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*The Bond Buyer's* 24<sup>TH</sup> Annual  
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# ALTERNATIVE FINANCING IN THE MUNICIPAL MARKET: FINANCIAL AND POLICY CONSIDERATIONS

OCTOBER 8, 2014

SAN DIEGO, CA

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**SESSION FOUR:  
DISCLOSURE AND REPORTING –  
EXPOSING THE INTERSECTION  
BETWEEN MUNICIPAL SECURITIES  
AND OTHER FORMS OF DEBT**

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# DISCLOSURE GAPS FOR DIRECT BANK LOANS

## How did we get here?

Lisa Washburn, Managing Director

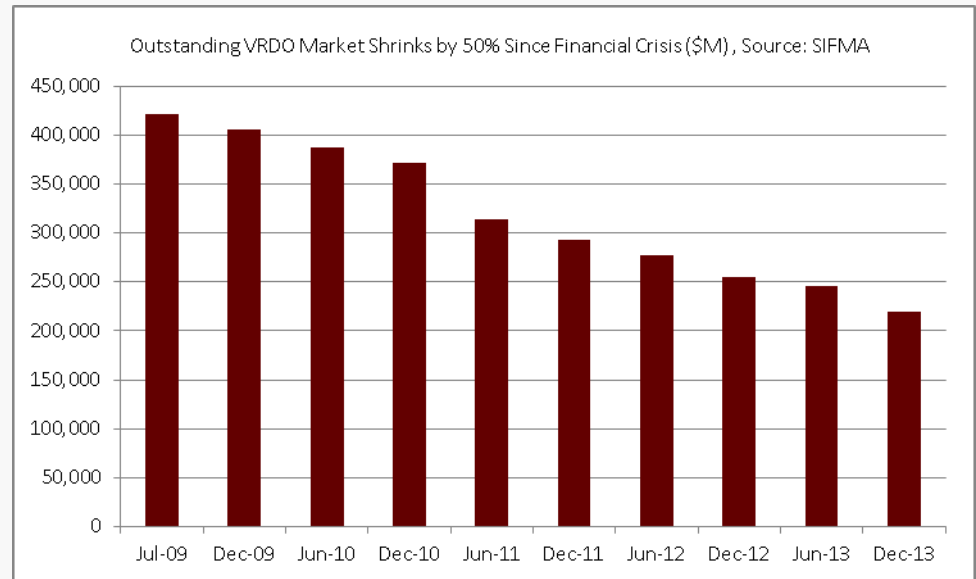
October 8, 2014

## **Gaps in disclosure become clearer during the financial crisis**

- **During the crisis the municipal market experienced**
  - Collapse of the bond insurance industry
  - ARS market failure
  - VRDO tenders
- **Bank bonds, high max rates, accelerated repayments**
  - Counterparty troubles causing issuer credit strains
  - Incomplete disclosure of terms, lack of public documents
- **Issuer credit critical; no longer masked by insurance**
- **Greater investor appreciation of “hidden risks”**

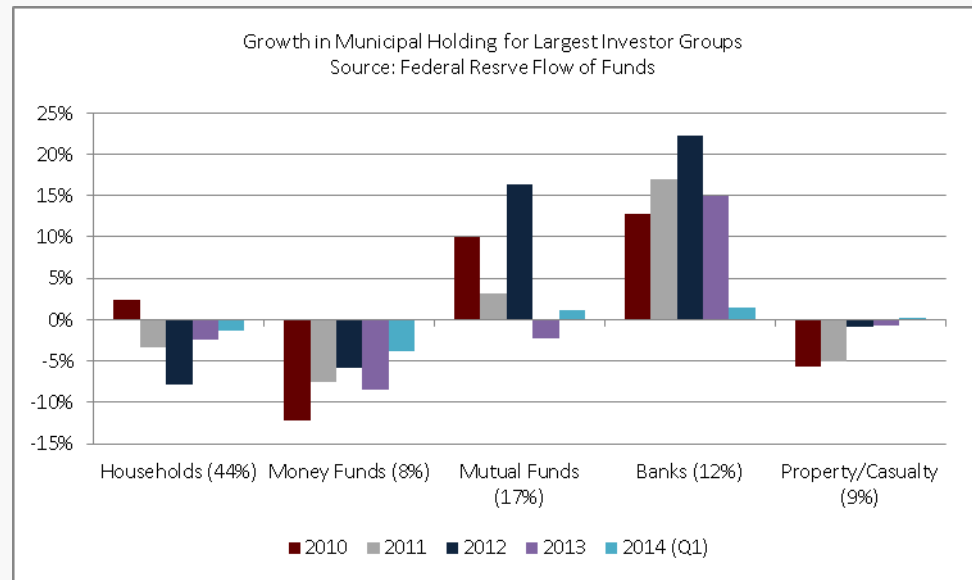
## MSRB implements changes to SHORT system

