Chapter 10

CONTINUING DISCLOSURE AND INVESTOR RELATIONS PROGRAMS

In order to issue debt, an issuer is required to provide disclosure (usually in the form of an Official Statement) to actual and potential investors at the time the debt is originally issued. Descriptions of the process of preparing this initial disclosure are provided in **Chapter 1, Overview of a Debt Financing** in the sections titled **Roles and Responsibilities of Principal Participants** and **Basic Legal Documents**. In addition, issuers are required in most cases to provide certain ongoing disclosure to investors and the market regarding their outstanding issues. This chapter of the *California Debt Issuance Primer* discusses these ongoing disclosure requirements and the related topic of investor relations programs.

When an Official Statement is prepared, issuers and their teams make line-by-line decisions about whether information is material to investors. However, despite the customary emphasis placed on the Official Statement, new issue disclosure in an Official Statement should be understood to be just one part of an overall program of continuing disclosure provided by each issuer in response to:

- Legal requirements
- The issuer's governmental functions, and
- The need for efficiency in transmitting material information to investors

Regardless of the requirements of the Securities and Exchange Commission's (SEC) securities laws and rules, issuers should determine whether it is in their financial interest and the interest of the public they serve to:

- Provide continuing disclosure on a periodic basis more frequently than required by securities laws
- Establish a procedure for the communication of material new developments in a format appropriate for investors, and
- Create an investor relations program

In considering these possibilities for extending investor disclosure, it is important for issuers of municipal securities to review the existing legal requirements for continuing disclosure. In addition, it is useful to understand the separate legal requirements for private corporations in

making continuing disclosure and to recognize the differences between corporate finance and public finance. The corporate model is based on distinct requirements of the securities laws and the stock exchanges, however the corporate rules are based on practical experience and thus provide useful insights for municipal issuers who are developing voluntary disclosure programs.

Continuing Disclosure Requirements

SEC Rule 15c2-12 requires issuers of municipal securities and certain other "obligated persons" to make contractual promises to provide continuing information to the marketplace during the life of securities' issues. An underwriter is not permitted to purchase or sell municipal securities in connection with a primary offering of $1 million or more unless it has "reasonably determined" that an issuer of municipal securities or an obligated person has undertaken in a written agreement for the benefit of holders of the securities to provide (by filing with certain specified national and state information repositories) the following four categories of information:

- Certain annual financial information for each obligated person for whom financial information or operating data is presented in the final Official Statement, or for obligated persons meeting certain objective criteria

- If not provided with the annual financial information, then when and if available, the audited financial statements of the obligated person(s)

- Timely notices of the occurrence of any of the 11 events described later in this chapter, if material to bondholders

- Notice of any failure to file the required annual financial information

An obligated person is defined to mean "any person who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations on the municipal securities to be sold," and will be required to provide continuing disclosure. In pure conduit financings, the borrower/obligor will often undertake the full responsibility for continuing disclosure.

The annual financial information for the annual report is to be "financial information or operating data . . . of the type included in the final Official Statement with respect to such obligated person . . . ." Generally, this will be quantitative data derived from the obligated person's records. Financial information is described by the SEC as the type of information that is provided in the financial statements of a corporation subject to generally accepted accounting principles. Nonetheless, it is recognized that many governmental entities do not report their financial information in the form of a corporate balance sheet, income statement, or changes in fund balances.

The operating data required to be provided annually, like the financial information, is operating data of the type set forth in the Official Statement. The SEC uses a hospital financing to illustrate the intended requirements. An Official Statement for a hospital financing describes the hospital, its administration and management, economic base, service area, and capital plans. This information is not operating data. Operating data includes such statistics as bed utilization, admissions, categories of admissions (such as coronary care, pediatrics, etc.), and payor information (such as percentages of Medicare, Medicaid, and private insurance). It is this information, which varies from year to year, that is considered operating data subject to the annual disclosure requirements.

To summarize, the final Official Statement—a disclosure document drafted in light of the requirement of the federal securities laws to disclose material facts—is the determining source of the financial information and operating data to be provided annually. Nonquantitative information disclosed in the final Official Statement that is neither financial information nor operating data is not subject to annual disclosure regardless of its materiality unless its disclosure is necessary to prevent the quantitative disclosure from being misleading. Although there is no legal duty to disclose nonquantitative material information annually, issuers may find that it is in their best interests to undertake voluntarily a program of more comprehensive annual disclosure. The full text of SEC Rule 15c2-12 is set out in **Appendix D – Legal References**.

