ISSUE BRIEF

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ELECTRONIC DISCLOSURE

By facilitating rapid and widespread information dissemination, the Internet has had a significant impact on capital-raising techniques and, more broadly, on the structure of the securities industry. **SEC Interpretation: Use of Electronic Media**, April 28, 2000

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INTRODUCTION

Background

To the municipal issuer, disclosure should be an important part of its investor relations program. Fundamentally, it protects the interests of the bondholder and the issuer. In theory, if potential bond investors have unfettered access to financial data, they will have more information on which to base their purchase decisions and will choose investments appropriate for their portfolios.

The business reasons for the issuer to disclose are many. Theoretically, the more information readily available to the market, the more efficiently bonds will be priced. At a minimum, a poorly disclosing issuer's future bond issues may subsequently be viewed as "risky" to potential buyers and underwriters, leading ultimately to higher costs to sell the bonds because of the potential for "surprises." Therefore, good disclosure is crucial for municipal issuers.

Issuers of municipal securities are beginning to use the Internet to provide disclosure information about the entity and their outstanding bonds, as well as new offerings of their securities. The trend toward increased availability of information through the Internet has the promise to help to promote transparency, liquidity, and efficiency in capital markets. At the same time, this trend opens up new questions regarding what, how, and when information needs to be disseminated electronically.

Overview

This Issue Brief begins with a summary of Securities and Exchange Commission (SEC) disclosure requirements and discusses ways the bond community utilizes electronic disclosure to supplement and/or meet disclosure requirements. Next, the Issue Brief discusses SEC's recently published Interpretation on the use of electronic media, as well as how this Interpretation was received by the bond community. Lastly, the Issue Brief gives a number of recommendations that issuers should consider when contemplating an electronic disclosure program or fine tuning an existing program. Appendix A found at the end of the Issue Brief, provides more detail on SEC disclosure rules. Appendix B provides

references on the topic of municipal disclosure.

SEC DISCLOSURE REQUIREMENTS

SEC Rules 15c2-12 and 10b-5 have set the basic regulatory cornerstone for good municipal securities disclosure (see Appendix A for a more detailed explanation of these disclosure provisions). In general, these rules require an underwriter, for offerings in excess of $1 million, to obtain, review and distribute to investors copies of the issuer's preliminary official statement (POS) and final official statement (OS). In turn, the underwriter is required to send the POS to any potential customer until the OS is available. In addition, for continuing disclosure, the SEC requires underwriters, with limited exceptions, in order to purchase or sell municipal securities in a primary offering, to determine that the issuer has undertaken a written agreement to provide continuing disclosure information (such as annual financial statements and material event notices) to the market. Failure to accurately and completely adhere to these requirements and related continuing disclosure agreements exposes both the underwriter and issuer to potential liability from the SEC and from private parties.

USES OF ELECTRONIC MEDIA TO ADDRESS DISCLOSURE REQUIREMENTS

There are a number of ways the municipal bond community uses electronic delivery for disclosure purposes. One area is delivery of an OS as required by SEC Rule 15c2-12. As stated previously, underwriters are required to provide an OS to a prospective investor when requested. The innovation of the Internet has made OS dissemination much more cost-effective and widespread. Now, many underwriters provide them electronically. For instance, the State Treasurer's Office (STO) utilizes electronic POS distribution. The investor receives an e-mail notification from STO's electronic service provider, which advises the investor of the availability of the electronic POS, what software is needed to download the information, and where a printed version can be obtained. The e-mail contains standard disclaimer language. By clicking on the hyperlink in the e-mail, the investor acknowledges receiving the POS electronically and agrees to certain terms and conditions. At the electronic service provider site, there is another disclaimer that the investor must accept before accessing the information.

Some issuers also post an OS on their web sites. For instance, STO posts the POS for upcoming state bond sales on its web site. The City of Oakland provides users on-line access to its outstanding OSs. In addition, as mentioned above, there are a number of private companies that act as disclosure or dissemination agents and provide this service for municipalities for a fee.

The posting of an OS can be efficient in terms of timeliness and cost-effectiveness. Previously, issuers or their underwriters had to physically deliver a POS to prospective investors through the mail, by express delivery, or messenger service. Now, investors can go directly to an issuer's (or other's) web site and download a POS or OS, thus cutting the amount of time to receive the document and reducing the cost to the issuer. In particular, issuer printing and delivery costs can be significantly reduced.

