CPIM

Center For Public Investment Management

A PROGRAM BROUGHT TO YOU BY:

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Continuing Disclosure and Municipal Securities

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Presenter

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Securities Law Compliance

- Compliance with federal securities law primarily revolves around continuing disclosure and Securities and Exchange Commission ("SEC") Rule 15c2-12.
- Might be the most common area of non-compliance for issuers of municipal debt (particularly prior to the SEC's 2014 MCDC Initiative).
- Can apply to all types of municipal securities, regardless of tax status (i.e. tax-exempt, tax advantaged, or taxable).
  - Note that "municipal securities" is a general term referring to a bond, note, certificate of participation or other obligation issued by a state or local government or their agencies or authorities (such as cities, villages, counties, school districts, townships, etc.). A prime feature of most municipal securities is that the interest paid on them is generally excluded from gross income of the holder for federal income tax purposes and is also exempt from state income taxes.

What is Continuing Disclosure?

- Continuing disclosure is simply information that an issuer of municipal securities is required to disclose to municipal investors on a periodic basis (normally annually) and when certain events occur.
  - Sometimes referred to as “secondary market disclosure” since it follows the disclosures made during the initial, primary offering. These disclosures help investors in the secondary market with their investing decisions.
  - Similar in purpose to disclosures made by publicly traded companies (10-Qs, 10-Ks, 8-Ks).
- Continuing disclosure is required by SEC Rule 15c2-12 (the "Rule"). Since 1995, it has prohibited underwriters from purchasing municipal securities subject to the Rule unless the municipal issuer had a written agreement to provide continuing disclosure to investors.

When Is It Required?

- Triggered by a new issuance of municipal securities.
- Most issues that are $1,000,000 or more in principal amount and that are publicly offered in the municipal bond market (i.e. not privately placed) are subject to the requirements of the Rule.
- Securities sold with an official statement or other offering document (a.k.a. “primary market disclosure”) will likely have a continuing disclosure requirement.
- In such situations, a continuing disclosure undertaking / agreement / certificate (“CDA”) is usually entered into for each new issue.
- Disclosure obligations of CDAs typically terminate when securities are fully paid off, either at final maturity or by a defeasance with an escrow fund.

Common Exceptions

- Municipal securities that total less than $1,000,000 in aggregate principal amount.
- Private / direct placements – for issues that exceed $1,000,000 in total principal, exemption available from both primary and secondary market disclosures if sold:
  - (1) in authorized denominations of $100,000 or more, and
  - (2) to no more than 35 sophisticated investors.
- Partial exemption for issuers with not more than $10,000,000 in debt outstanding (including the new issue).
  - However, still required to provide at least annual disclosure of financial information and operating data that is “customarily prepared” and is “publicly available.” Also still required to make event-based disclosures under the Rule.

What Do I Need to Disclose?

- Two main categories of continuing disclosures:
  - (1) Annual financial information
  - (2) Event notices (sometimes also referred to as material event notices)
- Annual financial information – generally means financial information and operating data (including audited financial statements) about the issuer that has been updated for the past fiscal year and that is similar to the financial information and operating data that was presented in the official statement for the underlying debt issue.

Annual Financial Information

- The Rule itself does not set forth any specific requirements for what is included in an annual financial information report (“AFIR”) other than stating that it should include:
  - (1) Financial information and operating data of the type included in the final official statement; and
  - (2) Audited financial statements.
- SEC Release No. 34-34961 stated that the financial information and operating data to be provided pursuant to a CDA should "mirror" the financial information and operating data contained in the official statement. In the SEC's view, this standard has a "quantitative focus" on objective data, but the SEC declined to set specific parameters.

Annual Financial Information

- Because of this ambiguity, it is the CDA that specifies the exact information that must be disclosed in each annual report.
- Bond counsel prepares the CDA, and the CDA is included in the transcript of proceedings for the securities.
- The AFIR requirements of the CDA should match up with what the official statement stated would be included in the issuer's AFIRs.

Audited Financial Statements

- Audited financial statements should be included with the AFIR, but they may be filed later if they have not been released by the deadline for filing the AFIR.
- Consult with bond counsel about including unaudited financial statements in your AFIR if your audited financial statements are not ready yet.
- Recommend filing the version of the issuer's audited financial statements that is released by the Auditor of State.

Event Notices

- Event notices are provided to investors to alert them to the occurrence of certain specified events that impact the debt issue or that may indicate a change in the ability of the issuer or other obligated person to repay the debt.
- The Rule currently lists 14 categories of events that must be disclosed to investors.
- Event notices are still often referred to as “material event notices,” but that terminology can be misleading.
- The Rule was amended in 2010 so that most listed events no longer have a “materiality” qualifier and must be disclosed regardless of the issuer’s opinion as to their materiality.

