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Dominique Blom
Office of Public Housing Investments
451 7th St., SW
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RE: Comments to Draft PIH Notice Regarding Public Housing Agencies And Their Related Affiliates And Instrumentalities

Our firm, Reno & Cavanaugh PLLC, hereby provides comments to the draft notice regarding the applicability of public housing program requirements to transactions between public housing agencies and their related affiliates and instrumentalities, which we received by email on April 7, 2006. As you may know, Reno & Cavanaugh currently represents more than 40 public housing authorities and receivers nationwide with respect to their mixed-finance transactions, public housing regulatory matters, and Inspector General audits. Our comments are informed by our long involvement in the field of public housing development and our extensive work with public housing authorities (PHAs) nationwide. Our comments do not represent the interests of any specific clients, although we have consulted with several in the course of preparing these comments.

At the outset, we urge the Department to keep in mind that PHAs across the country have been seeking to employ affiliated entities in creative, entrepreneurial ways that will lessen their dependence on federal funding, leverage the PHAs' own expertise, and support their missions of providing affordable housing. This notice is an important opportunity to further those goals, but in order to effectively foster the innovation while also safeguarding federal assets, preventing fraud and responding to other concerns raised by the Office of Inspector General, we believe that certain aspects of the notice require significant reconsideration by the Department.

Before we turn to the substance of the notice, we first note our appreciation of the opportunity to comment, although we regret that the time frame has been so brief; this clearly hinders the development of sound, comprehensive, and effective guidance. We strongly urge the Department to convene a working group such as that convened several years ago to develop the Cost Control and Safe Harbor Standards. At minimum, we urge the Department to continue to accept comments and to continue an open dialogue. The final notice will have a significant impact on the course of PHAs and their affiliated entities in the years to come.

Below, we present our key comments in a very summary form, as an introduction to the most significant issues and our proposals for resolving them.

- 1) **Entities Should Be Regulated In Accordance With How Closely Related They Are To The PHA.** The draft notice appears to treat entities with even a slight PHA affiliation as subject to all public housing regulatory requirements, undermining the benefits of using affiliates and inhibiting all innovation. Our alternative definitions of “Instrumentality” and “Affiliates” instead link the amount of regulation with the amount of control that the PHA exercises over the entity, which enables some flexibility while still retaining appropriate safeguards.
- 2) **Conflicts Of Interest Provisions Must Be Practical.** The current conflicts provisions produce unworkable and unreasonable results, such as requiring board approval for every contract of a controlled entity. We propose following a private sector model that is more practical yet contains appropriate safeguards.
- 3) **A Fair “Safe Harbor” Is Necessary.** As the Notice will provide significant new guidance, PHAs must be given time to implement before being deemed out of compliance. In terms of retroactive application and cost reimbursement, we see no point in applying retroactive rules for single-asset entities involved in closed, HUD-approved transactions; also, past actions taken in accordance with then-existing guidance should not be penalized under rules just now being announced, particularly as HUD has been encouraging PHAs to act entrepreneurially, but without any formal guidance.
- 4) **Need to Clarify Relevance to Non-Development Regulations.** Further consideration needs to be given to how this notice interacts with existing guidance in 24 CFR 943 regarding affiliates providing management, administrative or social services. We would be happy to provide further analysis of this issue, with additional time.
- 5) **General Requirements Should Be Addressed In A Separate Notice.** Much of the draft notice does not in fact deal specifically with related entity issues, which confuses and dilutes the guidance. Guidance that relates to development transactions generally should go in a separate guidance document.

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The above list summarizes some major points in brief; the remainder of this letter describes in more detail our reasoning and proposed changes for some of these issues. In addition, at Exhibit 1 is a clean version of the draft notice as reworked in accordance with our comments; at Exhibit 2 is a blackline of our comments against the draft posted by HUD. Finally, Exhibit 3 contains certain short explanations to comments in specific sections, which will help explain why we made the changes.