- **Additional terms, documents**
- **Did not become effective until 2011, after financial crisis**
  - Dramatically shrinking VRDO market
- **Less available credit and liquidity and higher cost**
  - Some providers exit market
  - Others no longer effective counterparties for Rule 2a-7
- **And, issuer avoidance of structure**



## But as VRDO market declines, similar risks emerge in growing bank loan market

- Issuers left with non-performing VRDOs need solution
- Downgraded banks need an alternative to stay in market
- ***Direct bank loans fill the gap***
  - At first, good fix for broken VRDOs
  - Other benefits accelerate product growth



## Direct loans have advantages for issuers

- Access to an alternate source of capital and new lenders
- Customized arrangement between issuer and lender
- Familiar structure (VRDO-like) but without the counterparty (bank and remarketing risk)
- Less costly; typically no ratings, no offering document
- *No required disclosure under 15c2-12, yet direct loan typically poses similar credit and liquidity risks to issuers as VRDOs*

## **Although not required existing bondholders need disclosure**

- **Dodd-Frank mandate to remove reliance on rating agencies**
  - Investors required to make independent credit assessment
- **Entering into a new bank loan can impact credit and/or liquidity profile**
  - Increase debt outstanding
  - Potentially different covenants and remedy triggers
  - Assets previously available may have been pledged to bank
  - Structural risks, such as a balloon payment
- **Lack of/delayed disclosure impairs investor ability to make timely assessment of the loan's impact on the issuer's credit profile and impedes**
  - Ability to assess whether to hold or sell bonds
  - Assess impact of rating deterioration (asymmetrical information)
  - Valuation of the bonds



## **Industry recognition that better direct loan disclosure is needed**

- **Bank Loan Disclosure Task Force published white paper “Consideration Regarding Voluntary Secondary Market Disclosure”**
  - American Bankers Association (ABA), Bond Dealers of America (BDA), Government Finance Officers Association (GFOA), Investment Company Institute (ICI), National Association of Bond Lawyers (NABL), National Association of Health and Educational Facilities Finance Authorities (NAHEFFA), National Association of Independent Public Finance Advisors (NAIPFA), National Federation of Municipal Analysts (NFMA), Securities Industry and Financial Markets Association (SIMFA)
- **MSRB Notice 2012-18 encouraging voluntary disclosure**
- **S&P published on requirement to disclose bank loans to them and ramifications for failure to do so**
- **GFOA published “Best Practice Understanding Bank Loans”**