Event Notices

- The Rule currently lists the following 14 categories of events:
  - Principal and interest payment delinquencies;
  - Non-payment related defaults, if material;
  - Unscheduled draws on debt service reserves reflecting financial difficulties;
  - Unscheduled draws on credit enhancements reflecting financial difficulties;
  - Substitution of credit or liquidity providers, or their failure to perform;
  - 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;
  - Modifications to rights of security holders, if material;
  - Bond calls, if material, and tender offers;
  - Defeasances;
  - Release, substitution, or sale of property securing repayment of the securities, if material;
  - **Rating changes** (including rating changes of bond insurers or other credit enhancements such as the Ohio School District Credit Enhancement Program);
  - Bankruptcy, insolvency, receivership or similar event of the obligated person;
  - 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
  - Appointment of a successor or additional bond registrar or the change of name of a bond registrar, if material.
- Also recommend filing a notice if an issuer changes the accounting principles used to prepare its financial statements (such as from GAAP to cash basis).

Proposed Event Notices

- SEC has proposed adding two additional categories of event notices to the existing 14 categories in the Rule.
- #15 – "Incurrence of a financial obligation of the obligated person, ***if material***, or 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***." [emphasis added]
  - Financial obligation would mean "a debt obligation, **lease**, guarantee, derivative instrument, or monetary obligation resulting from a judicial, administrative, or arbitration proceeding." This definition would exclude municipal securities for which a final official statement has been provided to the MSRB.
  - The term "lease" includes both operating and capital leases.
  - This event would include (1) financial obligations that were material in nature (by size or some other standard), even if there are no material covenants associated with such obligation, and (2) non-material financial obligations that have covenants, etc. that have a material effect on other security holders.
  - Materiality can be both positive (good news) or negative (bad news).
  - Determining materiality isn't always clear, and so the trend is to disclose when in doubt.
  - Case law has defined materiality as information as to which there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision.

Proposed Event Notices

- #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***.” [emphasis added]
- The proposed amendments would only affect new CDAs entered into after the Rule is amended.

Filing Deadlines

- Annual financial information reports (AFIRs) - must be filed by the due date set in the CDA.
  - These deadlines typically are in a range of 5-9 months after the issuer's fiscal year end.
- Event notices must be filed within 10 business days of the event.

EMMA

- Since July 1, 2009, all continuing disclosure filings must be made through the Municipal Securities Rulemaking Board's (MSRB) Electronic Municipal Market Access website, which is known as "EMMA" (http://emma.msrb.org/).
  - The MSRB is a self-regulatory organization created by Congress in 1975 to assist the SEC with the regulation of the municipal securities market.
- EMMA is now the sole repository for continuing disclosure filings.
- Thus, no information provided to or filed with the Ohio Municipal Advisory Council (OMAC) will serve to satisfy an issuer's continuing disclosure compliance obligations unless that information has been timely filed on EMMA.
  - OMAC's annual questionnaire process is often confusing for issuers.
- A dissemination agent (such as bond counsel) can make filings on EMMA on an issuer's behalf.

Why Compliance Is Important

- The SEC is starting to make secondary market disclosure compliance an enforcement priority.
- The SEC's 2014 Municipalities Continuing Disclosure Cooperation Initiative (commonly referred to as the "MCDC Initiative") targeted issuers and underwriters for not properly reporting material continuing disclosure failures pursuant to the five-year look back.
  - Reached settlements with 71 issuers.
  - Reached settlements with 72 underwriters, representing 96% of municipal underwriting market share, and imposed approximately $18 million in fines.
- Harrisburg, PA cease and desist order (2013) – SEC charged city with securities fraud for misleading public statements when its continuing disclosure was incomplete or outdated.
- Compliance review may be part of audit process.

Why Compliance Is Important

- The Rule requires issuers to report to investors any material non-compliance with the Rule's continuing disclosure requirements over the past five years (referred to as the five-year look back) in each official statement.
- What constitutes a failure to comply "in all material respects" with the Rule?
  - SEC has consistently refused to provide much in the way of concrete guidelines for such analyzing these questions.
  - MCDC settlements with both underwriters and issuers have provided some informal guidance.
  - 30 days or less post-deadline for AFIRs and audits appears to be non-material in the SEC's view.
  - For event notices, follow the 10 business day deadline in the Rule.

