

Scope of Discussion

- Overview of Municipal Securities Regulation
- Rule 15c2-12 (the Rule) and Continuing Disclosure Undertakings
- Recent SEC Enforcement Actions

Overview of Securities Regulation

- Federal Securities Regulation
 - The Securities Act of 1933
 - Regulates primary market transactions (initial sales of securities by issuers to underwriters)
 - The Securities Exchange Act of 1934
 - Primarily regulates secondary market transactions
 - The U.S. Securities and Exchange Commission (SEC), created under the 34 Act to enforce federal securities laws.
 - **The mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.**

Overview of Securities Regulation

- According to the SEC the main purposes of the 33 Act and the 34 Act can be reduced to two common-sense notions:
 - Issuers publicly offering securities for investment dollars must tell the public the truth about their businesses, the securities they are selling, and the risks involved in investing.
 - People who sell and trade securities – brokers, dealers, and exchanges – must treat investors fairly and honestly, putting investors' interests first.

Overview of Securities Regulation

- Municipal securities are generally exempt from the registration requirements of the 33 Act and governmental entities are generally exempt from the reporting requirements of the 34 Act.
- Not exempt from the anti-fraud provisions of the 33 Act and the 34 Act.
- Somewhat constrained by the so-called “Tower Amendment” included in the 1975 amendments to the 34 Act (which created the Municipal Securities Rulemaking Board (MSRB)).
 - SEC and MSRB prohibited from requiring issuer filing prior to issuance
 - MSRB prohibited from requiring any filing by issuers with the MSRB

Overview of Securities Regulation

- Over the past several decades the municipal market has grown significantly and with that growth has come a heightened interest in the market by the SEC.
- Series of well publicized defaults (NYC in the 1970's and Washington Public Power Supply System in the 1980's).
- In the mid-1990's, the SEC published an "Interpretive Release" as well as amendments to Rule 15c2-12 which implemented annual disclosure requirements for issuers of municipal securities.
 - Rule 15c2-12 of the 34 Act (1989, 1995, 2009)
- SEC's authority over municipal issuers is limited to enforcement of anti-fraud provisions.

Overview of Securities Regulation

- SEC enforcement actions against municipal issuers are generally brought under either Section 17(a) of the 33 Act or Section 10(b) of the 34 Act and Rule 10b-5 thereunder.
- Section 17(a) of the 33 Act prohibits obtaining money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.
 - A fact is material if there is a substantial likelihood that a reasonable investor would have viewed the information as “having significantly altered the ‘total mix’ of information available.”
 - To the extent the omitted information relates to contingent future events, materiality depends upon “a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of circumstances.”
- Negligence is sufficient to prove violations of Section 17(a) of the 33 Act.

Overview of Securities Regulation

- Section 10(b) of the Securities and Exchange Act of 1934
 - Prohibits the use, in connection with the purchase or sale of a security of any manipulative or deceptive device
- Rule 10b-5:
 - Prohibits the use of any instrumentality of interstate commerce, mails, or facilities of national securities exchange, in connection with the purchase or sale of any security, to:
 - (a) Employ any device, scheme or artifice to defraud;
 - (b) Make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
 - (c) Engage in an act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

Rule 15c2-12

- Promulgated in 1989 by Securities and Exchange Commission (SEC)
- Amended in 1994 to including continuing disclosure
- 2008: Designation of Municipal Securities Rulemaking Board's (MSRB) Electronic Municipal Market Access (EMMA) system as central depository for filings and elimination of small issuer exemption
- 2010: significant changes to list of event notices and filing deadline for notices
- 2018: addition of two event notices

Basics of the Rule

- Underwriters must comply with the provisions of the Rule unless an exemption applies
- Applies to primary offerings
- Principal amount of \$1 million or more

Basics of the Rule

- Requires an underwriter to determine that an issuer or other “obligated person” for which information is provided in the final official statement, has covenanted to provide both annual financial information (and audited financial statements, if and when available) and certain event disclosure.
- Additionally, the issuer or obligated person (hereinafter, referred to as the issuer) must provide notification in the event the required annual financial information is not provided on or before the date required in the written undertaking.

Basics of the Rule

- In traditional municipal bond issues, it is the issuer that will undertake to provide the required information.
 - Obligated person: Any person, including an issuer of municipal securities, who is either generally ... committed by contract or other arrangement to support payment of all or part of the obligations on the municipal securities in the offering (other than bond insurers, letter of credit or liquidity providers).
- The important distinction about Rule 15c2-12 is that it is a rule for underwriters to comply with but it requires issuers to enter into contractual undertakings.
- Rule 15c2-12 requires all filings to be made through the Municipal Securities Rulemaking Board (MSRB) and its Electronic Municipal Market Access (EMMA[®]) system, which is an internet-based platform.
- Exemptions: denoms of \$100,000, 35 sophisticated investors.