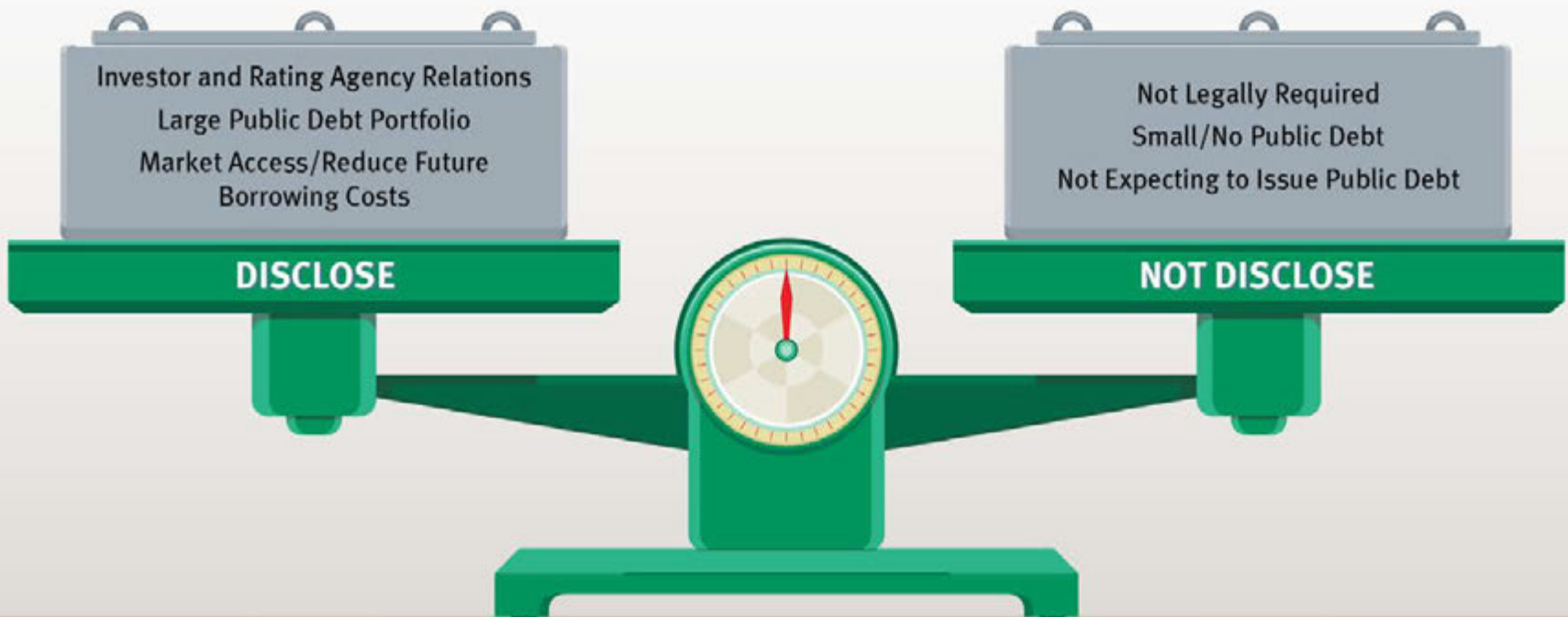


# Disclosure Rules for Direct Purchases: What Disclosure is Legally Required?

Presented by:  
Jenna Magan, Partner  
Orrick, Herrington & Sutcliffe

October 8, 2014

# To Disclose...or Not to Disclose... That is the Question



## Two Main Disclosure Rules

### Federal Securities Laws (Securities Exchange Act of 1934)

1. Rule 15c2-12
2. Rule 10b-5

### Both Rules apply to “securities”

- » If the direct purchase is considered a “loan” instead of a “security” under the federal securities laws, it is not subject to these rules
- » Hard to conclude if the instrument being purchased is called a “note” or “bond” -- even if the purchaser is willing to book it as a loan for its internal accounting purposes

## Rule 15c2-12

- Broker-dealer may not underwrite an issue of municipal bonds unless the underwriter has been able to:
  - » obtain and review an official statement that the issuer deems final as of its date; and
  - » obtain agreement of the issuer to provide continuing disclosure (annual reports and notices of specified “material events”)
- There are certain exemptions

## Rule 15c2-12: Exemptions

- No official statement is required in typical direct purchase because:
  - » Issues with denoms of \$100,000 or more are exempt if sold to no more than 35 sophisticated investors who do not have intent to resell
  - » May conclude that Rule 15c2-12 does not apply because:
    - there is no underwriting
    - there is no “municipal security”
- Bottom Line for Issuers: Rule 15c-12 applies to underwriters, not issuers, so reasonable to defer to direct purchaser or another party to determine whether transaction is subject to Rule 15c2-12

# Rule 15c2-12: Reporting of Incurrence of Additional Debt Not Required



- No material event notice is required for incurrence of additional debt because:
  - » Rule 15c2-12 does not require that an issuer notify the market any time something “material” happens; and
  - » Rule 15c2-12 only requires notice of specified “material events”
- Best Practice for Issuers: Consider voluntary disclosure of incurrence of additional debt in direct purchase transaction if outstanding public debt



# Rule 10b-5



“It shall be unlawful for any person . . .

a) To employ any device, scheme or artifice to defraud,

b) 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 . . . .”

Must be “in connection with the purchase or sale of any security”





# The “Materiality” Standard

- “[w]hether or not there is a substantial likelihood that a reasonable investor or prospective investor would consider the information important in deciding whether or not to invest”
- Materiality is determined in context of all the facts and circumstances, but usually on a retroactive basis
- Guidance comes primarily from court decisions and SEC enforcement cases

## Rule 10b-5: In Direct Purchases

- No exemption from Rule 10b-5 for direct purchases
  - » Note that Rule 10b-5 only applies to “securities”
- Practice in direct purchase deals is that Issuer addresses 10b-5 issues without need to provide disclosure document to investor by:
  - » Disclosing material facts to the investor;
  - » Allowing investor to ask issuer questions and do its diligence; or
  - » Obtaining investor letter