Why Compliance Is Important

- Underwriters have their own due diligence responsibilities with respect to the five-year look back.
- It is now common to see underwriters engaging a third-party consultant to do a five-year look back review and prepare a report, and it's becoming a frequent component of issuance costs.
- Proposed event notice additions to the Rule would make the five-year look back review significantly more onerous for both issuers and underwriters.
- Market access – underwriters are under pressure (both externally and internally) to not underwrite securities for issuers unless they have a reasonable basis to believe that they will comply with their continuing disclosure obligations.

Post-MCDC Enforcement

- Beaumont Financing Authority ("BFA") Cease and Desist Proceedings (August 2017)
  - BFA issued about $260 million in 24 separate offerings from 2003-13.
  - City Manager of the City of Beaumont, CA managed both the City and BFA for 20 years (1995-2015), and he signed 24 CDAs on behalf of BFA.
  - BFA had a pattern of only partial compliance with its CDAs – AFIRs were filed late and missing certain data.
  - SEC focused its enforcement action on five BFA issues sold in 2012-13.
  - The five-year look back in all five official statements did not fully disclose BFA's non-compliance.
  - City Manager thus reviewed and approved "materially misleading" official statements, or else failed to review or ignored such false info.
  - BFA did not have any policies or procedures for preparing official statements or for post-issuance compliance.

Post-MCDC Enforcement

- Beaumont Financing Authority ("BFA") takeaways:
  - In SEC's view, BFA's material misrepresentations in the five-year look back violated the antifraud provisions of Sections 17(a)(2) [material misstatements or omissions] and 17(a)(3) [engaging in fraud or deceit] of the Securities Act of 1933.
  - SEC felt that this "significantly altered" the total mix of information made available to investors, thus making the bonds "appear more attractive to investors."
  - Negligence is sufficient to establish violations of Sections 17(a)(2)-(3).
  - Ignorance is not a defense if it was your responsibility to ensure the accuracy of such statements.
  - BFA had to agree to a series of corrective measures.
  - City Manager was charged in federal court with making false statements and settled for a $37,500 fine and a lifetime ban from municipal bond offerings.
  - Underwriter also subject to fines and cease-and-desist order.
  - Expect more SEC enforcement of these types of violations.

Selective Disclosure

- MSRB published a market advisory in September 2017 to advice issuers against making "selective disclosure," which occurs when "certain investors are given access to information but other investors are not."
- Examples cited included investor road shows, investor conferences, and one-on-one investor calls or meetings, particularly question-and-answer sessions, where information not included in an official statement could be discussed.
- MSRB analogized to SEC's Regulation Fair Disclosure (Regulation FD), even though Reg. FD doesn't apply to municipal issuers.
- MSRB feels that selective disclosure could, in certain situations, result in insider trading and/or violations of the antifraud prohibitions that do apply to municipal issuers.
- Regulation FD provides that when selective disclosure is intentional, then public disclosure must be made simultaneously; if it was unintentional, then the issuer must make public disclosure promptly.
- For municipal issuers, public disclosure would be made on EMMA.

Remediating Disclosure Failures

- If you are concerned that the issuer you represent has not been making all of its required continuing disclosure filings, the first step is to understand what its actual disclosure requirements are.
  - Note that an issuer's disclosure requirements can, and often do, vary by each bond issuance, although each bond counsel typically keeps its requirements relatively uniform.
- The next step is to review the issuer's filings for each bond issue to determine what is missing.
- Performing a five-year look back should be sufficient in most situations.

Remediating Disclosure Failures

- Rating changes are one area that can be difficult to reconstruct, especially for insured securities.
- Experienced counsel is recommended for a five-year look back review.
- The necessary AFIRs and event notices then need to be drafted along with a “failure to file” notice for any missing annual financial information.
- Remedial filings must be posted on EMMA and linked to the proper bond issues.
- Any material failures must be disclosed in the issuer’s official statements for the next five years.
  - Remember that missing or improper primary disclosure of past secondary disclosure failures was the target of the MCDC Initiative.
  - Important to make all necessary remedial filings before issuing new debt with an official statement.

Post-Issuance Compliance Policy

- Best practice is to have an official post-issuance compliance policy that covers both federal securities and tax law matters.
- Not legally required yet, but IRS has been asking issuers for several years about whether they have certain federal tax compliance policies in place.
  - Form 8038-G.
  - Common assumption is that not "checking the box" will increase audit risk, although IRS denies it.
  - Policies & procedures already part of SEC's review.
- If you have a policy, make sure to review it regularly (at least annually).
- Ignoring/flagrantly violating an official policy creates additional problems.

Questions?

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