Failure to Comply

- Failure to comply with the contractual undertaking is not a violation of the Rule but misrepresenting your past compliance (in an offering document) might be an issue under federal securities laws.
- Specific performance by bondholders under continuing disclosure undertaking
- Disclosure of noncompliance in future official statements
- Underwriters cannot sell future debt issues unless they have a reasonable belief that issuer will comply with the Rule
- SEC Enforcement Actions
- Citation from Auditor of State

Underwriter's Due Diligence

- Why is this important for underwriters?
- What due diligence do they conduct on past continuing disclosure compliance?
- How does an underwriter get comfortable that issuer will comply moving forward, especially if past compliance is spotty?

What information must be provided?

- Annual financial information
 - Financial information and operating data of the type included in the Official Statement under the captions **FINANCIAL MATTERS, AD VALOREM PROPERTY TAXES – Collections and – Delinquencies, OTHER MAJOR GENERAL FUND REVENUE SOURCES, CITY DEBT AND OTHER LONG TERM OBLIGATIONS, DEBT TABLES A, B, C and D and APPENDIX A,**
 - Typically 180-270 days after end of fiscal year
- Audited financial statements
 - If and when available; not typically within the same deadline as annual financial information above but check language to be certain
- Event notices

Event notices

File within 10 business days of occurrence. Some contain materiality determination, some do not:

1. Principal and interest payment delinquencies;
2. Non-payment related defaults, if material;
3. Unscheduled draws on debt service reserves reflecting financial difficulties;
4. Unscheduled draws on credit enhancements reflecting financial difficulties;
5. Substitution of credit or liquidity providers, or their failure to perform;
6. (Issuance of) Adverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the security, or other material events affecting the tax status of the security;
7. Modifications to rights of security holders, if material;
8. Bond calls, if material, and tender offers;
9. Defeasances;

Event Notices (cont'd)

10. Release, substitution, or sale of property securing repayment of the securities, if material;
11. Rating changes;
12. Bankruptcy, insolvency, receivership or similar event of the Obligated Person
13. The consummation of a merger, consolidation, or acquisition involving an Obligated Person or the sale of all or substantially all of the assets of the Obligated Person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material; and
14. Appointment of a successor or additional bond registrar or the change of name of a bond registrar, if material.

New Events to be Reported

- In 2018, SEC announced approval of amendments to the Rule that will increase the number of events that must be included in continuing disclosure undertakings (from 14 to 16). See SEC Release No. 34-83885.
- Reasons for the amendment:
 - Increasing use of private placements and direct purchases of municipal securities as alternatives to public offerings.
 - SEC’s aim was to increase transparency of debt outside of the “bond” market because of the amount of such debt since the financial crisis.

Event Notices – 2 new events

- Effective for new continuing disclosure agreements entered into on or after February 27, 2019:
 15. Incurrence of: (i) a financial obligation of the obligated person, if material, or (ii) agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material.
 16. Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, any of which reflect financial difficulties.

Financial Obligation

- The amendments defined the term “financial obligation” to mean: (i) debt obligation; (ii) derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or (iii) a guarantee of (i) or (ii).
- The definition of the term “financial obligation” does not include ordinary financial and operating liabilities incurred in the normal course of an issuer’s business, only an issuer’s debt, debt-like, and debt-related obligations.
- The term financial obligation does not include municipal securities for which a final official statement has been provided to the MSRB “consistent with the Rule,” regardless of whether the OS filing is done on a voluntary basis.

Financial Obligation

- The term “debt obligation” includes
 - short-term and long-term debt obligations of an issuer (i.e., notes or bonds)
 - Can be under the terms of an indenture, loan agreement, lease, or similar contract, regardless of the length of the debt obligation’s repayment period
 - Leases – if operates as a “vehicle to borrow money” then should be considered to be a financial obligation under the Rule.
- Derivatives: meant to include any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument to which an issuer is a counterparty provided that such instruments are related to an existing or planned debt obligation.
- Both the guarantor and the beneficiary of the guarantee might need to make the disclosures.
- Examples:
 - Issuance of bond anticipation notes that do not have an official statement.
 - County provides credit backstop for port authority bonds. This would be a financial obligation under the rule and County would need to file notice.

Financial Obligation

- Materiality:
 - Some issuers using accounting standard
 - Threshold percentage of existing obligations, overall bond portfolio, overall balance sheet
- Default:
 - monetary default - where an issuer fails to pay principal, interest, or other funds due
 - non-payment (covenant) default, where an issuer fails to comply with specified covenants.
- Affecting security holders:
 - What does this mean?

Financial Obligation – Form of Notice

- Description of material terms of the obligation.
- Submit financing documents or notice with description of material terms of the financial obligation.
- Ex: principal amount, date of incurrence (remember 10-day filing period applies), maturity, amortization schedule, interest rate (or interest rate formula, if variable), default rates
- Could submit term sheets, continuing covenant agreements or financial covenant reports.
- Confidential information (e.g., account numbers, personally identifiable information, contact info) should be excluded.