DisclosureUSA; Central Post Office

On September 7, 2004, SEC staff issued an Interpretative Letter expressing the view that an issuer that chooses to satisfy an existing undertaking under SEC Rule 15c2-12 by transmitting continuing disclosure filings, either directly or indirectly, through an indenture trustee or a designated agent to DisclosureUSA for submission to the Nationally Recognized Municipal Securities Information Repositories (NRMSIRs) and any applicable State Information Depository (SID), is acting in a manner consistent with the intent of Rule 15c2-12. Accordingly, local agencies may now make continuing disclosure filings under Rule 15c2-12 electronically at a single location through the use of the website or “central post office” created for this purpose at **www.DisclosureUSA.org**. DisclosureUSA is an Internet-based electronic filing system whereby issuers and other filers may upload documents for immediate transmission, together with Committee on Uniform Securities Identification Procedures (CUSIP) numbers and other indexing information, to each NRMSIR and any appropriate SID.

The DisclosureUSA website is a “central post office” that forwards local agency filings to each NRMSIR and any applicable SID. By filing with DisclosureUSA, local agencies need not file directly with the NRMSIRs and SIDs. DisclosureUSA provides an electronic return receipt to filers as evidence that a filing has been received by each NRMSIR and, if required, each SID. The website also includes an optional electronic “tickler” system to notify persons and agencies of upcoming filing deadlines.

If a local agency is unable to submit its filings electronically, it may submit paper filings for a fee. The filings will be converted to electronic format, indexed, and forwarded to the NRMSIRs and any appropriate SIDs. Electronic filings made on the DisclosureUSA website are free of charge.

Distinguishing Corporate Periodic Disclosure

The requirement that annual financial information be determined by reference to the final Official Statement is highly significant and is best understood by comparison with corporate requirements. The regulatory model for corporate finance, based on Congressional enactment of Sections 12, 13, and 15 of the Securities Exchange Act of 1934 ("1934 Act"), authorizes the SEC to define line item continuing disclosure rules directly mandating the use of Forms 10-K and 10-Q by 1934 Act reporting companies. SEC Regulation S-K provides specific line item disclosure requirements of general applicability for all reporting companies regardless of variations in the industries they represent.

For public finance, the SEC has determined that rules of general applicability would be unworkable as the issuers of municipal securities are simply too diverse. In addition, Section 103 of the Internal Revenue Code of 1986, as amended, permits tax-exempt financings by states and political subdivisions in which capital is raised for persons other than the governmental issuer of the securities. These various "obligated persons" compound the diversity in public finance. The SEC concluded that for public finance it would be necessary to modify the line item regulatory model contained in SEC rules and regulations that are applied to 1934 Act reporting companies.

Rule 15c2-12(b)(5) developed a standard of annual disclosure that was designed to provide flexibility for each offering of municipal securities. The line items for continuing disclosure are derived from the information set forth in the Official Statement. The Official Statement is prepared under the standard of care required by Section 17 of the Securities Act of 1933 and by Section 10 of the 1934 Act, including Rule 10b-5. The full text of these provisions is set out in **Appendix D – Legal References**.

An Official Statement must contain all information that is material to the offering in light of the circumstances in which the information is given. Rule 15c2-12(b)(5) requires that the financial information and operating data, determined at the time of preparation of the Official Statement to be material, is to form the basis of the line item annual disclosure drafted into the continuing disclosure agreement.

The public finance model accordingly establishes a set of line item continuing disclosure requirements unique to each financing. The method for determining the line items is found in the rule, but the line items dictating the content of annual disclosure must be drafted into a contract for each financing—the continuing disclosure agreement—in order to bind the issuer or other obligated persons.

The SEC's recognition that municipal issuers cannot be subjected to the rules of general applicability that apply to for-profit private corporations should be fully appreciated when developing a voluntary program for more frequent or more extensive continuing disclosure than required by Rule 15c2-12, and for developing an investor relations program. Like the Official Statement and the continuing disclosure obligation, voluntary programs are apt to vary among the different types of municipal issuers.