Some issuers also are providing required continuing disclosure information on their

own or other web sites. For instance, the County of Sacramento has a section on its web site labeled "Continuing Disclosure," which includes information about the county government, financial information, sources of revenue, factors affecting revenues and expenditures, a debt summary, and economic and demographic information. This information is taken from the city's annual Tax Revenue Anticipation Note Official Statement.

There are ongoing costs to keep continuing disclosure sections of web sites updated. These costs need to be factored into the decision-making process.

SEC INTERPRETATION: USE OF ELECTRONIC MEDIA

On April 28, 2000, the SEC published guidance in the form of an Interpretation, entitled Use of Electronic Media [File No. S7-11-00]. The Interpretation affects all issuers (including municipal issuers) and addresses the use of electronic media in three ways: 1) updates previous guidance, 2) discusses an issuer's liability for web site content, and 3) outlines basic legal principles that issuers and market intermediaries should consider in conducting online offerings. The Interpretation also sought comments on a number of technical concepts to determine whether further regulatory action is necessary.

Electronic Delivery of Official Statements and Annual Reports

The April 28th Interpretation clarified previous SEC interpretations that dealt with the dissemination of investor material via electronic media. The SEC published two previous Interpretations (No. 7233 and No. 7288) that set the original policy for electronic delivery. The latest Interpretation kept this foundation in place but clarified certain regulatory issues relating to electronic delivery.

Consent Issues

Informed Consent – Informed consent means that the underwriter must obtain the consent of the investor prior to electronic delivery of the information. This ensures that the intended recipient is willing to accept delivery of information through electronic media and has actual notice that it will be delivered electronically. Previous SEC interpretations allowed informed consent and required the proof of consent to be written or electronic. In the latest Interpretation, the SEC stated that, in the name of timeliness, an issuer or market intermediary may obtain an informed consent via telephone, as long as a record of that consent is retained. Such telephonic consent must be obtained in a manner that assures its authenticity.

Global Consent – Global consent, as presented in previous interpretations, stated that investors could consent to the electronic delivery of all documents on behalf of a single issuer or underwriter. The latest SEC Interpretation clarified that an investor may give global consent to electronic delivery as long as such consent is informed. For example, an investor can consent to electronic delivery of <u>all</u> documents of <u>any</u> issuer in which that investor buys or owns securities through a particular underwriter. The SEC pointed out, however, that global consent cannot be established merely through a particular provision in the account-opening agreement, but must be established through an active process such as a separate electronic delivery notification. In addition, investors must be able to revoke such global consent at any time.

Access-Equals-Delivery – Under this model, investors would be assumed to have access to the Internet, thereby allowing delivery to be accomplished solely by an issuer posting a document on a web site. The SEC stated that the time for this model had not yet arrived because many people in the country do not have Internet access and others do not want to download large documents.

The Bond Market Association (TBMA), a group that represents securities firms and banks that underwrite, trade and sell debt securities, believes that Internet access among investors **has** attained a level that may justify adoption of this model. They believe that adoption of a "lowest common denominator" regulatory approach constrains the ability and incentives of innovators to adopt efficient business models. TBMA also feels that issuers should be able to rely upon this model in circumstances where the intended recipient previously has used electronic communication or where there are other factors that support the conclusion that the prospective investors have access to electronic media.

The SEC cited several specific factors for not supporting access-equals-delivery, including the fact that investors would not rely upon the Internet as their sole source of information, would not want to read a large document on screen, and would not want to wait while the document downloads. The Securities Industry Association (SIA), a group that represents investment banks, broker-dealers, and mutual fund companies, believes that at current access speeds, there is no real impediment. As a matter of fact, SIA believes that the time that it would take to download a document over the Internet at dial-up connection speeds is vastly superior to the two to four days it would take to receive a document. SIA also believes that institutional investors and individual online investors, in particular, can deal with the technology and would probably prefer the electronic method. This would save issuers and broker-dealers the costs and time of printing documents and initiating contact with these individuals. Most commenters believe that the access-equals-delivery option should be given and the choice should be left up to the individual investor.

Implied Consent – Since the SEC has not approved the access-equals-delivery model, some have suggested that a form of implied consent should be used to signal that the investor approves of receiving documents through electronic means. In such a model, the issuer could rely on electronic delivery if investors do not affirmatively object when notified of the issuer's or intermediary's intention to deliver documents in an electronic format. The SEC believed that it would not be appropriate for issuers or intermediaries to rely on implied consent because of the significant harm that would result through inadvertent failures to object.