Below is more detail on the six key points summarized above:

Entities should be regulated in accordance with how closely related they are to the PHA. The current definitions of “Instrumentalities” and “Affiliates” essentially negate the benefits of using

affiliated entities by imposing regulatory burdens on a very broad category of entities. We propose alternative definitions of “Instrumentality” and “Affiliates” that link the amount of regulation with the amount of control that the PHA exercises over the entity.

First, with respect to “Instrumentalities,” the most heavily regulated type of entity, we believe that the definition should be broader. In the context of general corporate law, the defining characteristic of an “instrumentality” is that the entity is controlled by another entity, and so we similarly propose to define an Instrumentality as an entity controlled by a PHA, whose the assets must be returned to the PHA upon dissolution (thus protecting such assets from misuse). Such “controlled entities” are essentially an arm of the PHA, and thus it does not make sense to procure them. However, they should be subject to all public housing requirements as if they were the PHA themselves.

On the other hand, the draft notice’s definition of “Affiliate” is so broad that it might include an entity that has even a single employee of a PHA on its board. To require all such entities to follow all public housing requirements, as proposed in the notice, would essentially negate any benefit that could be gained from working with such entities and would inhibit, not foster, any entrepreneurial activity and even civic participation by PHA staff and board. Our alternative is to define a category of “Related Entities,” which are entities that may have some affiliation with a PHA but are not controlled by the PHA (i.e., they are not as closely tied to the PHA as an Instrumentality, and therefore deserve certain additional flexibility). Such entities should be procured pursuant to Part 85 and must abide by public housing requirements to the extent applicable, but should not be bound by the full panoply of requirements that a PHA is. As our comments indicate, however, PHAs must be especially careful in their relationships with Related Parties in order to ensure that there are no conflicts of interest or misuse of public housing funds.

A final note on definitions: we removed references to state law, since the use of state law to define these entities for HUD purposes would result in unworkable ambiguity and disparate application across the country.

Conflicts Of Interest Provisions Must Be Practical. Under the current draft notice, PHAs appear to have less flexibility in contracting with affiliates than in the past. Some of the policies proposed in the draft notice are simply unworkable on a practical basis; for example, since PHAs and Instrumentalities will often have identical boards, under the notice the PHA board cannot act and must request a waiver from HUD each time it enters into a contract with an Instrumentality. We urge HUD to follow the lead set in other regulated industries, where wholly-controlled entities can contract with one another without running afoul of conflicts of interests provisions. The Securities and Exchange Commission, for example, explicitly exempts wholly-controlled entities from the conflict of interest regulations, and does not see a conflict where an executive receives a salary from a company and its wholly owned affiliate.¹

¹The analogy is not perfect (nor is our understanding of securities law), but the analogy is instructive for treatment of conflict of interest for related entities and for interested parties by the federal agency that regulates financial transactions.

We agree with the Draft Notice that conflicts of interest under the ACC and 24 CFR 85.36 are primarily focused on financial conflicts of interest and thus propose that prohibited conflicts be clearly identified as those resulting in a personal financial benefit, such as the receipt of profits or bonuses directly by a staff person due solely to work done for Instrumentalities or Related Entities. We do propose as a safeguard that the PHA board has a duty to determine that any PHA contract with an Instrumentality or Related Entity is fair and reasonable.

A Fair “Safe Harbor” Is Necessary. Given the complexity of the rules and the fact that many affiliated entities have already been created, it is critical to provide a window of time for PHAs to come into compliance with the new rules of the notice. We obviously agree that where funds were mishandled pursuant to already-existing rules the situation must be rectified, and our markup of the draft notice retains the cost reimbursement section for such situations. However, we do not think it is fair or authorized by law to establish new rules in an area in which PHAs have had very little guidance to date, and to require reimbursement of funds based on those new rules, especially where the financial arrangements were previously approved by HUD. The implication that Field Offices could audit and require changes to closed transactions is especially disturbing, particularly where PHAs actually received HUD approval to enter into the documents.