Continuing Disclosure Agreement

The contractual undertaking required by Rule 15c2-12—the continuing disclosure agreement—must:

- Include the name(s) of the entity or entities that will provide the annual reports and event reports, either by name or by describing objective criteria
- Specify the type of financial information and operating data that will be included in the annual report
- Specify the accounting principles to be used for any financial statements, and whether they will be audited
- Indicate the date in each year by which the annual report for the preceding fiscal year will be provided

The promise to make the annual reports and the event reports must be included in the trust indenture, bond resolution, loan or lease agreement, or some other document that is enforceable by bondholders, and also must be reflected in the bond purchase contract or notice of sale for competitively bid issues, and described fully in the Official Statement. Noncompliance must be reported to the repositories and disclosed in future Official Statements for five years, thus adversely affecting the market for the issuer's bonds.

Event Disclosure

The 11 events that must be disclosed, when they occur, are:

- Principal and interest payment delinquencies
- Nonpayment related defaults
- 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 or events affecting the tax-exempt status of the security

- Modifications to rights of security holders
- Optional or unscheduled bond calls
- Defeasances
- Release, substitution, or sale of property securing repayment of the securities
- Rating changes

Exemptions from Rule 15c2-12

Certain exemptions apply to Rule 15c2-12. The primary market and continuing disclosure provisions of Rule 15c2-12 do not apply to a primary offering of bonds in authorized denominations of $100,000 or more if:

- Sale is made to no more than 35 sophisticated investors (as defined)
- Bonds have a maturity of nine months or less
- Bonds have tender rights at par at least every nine months

In addition, there are two partial exemptions for the continuing disclosure rules only:

- The requirement to provide annual reports will not be applied to issues with 18 months or less maturity (but they must undertake to make the event disclosures)
- Certain "small issuers" (i.e. no obligated person with respect to more than $10 million in outstanding bonds at the time of the issuance) may make less specific annual reports, and file them in fewer places. These small issuers must still make the event disclosures.

Reasons Not to Expand Continuing Disclosure

Unless one of the listed 11 events occurs, continuing disclosure under SEC Rule 15c2-12 is on an annual basis and is limited to predetermined financial information and operating data contained in the Official Statement. The continuing disclosure requirement therefore does not necessarily include all material information. In determining whether to voluntarily expand continuing disclosure to quarterly or semiannual periods or to cover more extensive information, an issuer of municipal securities should consider the following reasons not to provide more information:

- If the issuer is exempt under SEC Rule 15c2-12, it is arguable that continuing disclosure is not material to the marketplace. For example, securities of an issuer subject to the small issuer exemption may not actively trade and therefore the benefit to the market may be outweighed by the cost to the issuer. However, while unenhanced issuers of variable rate demand obligations (VRDOs) technically

qualify for the exemption, the marketplace—particularly money market funds—does need regular updates of financial and operating data, and many investors may not purchase an unenhanced VRDO if continuing disclosure is not available.

- If the issuer is a conduit issuer, continuing information about the issuer may not be material. For example, if the issuer finances hospitals, universities, private companies, etc., material continuing disclosure is more likely to be based on information about the underlying borrower.

- The issuer may not be able to prepare financial information and operating data at intervals more frequently than annually. The 1934 Act requires reporting companies to bear the cost of preparing the quarterly financial information included in Form 10-Q, but the expense of quarterly or semiannual accounting procedures may not be justified for a municipal issuer of debt that trades relatively infrequently when compared to a corporate issuer of stock.

- Material misstatements or omissions in the annual or event reports may be the basis for claims of securities fraud under Rule 10b-5 and other federal or state securities laws, actionable by the SEC or private plaintiffs (bondholders or other investors), with potential liability for issuers or other obligated persons

Reasons for Expanding Annual Continuing Disclosure

The diversity of the municipal securities market necessitates that any decision to bear the cost of voluntarily expanding the continuing disclosure obligation will require consideration of a number of factors including:

- The amount of debt outstanding
- The size of the issuer
- The type of securities issued
- The volatility of secondary market prices
- The volume of trading activity
- Whether material information about the issuer or its securities frequently changes
- The practicality of preparing periodic information

The following points illustrate why many issuers may choose to expand disclosure:

- The preparation of regular periodic information provides the issuer with opportunities for managerial control of information. Preparation of disclosure information at the time of drafting an Official Statement may be a highly inconvenient time for the issuer to assemble information. Furthermore, the

pressures from underwriters and lawyers in the context of a new distribution to gather information may result in a loss of control of the substance and format of the disclosure. If market information is prepared outside the context of a new offering, the issuer is in a better position to time the preparation of disclosure to the receipt of internal information, such as the annual audit.