The issue of implied consent resulted in a number of comments. For instance, Kutak Rock, a national law firm, believes that the SEC's concern that investors could change e-mail addresses and, therefore, not receive information, parallels the possibility that investors could change their physical addresses. Kutak Rock believes that the issuer would have an obligation to use other means to contact recipients (for example, telephone calls or regular mail) to maintain current contact information. TBMA states that the issuer should be permitted to inform online investors that, on an ongoing basis, information that is required to be delivered would be available on a web site.

Choice of Media

A previous SEC Interpretation stated that the use of a particular medium should not be so burdensome that intended recipients cannot effectively access the information provided. Some have interpreted this statement to mean that issuers cannot post documents on their web sites in the portable document file (PDF) format since reading PDF files requires users to download Adobe Acrobat. Hypertext markup language (HTML) documents, in contrast, can be read without any special software. In its latest Interpretation, the SEC clarified that PDF documents can be used if their use is not so burdensome as to effectively prevent access. In order to use PDF documents, the SEC requires issuers and underwriters to inform investors of the requirements necessary to download PDF documents when obtaining consent to delivery and to provide investors with necessary software and technical assistance at no cost.

Many commenters believe that the SEC requirements for using PDF would be open to interpretation and onerous. For example, the definition of "technical assistance at no cost" is subject to interpretation. These entities feel that the investor should link to Adobe's web site and use Acrobat's help screen to satisfy this requirement. Others believe that the latest Interpretation imposed especially stringent procedural requirements on PDF and not on other electronic formats.

The Envelope Theory: Hyperlinking Between Documents

Previous SEC interpretations provided examples of situations that showed how issuers and underwriters can meet their OS delivery obligations through electronic media. These examples pointed out that documents in close proximity to one another on a web site are considered delivered together. In addition, examples showed that documents hyperlinked to each other (one document having the imbedded address of another document in it) are considered delivered together as if they are in the same paper envelope (known as the "envelope theory"). These examples have created ambiguities that have led some to believe, for example, that if an OS is posted on a web site, then everything on that web site becomes part of the OS.

In its latest Interpretation, the SEC clarified that information on a web site would become part of an OS only if an issuer or underwriter acts to make it part of the OS. For example, when an issuer includes a hyperlink in an OS, the hyperlinked document becomes part of the OS. Such hyperlinked documents must be filed as part of the OS and the issuer will be liable for any information in this hyperlinked document.

The envelope theory presented some concerns for commenters. The National Association of Bond Lawyers (NABL) thinks that the envelope theory is analogous to the continuing disclosure requirements of Rule 15c2-12. This rule holds that information contained in an OS, but not supplied by an obligated person, is not required to be updated. Thus, documents hyperlinked to an OS should not be consider part of that OS, and, hence, should not be required to be updated.

SEC officials, speaking to industry associations, have stated that one way of preventing the endorsement of hyperlinked documents is to refer to the document by listing the web address only, instead of hyperlinking. In this way, the investor would have to actively retype or cut and

paste the address instead of just clicking on it.

Web Site Content

The SEC pointed out to issuers that federal securities laws apply in the same manner to the content of their web sites as to any other statements made by or attributable to them. To resolve some common questions received from the financial community in response to this principle, the SEC Interpretation discussed issuer responsibility for content on or hyperlinked with its web site.

Issuer Responsibility for Hyperlinked Information on Third-Party Web Sites

According to the SEC Interpretation, there are a number of factors that must be considered when deciding whether an issuer has "adopted" information on a third-party (non-issuer) web site to which it has established a hyperlink. Adopting information means that the issuer represents this information as true and is fully liable for its accuracy. First, the SEC ruled that when an issuer embeds a hyperlink to a web site in a document required to be filed under federal securities laws, the issuer always should be deemed to be adopting the hyperlinked information.

Another factor contributing to issuer responsibility for hyperlinked information is the presence or absence of precautions against investor confusion about the source of this information. For example, the risk of confusion would be lessened if the investor was presented with a "portal screen"[1] stating that he or she is leaving the issuer's web site and that the information subsequent is not the issuer's. However, the chance of confusion is heightened if the third-party web site is "framed" or "inlined"[2]. In these two formats, the investors may not know that they have accessed third-party information because both web sites are visible simultaneously and often a clear distinction cannot be made between them. Kutak Rock believes that using a portal screen would eliminate any argument that the issuer has adopted information contained in this linked web site. According to the SEC, in recent discussions with CDIAC, the use of such a portal screen would not absolve the issuer of responsibility for this third-party information.

