANs, Series A	$169m	7/19/95
TRANs, Series B	31m	8/10/95
Taxable Notes	600m	7/10/95
Teeter Notes	64m	6/30/95
Tax. Teeter Notes	111m	6/30/95
	======	
	$975m (proposed to be rolled over until 6/30/96)	
Pooled TRANs	$299.6m	7/28/95

Summary of Long-Term Obligations

	Par Amount	Outstanding Par	Payments Due FY 1994-95	Payments Due FY 1995-96
General Obligation Bonds	$372m	$323m	$ 9m	$24m
COPs	474m	396m	14m	38m
Revenue Bonds	322m	245m	9m	20m
Tax Allocation Bonds	89m	88m	2.6m	6.6m
Assessment Districts	54m	52m	1.7m	4.7m
Mello-Roos/Community Facility Districts	599m	570m	19m	49m
	====	====	====	====
Total	$1.9b	$1.6b	$56m	$142m

OTHER CALIFORNIA LOCAL GOVERNMENT SHORT-TERM DEBT

Friday, June 30. $12 million taxable Montebello TRANs due.

Friday, June 30. $11.95 million Montebello Taxable Notes due.

Friday, June 30. $10 million taxable Placentia TRANs due.

Friday, June 30. $3.7 million tax-exempt Placentia TRANs due.

Friday, June 30. $2.2 million tax-exempt La Habre TRANs due.

Friday, June 30. $1.1 million tax-exempt Chowchilla USD TRANs due.

Wednesday, July 5. $2.1 million tax-exempt Seal Beach TRANs due.

Saturday, July 15. $1.955 million tax-exempt Buena Park TRANs due.

Monday, July 17. $4.75 million tax-exempt Laguna Beach TRANs due.

Wednesday, July 26. $62.455 million taxable Irvine TRANs due.

Wednesday, July 26. $3.85 million tax-exempt Cypress TRANs due.

Friday, July 28. $24.5 million tax-exempt Anaheim TRANs due.

Friday, July 28. $22.7 million tax-exempt Saddleback Valley USD TRANs due.

Friday, July 28. $20.7 million tax-exempt Irvine USD TRANs due.

Friday, July 28. $9.95 million tax-exempt Irvine TRANs due.

Friday, July 28. $5.2 million tax-exempt Brea TRANs due.

Friday, July 28. $4.8 million tax-exempt Claremont TRANs due.

Monday, July 31. $4.5 million tax-exempt Fullerton TRANs due.

Tuesday, August 1. $8.7 million tax-exempt City of Orange TRANs due.

Tuesday, August 1. $3.5 million tax-exempt Yorba Linda TRANs due.

Friday, August 25. $50 million taxable Placentia-Yorba Linda USD TRANs due.

ORANGE COUNTY NOTES
ISSUES HELD BY MONEY MARKET FUNDS

Maturity Date	Issue	% Issue Held by Funds
6/13/95	Newport Mesa Unified School District $46,960,000	53.15% ($24,960,000) held by 1 fund
6/13/95	North Orange County Community College District Taxable Notes $56,285,000	84.90% ($47,785,000) held by 1 fund
6/13/95	Irvine California Unified School District $54,575,000	84.97% ($46,375,000) held by 1 fund
6/13/95	Orange County Board of Education Taxable Notes $42,180,000	85.06% ($35,880,000) held by 1 fund
6/28/95	Orange County TRANs ("Pooled TRANs") $296,660,000	38.44% ($114,050,000) held by 2 funds
6/30/95	Orange County Teeter Plan Notes $64,000,000	60.94% ($39,000,000) held by 3 funds
7/10/95	Orange County Taxable Notes $600,000,000	64.08% ($384,500,000) held by 13 funds
7/19/95	Orange County TRANs, Series A $169,000,000	53.75% ($90,850,000) held by 10 funds
7/26/95	City of Irvine Taxable Notes $62,455,000	75.98% ($47,455,000) held by 1 fund
7/28/95	Saddleback Valley TRANs $22,700,000	33.04% ($7,500,000) held by 1 fund
8/1/95	Orange County Flood Control District Taxable Notes $100,000,000	41% ($41,000,000) held by 1 fund
8/10/95	Orange County TRANs, Series B $31,000,000	85.48% ($26,500,000) held by 4 funds

