

CDIAC
DEBT BASICS
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INITIAL DISCLOSURE
OBLIGATIONS OF MUNICIPAL BOND ISSUERS

Presented by
Victor Hsu
vhsu@fulbright.com

FULBRIGHT
& Jaworski L.L.P.
Attorneys at Law

Outline

- ◆ Introduction
- ◆ Legal Foundation
- ◆ Disclosure Documentation
- ◆ The Disclosure Drafting Process
- ◆ Conclusion

Basic Statutes

- ◆ Securities Act of 1933
- ◆ Securities Exchange Act of 1934
- ◆ Investment Company Act of 1940
- ◆ Trust Indenture Act of 1939



Securities Act of 1933

- ◆ Registration and Line-Item Disclosure Regime
- ◆ Requires SEC registration before securities may be sold in a public offering, unless an exemption exists
- ◆ “Securities” is defined expansively, and includes guarantees and other credit support (so-called “separate securities”)
- ◆ Requires Underwriters to perform due diligence prior to public offering of securities
- ◆ Prohibits fraud in offer or sale of securities (Section 17(a))
- ◆ BUT...

Securities Act of 1933 (*cont.*)

- ◆ Municipal securities are generally **exempt** from '33 Act registration
- ◆ Section 3(a)(2) (exemption for any security issued or guaranteed by any state or any political subdivision or public instrumentality of a state or territory)
- ◆ Section 3(a)(3) (exempts bank securities such as letters of credit and standby bond purchase agreements)
- ◆ Section 3(a)(6) (exempts insurance policies)
- ◆ Antifraud provisions of Section 17(a) still apply; enforced by SEC

Securities Exchange Act of 1934

- ◆ Broker, Dealer and Municipal Securities Dealer Regulation
- ◆ Specifies ongoing reporting requirements for issuers of securities registered under the '33 Act
- ◆ Section 10(b) – prohibits fraud in purchase or sale of securities; applicable to municipal securities transactions
- ◆ Rule 10b-5 - no material inaccuracies; no materially misleading omissions
- ◆ Includes private right of action, as well as civil enforcement by SEC and criminal enforcement by DOJ
- ◆ Tower Amendment (immunity from SEC registration)
- ◆ Rule 15c2-12



SEC Rule 10b-5

“It shall be unlawful for any person, directly or indirectly, . . . to make any untrue statement of a material fact or to 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”

Disclosure Documentation

- ◆ Preliminary Official Statement and Official Statement
- ◆ Analogous to Prospectus in corporate financings; marketing materials intended for potential and actual investors
- ◆ In contrast to SEC-registered offerings, there is no legally specified format for POS and OS disclosure
- ◆ Typically prepared by Disclosure Counsel or Underwriter's Counsel with input from financing team
- ◆ No matter who does the drafting, the issuer (and not the lawyers!) retains responsibility for accuracy and is primarily liable for securities law violations for inadequate disclosure
- ◆ Other documents with disclosure significance
 - closing certificates
 - continuing disclosure annual reports and listed event notices

Preliminary Official Statement (POS)

- ◆ Describes terms of the securities offered, minus final pricing information
- ◆ Includes information about the issuer, including relevant financial information and operating data
- ◆ Typically includes audited financial statements
- ◆ Must be reviewed by the Underwriter before it bids for or offers to purchase and sell the bonds
 - required by federal securities laws
 - establishes “due diligence” defense for underwriters (this defense is not available to issuers)
- ◆ SEC Rule 15c2-12 requires the Underwriter to confirm that issuer has “deemed final” the Preliminary Official Statement
- ◆ Rule 15c2-12 digression

Official Statement (OS)

- ◆ Content almost identical to POS but also includes final pricing information, including principal amounts, maturities and interest rates
- ◆ Delivered to Underwriter within seven business days of bond pricing and in time to accompany buyer confirmations
- ◆ Generally required to be posted on MSRB's EMMA system.

The Disclosure Drafting Process

- ◆ Hire Competent Professionals
- ◆ Issuer Policies and Procedures
- ◆ Rule 10b-5 Considerations
- ◆ Special Considerations regarding Audited Financials
- ◆ SEC Plain-English Rules

Hire Competent Professionals

- ◆ Potential securities fraud liability is ever present
 - Financings almost always involve significant amounts of money, and disclosure deficiencies can lead to significant losses
 - SEC has made it clear that it will take enforcement action for inadequate disclosure, even when there are no payment defaults or investor losses
 - SEC has increased its scrutiny over the municipal securities market; believes the market to be under-regulated and rife with disclosure abuses

Hire Competent Professionals (*cont.*)



- ◆ Severe consequences for getting it wrong, including civil and criminal liability
 - Not limited to SEC civil injunctions and fines
 - In enforcement actions following the Orange County bankruptcy, Treasurer-Tax Collector was convicted of six felonies; Assistant Treasurer convicted of five felonies and sentenced to three years in prison
 - In enforcement actions relating to the City of San Diego's pension underfunding, five City officials and four Pension Board officials faced variety of federal and State civil and criminal charges
- ◆ You can reasonably rely on your hired professionals and consultants, but they cannot absolve you of responsibility for fair and accurate disclosure

Issuer Policies and Procedures

- ◆ Staff your in-house financing team with experienced members
- ◆ Clearly identify roles and responsibilities
- ◆ Checks and balances
- ◆ Guidance from SEC enforcement action against City of San Diego and 2007 White Paper to Congress



Rule 10b-5 Considerations

- ◆ No material inaccuracies or materially misleading omissions
- ◆ Materiality
 - substantial likelihood that a reasonable investor would consider the statement or omission as significant to the investment decision
 - objective standard
- ◆ No one-size-fits-all checklist approach
- ◆ Guidance from SEC enforcement actions

Special Considerations Regarding Audited Financials

- ◆ Disclosure Problems Caused by Stale Financials
- ◆ Quantitative versus Qualitative Materiality – SAB 99
- ◆ Pro Forma Presentations
- ◆ Management Discussion and Analysis – GASB 34
- ◆ Auditor Consents and Related Disclosure

SEC Plain-English Rules

- ◆ SEC Rule 421(b) applies to '33 Act registered offerings, but can be useful guidance for municipal offerings
- ◆ Rule 421(b) applies to prospectus cover page, Summary and Risk Factors sections
- ◆ Plain English writing principles
- ◆ Goal is to enhance readability



Great Moments in Municipal Securities History

- 1975 — New York City defaults on \$4 billion of commercial paper
- 1983 — WPPSS defaults on \$2.25 billion of bonds
- 1994 — Orange County files largest municipal bankruptcy case in history (until Jefferson County, Alabama took the crown in 2011)
- 2004 — City of San Diego discloses massive pension and retiree health liabilities
- 2008 — Subprime mortgage crisis; conservatorship of Fannie Mae and Freddie Mac; rating downgrades of municipal bond insurers; sale of Bear Stearns to J.P. Morgan; bankruptcy of Lehman Brothers; sale of Merrill Lynch to Bank of America; start of multi-year period of fiscal stress for thousands of local governments

Conclusion

- ◆ What will you take away from this?
- ◆ Key thoughts
- ◆ Questions and Answers





For additional information please contact:

Victor Hsu

Fulbright & Jaworski L.L.P.

(213) 892-9326

vhsu@fulbright.com