- If, for example, an information package is prepared each February 1 and August 1, staff can be organized on key dates before the information package is delivered to assemble the necessary information

- Periodic updates allow the possibility of Official Statements cross-referencing the information already in the marketplace. This is the corporate model. New corporate issues for many reporting companies incorporate by reference the information previously filed on Forms 10-K and 10-Q. SEC Rule 15c2-12 was drafted to allow new issue disclosure in Official Statements to reference existing disclosure in the marketplace. An Official Statement that cross-references periodic disclosure can therefore be an abbreviated document requiring considerably less time to prepare than is ordinarily the case.

- A portion of the Official Statements of many frequent issuers contains information that is relatively constant and can be reviewed at periodic intervals without the necessity of review each time an Official Statement is prepared

- There are circumstances in which a variety of issuers have the same "obligated person" providing security. The obligated person can control the disclosure about itself by periodic filings at the national repositories. The various issuers cross-reference the information periodically filed by the obligated person.

- The SEC and many scholars prefer the corporate model of emphasizing regular, periodic disclosure rather than disclosure when capital is formed by the issuance of bonds. The information transmitted to investors is said to be more efficiently communicated to the benefit of both the marketplace and the issuers.

Reasons for Expanding Event Disclosure

The timely disclosure of the listed 11 events does not require timely disclosure of all material information—an approach that follows the corporate requirements of the federal securities laws. Reporting companies under the 1934 Act are required to file timely reports on specific events on Form 8-K, otherwise there is no general securities law requirement to disclose material information until the filing of the next Form 10-Q or 10-K.

Many private companies, however, trade on exchanges or are subject to National Association of Securities Dealers (NASD) rules for over-the-counter trading. For example, the New York Stock Exchange (NYSE) Manual provides as follows:

- A listed company is expected to release quickly to the public any news or information that might reasonably be expected to materially affect the market for its

securities. This is one of the most important and fundamental purposes of the listing agreement that the company enters into with the NYSE.

- A listed company also should act promptly to dispel unfounded rumors that result in unusual market activity or price variations

- It should be a company's primary concern to assure that news will be handled in proper perspective. This necessitates appropriate restraint, good judgment, and careful adherence to the facts. Any projections of financial data, for example, should be soundly based, appropriately qualified, conservative, and factual. Excessive or misleading conservatism should be avoided. Likewise, the repetitive release of essentially the same information is not appropriate.

- Few things are more damaging to a company's shareholder relations or to the general public's regard for a company's securities than information improperly withheld. On the other hand, volumes of press releases are not useful since important items can become confused with trivia.

The SEC does not address timely disclosure of material information because it is extensively covered by self-regulatory agencies, such as the stock exchanges. The NYSE Manual deals with the means of timely disclosure in the following manner:

> "The normal method of publication of important corporate data is by means of a press release. This may be either by telephone or in written form. Any release of information that could reasonably be expected to have an impact on the market for a company's securities should be given to the wire services and the press 'For Immediate Release.'"

The need for immediate disclosure may not be as apparent in the less volatile municipal debt market as it is in the more unpredictable corporate stock market. However, the corporate disclosure system sets a standard that should be evaluated in light of the issuer's circumstances. The Government Finance Officers Association (GFOA) urges prompt disclosure of material information but suggests that filing with a repository rather than a press release ordinarily will be an appropriate channel of communication.

A major reason the NYSE and other self-regulatory organizations that govern disclosure of private corporations are adamant about timely disclosure of material financial news is managerial control. It is in the best interest of both the corporation and investors for the corporation to control the flow of information to the marketplace. If management does not release material information promptly, it is likely to find itself responding to rumors and attempting to correct misinformation.

The problem of rumor and misinformation is particularly significant in the public sector. The news media is likely to uncover information, or politicians with their own agendas are likely to leak information, if it is not released in an orderly manner by officials responsible for

communications with investors. Neither the media nor politicians should be the primary source of dissemination of material information.