## When Does Rule 10b-5 Apply?

- There is no requirement under federal securities laws for issuers to continuously update investors
- Rule 10b-5 applies whenever an issuer is “speaking to the market”
  - » New offerings
  - » Annual Report under Rule 15c2-12
  - » Voluntary Filings
    - If issuers choose to voluntarily disclose direct purchase or post redacted documents, keep in mind that Rule 10b-5 applies

# Bank Loans - What are the Applicable GASB Accounting and Disclosure Requirements?

***GASB Chair David A. Vaudt***  
***October 8, 2014***

*The views expressed in this presentation are those of Mr. Vaudt. Official positions of the GASB on accounting and financial reporting matters are determined only after extensive due process and deliberation.*

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# GASB Accounting Requirements

- Propriety Fund (Business-Type Activities) Financial Statements
  - *Account for bank loans directly related to, and expected to be paid from, proprietary funds as liabilities in the proprietary fund financial statements*
  - Bonds, notes and other long-term liabilities of proprietary funds are specific fund liabilities, even though the full faith and credit of the government may be pledged as further assurance
  - GASB Codification 1500.102

# GASB Accounting Requirements

- Governmental Fund Financial Statements
  - *Account for non-proproprietary fund bank loan amounts due and payable, if any, as liabilities in the governmental fund financial statements*
  - Due and payable – matured, but unpaid principal and interest
  - Generally unmatured non-proproprietary fund long-term indebtedness should not be recorded in governmental funds
  - GASB Codification 1500.103, 1500.121-.123, and 1600.120-.122

# GASB Accounting Requirements

- Government-Wide Financial Statements
  - *Report bank loans related to proprietary funds as liabilities in the “business-type activities” column of the government-wide financial statements*
  - *Report all other bank loans as liabilities in the “governmental activities” column of the government-wide financial statements*
  - GASB Codification 1500.102 and 1500.121

# GASB Disclosure Requirements

- Note Disclosures about Long-Term Liabilities
  - *Include all bank loans on the schedule of long-term liabilities in the notes to the financial statements*
    - *Beginning- and end-of-year balances*
    - *Increases and decreases*
    - *Portions of each item that are due in one year*
  - Long-term liabilities – such as bonds, notes, loans, and leases payable
  - GASB Codification 2300.120
  - See GASB Statement 34, Appendix C, for an illustration of a schedule of long-term liabilities



# GASB Disclosure Requirements

- Note Disclosures about Debt Service Requirements
  - *Include the principal and interest requirements on all bank loans in the notes to the financial statements*
    - *Principal and interest requirements to maturity*
    - *Presented separately for each of the five subsequent fiscal years and in five-year increments thereafter*
    - *The terms by which interest rates change for variable-rate debt*
  - GASB Codification 2300.120
  - See GASB Statement 38, Appendix C, Illustration 7 for an example disclosure of debt service requirements

# GASB Disclosure Requirements

- Note Disclosures about Significant Violations of Legal or Contractual Provisions
  - *Include disclosure of significant violations of bank loan related covenants, and actions taken to address such violations, in the notes to the financial statements*
  - GASB Codification 1200.112
  - See GASB Statement 38, Appendix C, Illustrations 5 and 6 for example disclosures of legal or contractual provision violations



# Voluntary Disclosure of Bank Loans

Lynnette Kelly, *MSRB Executive Director*

# Background

- State and local governments increasingly using bank loans as a municipal financing tool
- Banks have long played a role in municipal finance, for example through liquidity facilities and letters of credit to support variable rate demand obligations
- Like bank loans, VRDOs not initially covered under existing disclosure framework
- Emerging products and practices raise questions about disclosure

# MSRB Resources on Bank Loans

- Determining whether a bank loan is a security ([MSRB Notice 2011-52](#))
- Providing voluntary disclosure on bank loans on EMMA ([MSRB Notice 2012-18](#))

# Voluntary Disclosures on EMMA

- Issuers may provide additional information to market participants on a voluntary basis via **EMMA**® including:
  - Information about bank loans
  - Pre-sale information such as preliminary official statements or investor and rating agency presentations
  - Information about the timing of and accounting standard used to prepare annual financials
  - Investor website address

# Disclosure Resources for Issuers

- “Putting EMMA to Work for You” outreach campaign
- MSRB Education Center
  - <http://www.msrb.org/EducationCenter.aspx>
- Email reminders for recurring financial disclosures
- Customizable display of issuer information on EMMA’s issuer homepages