APPENDIX II

FINANCIAL RESTRUCTURING PLAN

The key elements of Orange County's ("County") financial restructuring plan include: (1) issuance of $295 million Recovery Bonds as part of the settlement agreement with the other participants in the Orange County Investment Pool ("OCIP"); (2) issuance of long-term Certificates of Participation ("COPs"); (3) refinancing of short-term Teeter Notes with long-term Teeter Bonds; (4) rollover of existing short-term obligations; (5) a half-cent increase in the sales tax; and (6) sales of assets to generate revenues.

Orange County Finances, Fiscal Year 1995-1996. As a result of the $1.7 billion loss in the OCIP portfolio, Orange County lost $600 million in County investments. The County also suffered a loss of $152 million in estimated interest earnings for 1994-95. The County's financial health was closely tied to the OCIP both because of its dependence on the OCIP for interest income and because essentially all of the County's liquid assets were invested in the OCIP. While the County operating budget for fiscal year 1994-95 equaled $3.7 billion and the County General Fund Budget represented $1.6 billion of that amount, the discretionary portion of the General Fund Budget was $462.5 million. The largest portion of that amount ($162 million) was expected to come from investment income on County funds in the OCIP. Actual investment income for fiscal year 1994-95 is expected to be approximately $10 million.

Settlement Agreement. On May 2, 1995 the Bankruptcy Court entered an order approving a Comprehensive Settlement Agreement ("CSA") with the Bankruptcy Court, which was approved by the requisite number of OCIP participants.

Under the CSA, OCIP participants receive approximately 77% of their initial investment. The agreement permitted participants to select one of two options for treatment of the deficiency between that distribution and their investment balances. Under Option B, which was selected by less than 10% of the participants, the participants generally reserve their rights to litigate against the County to recover their deficiencies. Under Option A, participants release all related claims against the County, and receive in exchange the following three types of consideration intended to enable them eventually to receive approximately 100% of their investment.

The first component consists of approximately $236 million in Recovery Bonds to be distributed to Option A participants in amounts such that each school district or related entity participant will receive approximately $0.13 for each dollar invested, and the other Option A participants will receive $0.03 per dollar invested. (See "Long-Term Recovery Financing" below.)

The second component consists of approximately $343 million of Settlement Secured Claims allocated to Option A participants that are not school districts or related entities in an amount that provides them with about a 90% level of recovery as compared with school participants. The third component consists of $514 million of repayment claims that represent approximately $0.10 increments of the deficiency claims asserted by Option A participants. These are general unsecured claims in the County's bankruptcy; the holder is not entitled to receive payment from the County or out of any of its assets, whether under a plan of adjustment or otherwise, until full payment of all senior claims against the County.

Long-Term Recovery Financing. The County issued $295 million in 30 year tax exempt recovery bonds on June 16, 1995. The bonds have three levels of protection: a lien on the monies received from the state intercept of County motor vehicle fees; and an insurance policy from MBIA Insurance Corp; and super-priority status in the bankruptcy case.

The recovery bonds posed a potential problem with debt limit provisions in the California Constitution. On May 31, an Orange County Superior Court Judge ruled, as urged by the County, that the bonds were not subject to the debt limitation provision because they were being used to pay an involuntary obligation imposed by law that arose out of tort claims against the County.

Teeter Note Refinancing. $175 million of Teeter Notes are due on June 30, 1995 (Teeter financings are repaid from future delinquent property tax payments). The County plans to refinance its short-term Teeter Note debt in part by issuing $155 million in new long-term Teeter Bonds. The refinancing would yield $54 million in net proceeds after retirement of the Notes, plus $10 million a year in revenues, such moneys to be available for the County General fund.

The Industrial Bank of Japan is providing a letter of credit for the financing. Alliance Capital Management and several other money market fund managers have objected to any distribution to the existing Teeter Note holders on the ground that the distribution would discriminate against other similarly situated noteholders (i.e., noteholders of short-term debt). The bankruptcy court approved the Teeter plan refinancing.