Lastly, the presentation of the hyperlinked information by the issuer must be considered in determining whether the issuer has adopted the information. For instance, an issuer that selectively establishes and terminates hyperlinks to third-party web sites may be viewed as attempting to control the flow of information to investors and thus be determined to have adopted this information. Also, the layout of the screen containing a hyperlink is important in determining whether the third-party information has been adopted. Any attempt to differentiate a **specific** hyperlink compared to other hyperlinks may be considered an action of adopting the information on that specific third-party web site.

TBMA believes that an issuer should not be responsible for hyperlinked information if it clearly indicated that it does not endorse or affirm that information. In addition, TBMA believes that the SEC should draw a

[1] A portal screen is a page that appears before the user is launched into another web site.

[2] Framing is the process of allowing a user to view the contents of one web site while it is framed by information from another site, similar to the "picture-in-picture" feature offered on some televisions. Inlining is the process of displaying a graphic file on one web site that originates at another.

distinction between hyperlinks and URL addresses, on the one hand, and paper documents on the other. There clearly is a difference because, while in some cases a hyperlink brings a user to a specific document, in other cases a hyperlink merely serves as a convenient pathway to third party sources of information – which may include a whole library of documents.

Republication

In its Interpretation, the SEC pointed out that a unique characteristic of posting information on a web site is that such information is continuously available to the public unless it is taken off or replaced. The information posted on an issuer's web site potentially could be relied upon when making an investment decision. The SEC indicated that statements posted on an issuer web site may be considered to be "republished" each time the site is accessed by an investor and thus, could give rise to liability under Rules 10b-5 and 15c2-12.

One of the most heavily critiqued areas in the latest SEC Interpretation was the concept of "republication." In general, commenters believe that there should be no differentiation between information that is disseminated on paper and that information posted on an issuer's web site. Such a concept, it is felt, could significantly increase an issuer's disclosure obligations because instead of posting annual financial information, as required by SEC Rule 15c2-12, the issuer would have to update this information daily. Several commenters suggest that the SEC make it clear that information presented as of a certain date is not considered republished each time it is accessed by an investor. In addition, NABL suggests that issuers be allowed to designate continuing disclosure versus historical or archival portions of a web site.

SEC officials have addressed the "republication" issue in numerous speeches. SEC officials have indicated that they originally brought up this issue to alert market participants that some litigants in private lawsuits are contending that disclosure documents on web sites are republished. SEC staff asserted that it was not the intention of the SEC to adopt nor endorse the republication concept. One SEC official stated a personal belief that electronic documents should be treated the same as paper documents. The SEC staff recommended that issuers use legal and electronic tools to make sure that documents speak only as of their original publication date.

RECOMMENDATIONS

In light of the SEC interpretations and differing opinions regarding the implementation of electronic disclosure, CDIAC recommends that municipal issuers consider the following practices when contemplating an electronic disclosure program or fine-tuning an existing program:

- **Establish an investor relations program with a single contact person or unit.** Designate one person or unit with jurisdiction over the electronic disclosure portion of your web site. This person or unit would be responsible for fielding requests for continuing disclosure information from the public. (STO, for example, has a toll-free Investor Relations phone number and a single point of contact that coordinates investor relations activities.) When these requests are made, answer them on your web site to ensure that all potential investors have equal access to the answer. In addition, this person or unit

would be responsible for keeping electronic disclosure information current.

- **Do not rely on implied consent to deliver documents electronically to investors.** The SEC has stated that access-equals-delivery and implied consent are not currently acceptable models for delivering documents electronically to investors. Instead, get informed consent from investors. In this model, instead of relying on the fact that the investor does not affirmatively object to the receipt of electronic documents (implied consent), the investor would have to affirmatively accept their receipt. STO disseminates the POS for its sales through electronic distribution. The investor receives an e-mail notification from the investor of the availability of the electronic version, what software is needed to download the information, and where the investor can obtain a printed version.

- **Set up separate electronic disclosure and historical information sections of your web site.** Republication does not appear to be an issue with the SEC but it still may be an issue for civil litigants. Post current continuing disclosure information to an electronic disclosure section within your web site. Archive the outdated information to a historical section. To further avoid confusion, consider forcing an investor to acknowledge acceptance of the historical information (with an "as of" date) through a portal screen, stating that the investor is leaving the issuer's "current" section of its web site and going to a "historical" section.