Need to Clarify Relevance to Non-Development Regulations. As we understand it, the Department has not decided whether this notice should address non-development activities already covered by 24 CFR 943. We agree that this is a difficult call. Our markup uses [hard brackets] to identifies text to revisit depending on the Department’s final determination; however, due to the short time frame for comments, we have been unable to fully address the

Transactions with Controlled Parties are Exempt from General Self-Dealing Prohibitions. 15 USC 80a-17(a) prohibits investment companies from engaging in a list of transactions with “affiliated persons,” which cover the meat of the operations of an investment company, including buying and selling securities and loaning or borrowing money. Investment companies can receive waivers from the SEC. 15 USC 80a-17(b). And, fully owned subsidiaries are exempt from the conflict of interest requirements. (17 CFR 270.17a-3). In this context, “fully owned subsidiaries” are those whose outstanding securities, other than directors' qualifying shares, are owned by its parent and/or the parent's other fully owned subsidiaries, and which are not indebted to any person other than its parent and/or the parent's other fully owned subsidiaries *in an amount which is material in relation to the particular subsidiary*. Essentially, the SEC uses the term wholly-owned to mean effective control. Thus, when a PHA appoints or occupies the entire, or even a majority, of the board of an instrumentality, it has control similar to that of the parent/subsidiary relationship contemplated by the SEC regulation.

Employees or Board Members Do not Have “Financial Interests” Solely by Virtue of Board membership or Salary. The SEC analogy is also useful in seeing how an industry about monetary transactions views financial interests. For example, 15 USC 80a-56 prohibits certain transactions between related parties, but subsection make clearly states that that directors, officers or employees of a party to a transaction and who receive an ordinary fee or salary for usual and customary services will not be deemed to have a financial interest or to participate in the transaction solely by reason of the receipt of fee or salary. Similarly, 15 USC 80a-2 provides that a person is not an interested person solely by reason of his being a member of its board of directors or advisory board or an owner of its securities.

substantive ramifications of this issue. But if the Department permits, we are interested in providing additional comments in the coming days on this issue.

General Requirements Should Be Addressed In A Separate Notice. While we understand that HUD would like to address a broad range of Inspector General concerns in this notice, we believe that it is confusing to include in this notice so many provisions that are really related to general development issues, and not necessarily specifically directed towards Instrumentalities and Related Entities. Our redraft focuses attention on how these issues apply to Instrumentalities and Related Entities, and we urge the Department to issue a separate notice on general development issues applicable to PHAs and private partners rather than bury them in this notice. Our markup uses {curly brackets} to identify language that could be more effectively deleted or moved to separate notice. We would be happy to provide a draft of such separate notice as we envision it.

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In sum: we feel strongly that additional time and opportunity for dialogue is critical to producing effective and sound guidance, so we again urge the Department to consider this. Our reaction to this draft notice, and that of our clients, has been strong, and we look forward to working out a final notice that provides clear guidance to PHAs on how they may heartily pursue their missions with the assistance of their affiliated entities, within all legal requirements.

We note again that the attached exhibits further elucidate our comments. Exhibit 1 is a clean version of the notice incorporating all of our comments, for ease of readability. Exhibit 2 is a blackline. Exhibit 3 provides short explanations for certain of the comments we made in specific sections of the draft notice.

We look forward to your response.

Sincerely,

**EXHIBIT 1
CLEAN REVISED DRAFT NOTICE**

(in email-delivered version, please insert separate document)

EXHIBIT 2
BLACKLINED REVISED DRAFTT NOTICE

(in email-delivered version, please insert separate document)

EXHIBIT 3
BRIEF LINE BY LINE EXPLANATION OF SIGNIFICANT CHANGES

1) *Article I (Introduction)*

- a) I.D. – Defines Instrumentalities and Related Entities in accordance with the comments, and provides a more precise definition of Public Housing Funds.