Rollover. The County has reached an agreement with the Official Creditors Committee on an extension of the note maturity dates until June 30, 1996. The agreement provides for the payment of interest at the same basic rate as the existing notes, with an additional 0.95%. Five note issues totalling approximately $975 million mature between June 30 and August 15, 1995. The rollover agreement will not become effective unless holders representing at least 50% of the notes agree. It is not clear whether the required 50% will agree. A Bankruptcy Court hearing is scheduled for June 23 on the proposed rollover.

The rollover raises issues under rule 2a-7 of the Investment Company Act of 1940 because it is unclear whether the rollover debt would qualify as a money market fund investment. The Division of Investment Management has informally advised funds that the rollover debt should be treated as defaulted securities under rule 2a-7, in which case funds may accept the rollover debt subject to a finding of each fund's board that it is in the best interests of the fund to do so.

The rollover also raises a problem under the debt limit provisions of the California Constitution. As part of the rollover negotiations, the County and the Creditors Committee have agreed to a stipulation whereby the County, subject to certain reservations, will waive its right to challenge the validity provisions of the rollover debt and certain long-term debt issues under the California debt limit. The California Constitution requires 2/3 voter approval of debt that exceeds a locality's income and revenues for any given year. The debt must be repaid out of same year funds. This requirement will not be satisfied if the debt is rolled over until June 30, 1996, and paid off with revenues received during fiscal year 1996. Thus, County waiver of its right to challenge payment of the note holders is necessary. The waiver will not be effective unless the rollover agreement receives the requisite vote. In any case, the waiver may not affect the rights of others to challenge the payments.

Sales Tax Referendum. The restructuring plan hinges upon approval of a one-half cent increase in the sales tax by the Orange County voters in a June 27 referendum, which at least for now is very uncertain. The County Board of Supervisors voted to submit to the voters on June 27, 1995, a proposal to increase the County-wide sales tax by one-half cent for up to ten years ("Measure R"). If Measure R passes, the additional sales tax revenues are expected to produce approximately $130 million of additional income annually for the County General Fund and to contribute substantially to enabling the County to meet its obligations and recover from bankruptcy. The sales tax is not linked to debt; it would replenish the County General Fund reduced by the intercepted vehicle license fees. Measure R could be challenged in court; the ultimate outcome of such a challenge, should it arise, is uncertain.

New Debt Issues. The County would issue up to $750 million in new long-term bonds secured by the intercept of motor vehicle license fees that would otherwise go into the County General Fund. This would yield $660 million in net proceeds. Legislation has been enacted and signed by Gov. Wilson that provides for a state intercept mechanism under which the California Controller will remit monthly fees directly to the trustees for the bonds. The legislation also provides authority for the County to grant liens in favor of the holders of new County debt.

The County also would issue up to $500 million in new long-term COPs that would be repaid from enhanced operations of the waste management system. This would yield $360 million in net proceeds. The additional revenue would come from raising tipping fees and accepting out-of-County waste. Legislation exempting the receipt of out-of-County waste from certain requirements of the California Environmental Quality Act has been enacted and has been signed by Governor Wilson. A legal challenge from environmental groups is likely.

Assets Sales to Generate Revenues. The sale of major assets by the County will be difficult for a number of reasons, including federal and state laws and regulations. Thus, while the sales of assets will help in the restructuring, such sales will not provide sufficient funds to offset greatly the County's current financial deficit.

The two largest assets generally discussed for sale are the integrated waste management system ("IWMS") and John Wayne Airport ("JWA"). It is accepted generally that the IWMS will best serve the County if it is operated by the County as a business over the coming years. This is due in part to the estimated one to two years it would take to sell the IWMS.

Although the sale of JWA at this time would generate $150-300 million in revenues after repayment of debt, it is unlikely the County will proceed with the sale, largely due to current restrictions on sale in JWA bond documents and the fact that the sale would require the cooperation of the federal government, a change in federal law, and the redemption of outstanding bonds.