- **Consider the potential cost of posting documents to your web site in PDF form.** Be aware that the SEC has clarified that the use of PDF files is acceptable but requires that issuers and underwriters inform investors of the requirements necessary to download PDF documents and provide the necessary software and technical assistance. Barring further SEC clarification, this could be interpreted as either, at a minimum, requiring a link to Adobe Acrobat or, at most, providing the Acrobat software on the issuer web site and providing technical assistance in house. As an example, STO provides technical support to non-technical savvy investors who need help downloading PDF documents. Posting your documents in both PDF and HTML formats would enable an investor to choose the format most convenient for him or her.

- **Consider using disclaimers and portal screens or eliminating hyperlinks to avoid investor confusion.** The SEC has stated that information on a web site would become part of an OS only if an issuer or underwriter acts to make it part of the OS. Consider using a portal screen or changing the hyperlink to an Internet address that would have to be retyped or cut and pasted. In some cases, the proper use of a notice or disclaimer also could avoid investor confusion. STO uses disclaimers for both electronic distribution of documents and for access to the current POS on its web site. These disclaimers must be accepted before the investor has access to these documents.

APPENDIX A

DEFINITION OF DISCLOSURE

Disclosure Provisions

The SEC promulgated Rule 15c2-12 in 1989 to prevent fraud by enhancing the quality and timeliness of disclosure to investors in the municipal securities market. This rule was in response to consistently slow dissemination of information in connection with primary offerings of municipal securities. Rule 15c2-12 requires underwriters participating in primary offerings of municipal securities of $1 million or more to obtain, review, and distribute to investors copies of the issuer's disclosure documents. Specifically, it requires the underwriter, in a primary offering of municipal securities:

1) to obtain and review a copy of an OS deemed final by an issuer of the securities;

2) to make the most recent preliminary OS available, upon request, in non-competitively bid offerings;

3) to contract with an issuer of the securities, or its agent, to receive, within specified time periods, sufficient copies of the issuer's final OS, both to comply with this rule and any rules of the Municipal Securities Rulemaking Board (MSRB);

4) to provide, for a specified period of time, copies of the final OS to any potential customers upon request.

Rule 15c2-12 contains disclosure exemptions for underwriters participating in certain offerings of municipal securities issued in large denominations that are sold to no more than 35 sophisticated investors, have short-term maturities, or have short-term tender or put features.

The SEC adopted amendments to Rule 15c2-12, which became effective in July 1996, requiring issuers to provide continuing disclosure on bond issues. Underwriters of municipal securities must obtain a written agreement from issuers and/or other obligated persons to provide annual, updated financial and operating information and material events notices to registered repositories. This requirement exposes the issuer to potential liabilities for securities fraud under SEC Rule 10b-5 if their disclosure contains material misstatements or omits any information that an investor would consider important in the investment decision-making process. Such information includes:

1) Annual financial information (such as annual reports) to be provided to nationally recognized municipal securities information repositories (NRMSIRs) and state information depositories (SIDs).

2) Notice of eleven specified material events to NRMSIRs, SIDs, and to the MSRB.

3) Notice of failure to provide annual financial information to NRMSIRs, SIDs, and the MSRB.

There are limited exceptions to the continuing disclosure requirement for issues less than $1 million, certain small issuers whose outstanding municipal securities are

less than $10 million, and for certain short-term maturity issues.

Fraud Provisions

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 securities laws with the potential for substantial issuer liability. Rule 10b-5 was promulgated in 1942 and was approved for use in private securities litigation in 1947. Rule 10b-5 has been used frequently as authority to bring claims in federal court for recovery of losses sustained from the sale of securities. To succeed under Rule 10b-5, a plaintiff must prove that the defendant either employed a devise, scheme, or artifice to defraud or made a material false statement or omission relied upon by the plaintiff in connection with the purchase or sale of a security. In addition, the defendant must have had the intent to defraud, and the fraud must have damaged the plaintiff.

Rule 10b-5 relies heavily upon the concept of "materiality." It is not necessary to disclose every bit of information about an issuer or an issue. However, it is important that "material" information be disclosed to investors. According to the U.S. Supreme Court, a statement or omission is material if there is a substantial likelihood that a reasonable investor would consider it important in making the decision to purchase or sell the securities.

APPENDIX B

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