2) *Article II (Formation and Operation of Instrumentalities and Related Entities) and Article III (Considerations of Instrumentalities and Related Entities)*

- a) Split the former Article II (having the former title) into two pieces to provide clearer and more logical flow. “Moves” that are difficult to follow and changes other than “moves” are identified here.
- b) II.A. – deletes definitional type language that has been replaced in the definitions.
- c) II.C. Adds specific guidance as to predevelopment expenses
- d) II.D. – Clarifies HUD’s stated intent that procured Affiliates need not comply with Part 85 as if they were the PHA themselves, and replaces an example from the Section 8 program with an example from the public housing program.
- e) III.A. – Removes requirements relating to PHA certification to HUD and legal opinions related to due formation as an affiliate under state law.
- f) III.A.5. – New provision requiring PHAs to take reasonable efforts to prevent personal financial conflicts of interest and to enter into economically reasonable contracts that do not provide private inurement to PHA or Instrumentality employees or directors.
- g) III.A.6. -- New provision providing 60 day window for PHAs to conform existing affiliates to new definition of Instrumentalities.
- h) Deleted – requirement that PHA boards approve all contracts an Instrumentality enters into (but retained as requirements the general considerations). We are concerned that it is unduly burdensome and invites courts to “pierce the corporate veil.”
- i) Deleted – requirement to provide audited financial statements, unless required by GAAP accounting.
- j) Moved (to definition of Instrumentality) – requirement to provide assets to PHAs upon dissolution.

- k) III.A.7.—Added language to manage potential situation for an “Instrumentality” to remove itself from control by the PHA and take assets, etc. with it.
 - l) Added a new III.B. that provides guidance specific to Related Entities.
- 3) *Article IV (former Article III) (Disposition and Encumbrance of Public Housing Property)*
- a) Generally, this Article largely contains “general development information” that is not specifically tied to relations between a PHA and an affiliated entity. We suggest deletion here, and inclusion in a separate notice.
 - b) We also suggest that a transfer by a PHA to an Instrumentality for the purpose of development public housing should not constitute a disposition requiring approval outside of the mixed-finance development process. HUD’s protection here is that the exemption would be dependent upon either continuation of an existing Declaration of Trust or, at transfer, immediate recordation of a new Declaration of Trust or Declaration of Restrictive covenants.
 - c) IV.D-E. If you wish to retain general guidance regarding Guaranty, Recourse, and Indemnifications, we propose one unified provision which is derived from the mixed-finance excerpt quoted in the draft notice, but more easily adaptable to situations other than a limited partnership agreement. We also deleted the specific provision on indemnification, not out of policy disagreement, but because the topic is dealt with more fully and accurately in the previous section.
- 4) *Article V (formerly Article IV) (Allocation Methodologies)*
- a) Largely our comments consist of non-substantive organization, terminology, and clarification changes. In particular, we attempted to clarify the “substitute system” for allocating costs, as we and our clients found it generally confusing.
- 5) *Article VI (formerly Article V): (Reimbursement of Costs)*
- a) We found very problematic the implication that Field Offices could audit closed and HUD approved transactions. Our discussions with department staff indicate that this was not the intention, and we made changes accordingly.
 - b) Thematically, this guidance relates to development requirements – and rectifying violations – rather than to establishment and management of affiliates, and should be in a separate notice.
- 6) *Article VII (formerly Article VI) (Conflicts of Interest)*
- a) Changes reflect considerations identified in the comments.

- 7) *Article VIII (formerly Article VII) (Procurements of and Procurements by affiliated entities)*
 - a) Largely, the changes seek to clarify procedures, conform discussions of owner entity activities to regulatory language on “exercising significant functions” and clarify the Department’s assertion (and we believe the proper logical and regulatory response) that a procured Related Entity need not comply with Part 85 in its own contracting for goods and services.
- 8) *Article IX (formerly VIII) (Section 30, Public Housing Development and Capital Fund)*
 - a) This section merely restates law and guidance applicable to the relevant transaction and has no special applicability to affiliated entities. It should be moved to a separate notice.
- 9) *Article X (formerly IX) (HUD Monitoring and Reporting)*
 - a) Adds a note that the purpose of monitoring is to ensure compliance, not to re-draft or re-negotiate legal documents.