Financial Obligation – Underwriters’ Due Diligence

- Questions regarding policy, thresholds for determining materiality, procedures for compliance.
- Consult with bond counsel and be prepared to answer these questions (usually provided in advance of due diligence call).
- Some underwriters are requesting issuers to create a catalog of existing financial obligations
 - May need to check with other departments
 - Date incurred, amount, interest rates, amortization, maturity, events of default, default rates, security, key covenants, acceleration, termination events,
- Adoption of policy
- Determine who monitors

Voluntary Disclosure

- In addition to the financial information, operating data and audited financial statements that may be required under continuing disclosure agreements, a municipal issuer can voluntarily provide the municipal market with other useful information.
- Voluntary submissions should be thoughtfully reviewed for accuracy and completeness.
- In addition to intentional voluntary disclosures, any information distributed to the market or otherwise reasonably likely to reach the market will be subject to anti-fraud rules.

EMMA

- www.emma.msrb.org
- Free electronic submissions (searchable pdf) by issuers and obligated persons
- Free public access to filings
- Easily searchable for filings and offering documents
 - Issuer/obligated person name
 - 6- or 9-digit CUSIP

Recent SEC Enforcement Actions

- San Diego, California (November 14, 2006) – SEC entered a cease and desist order against the City that settled administrative proceedings concerning the failure to disclose substantial and growing City’s pension obligations.
 - Separate enforcement actions resulted in settlements with city officials including fines ranging from \$5,000 to \$25,000.
 - Remedial action taken by the City was noted very favorably by the SEC and included the development and implementation of very detailed disclosure policies and procedures for bond issuance.
- Takeaway: SEC will seek financial penalties against issuer employees.

Recent SEC Enforcement Actions

- City of Harrisburg (May 6, 2013) - Harrisburg stopped filing annual disclosure under continuing disclosure agreements and was held accountable by the SEC for information city posted to its website, including Mayor's 2009 "State of the City" Address, budget and fiscal reports.
- Takeaway: Just because it isn't posted on EMMA with continuing disclosure filings doesn't mean it's not subject to SEC scrutiny.

Recent SEC Enforcement Actions

- City of South Miami (May 22, 2013) –SEC brought enforcement action for allegedly false representations made to conduit issuer and not directly to the market where the representations went to tax-status of the bonds.
- Takeaway: Failure to comply with tax covenants will be subject to SEC scrutiny.
- City of Miami (SEC v City of Miami, U.S. District Court, Southern District of Florida, No. 13-22600 2016) - City and former budget director are charged with anti-fraud violations concerning year-end transfers to the City’s general fund, including misstatements in CAFR and offering documents that concealed alleged improper transfers.
 - The charges also include violation of a previous cease and desist order.
 - A federal jury found both the City and former budget director liable.
 - The City paid a settlement of \$1 million. The former budget director was fined \$15,000, although the SEC sought \$450,000.
 - First federal jury trial in a municipal securities enforcement action.
- Takeaway: “I fought the law and the law won.”

Recent SEC Enforcement Actions

- West Clark Community Schools (July 29, 2013) - Issuer told investors in a 2007 official statement that it was in material compliance with all previous Rule 15c2-12 undertakings when it had failed to make any annual filings.
 - Spring board for the SEC's Municipal Continuing Disclosure Cooperation (MCDC) Initiative.
 - MCDC was a voluntary program under which underwriters and issuers could turn themselves into the Enforcement Division and confess prior misstatements about prior continuing disclosure compliance.
 - Settlement agreements with 71 underwriters (96% of the market).
 - 71 issuer settlement agreements.
- Takeaway:. Be honest about past compliance with continuing disclosure.

The Price of Failure

- The price of failing to get disclosure right can be high.
- San Diego is reported to have spent more than \$26 million for internal investigations to determine what happened and who was responsible.
- State of New Jersey reportedly paid more than \$8 million to a law firm to assist it in developing disclosure policies and represent the State when it self-reported disclosure insufficiencies regarding pension liabilities.
- The City of Miami paid a \$1 million settlement after the jury verdict in 2016. That was in addition to the millions it had already paid out in legal fees over the previous 4 years.

Recent SEC Enforcement Actions

- **SEC Commissioner Clayton recently commented on bond counsel guidance with respect to primary and secondary disclosure and application of securities laws.**
- SEC putting together guidance/memorandum on this.

Questions?

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Disclaimer and Non-Disclosure: SEC “Municipal Advisor Rule”

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We will review the official statement for the Bonds in accordance with, and as part of, our respective responsibilities to investors under the federal securities laws, as applied to the facts and circumstances of this transaction.

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