



# Overview of Federal Laws and Securities and Exchange Commission Rules Governing Disclosure

Harriet M. Welch

March 18, 2014

39 Offices in 19 Countries



## Background to Disclosure Laws

- **Prior to the Great Depression**
  - No federal regulation of securities.
  - Only common law causes of action such as fraud and breach of fiduciary duty.
  - Sale of fraudulent securities increasingly prevalent leading up to Great Depression (when half of all securities worthless).
- **Objectives of Congress to Remedy Abuse**
  - Federal framework requiring disclosure of material information to investors.
  - Prohibit misrepresentations and other fraudulent conduct in purchase and sale of securities.
  - Policy: to create efficient capital markets.

# Federal Disclosure Laws

- **Securities Act of 1933**
  - Broad, accurate and complete disclosure in connection with primary offer and sale of securities
- **Securities Act of 1934**
  - Requires provision of information to investors in secondary markets
  - Sec. 10(b): unlawful to use manipulative or deceptive device or contrivance in connection with purchase or sale of securities
- **Rule 10b-5**
  - Adopted in 1942 to implement Sec. 10(b)
  - Prohibits the making of any untrue statement of material fact or omitting to state material fact in offer, purchase, or sale of securities
- **Rule 15c2-15**
  - Adopted in 1990
  - Regulates municipal securities brokers and dealers and requires continuing disclosure

# Federal Statutes Governing Disclosure

- **Securities Act of 1933 (primary offer and sale)**
  - Section 5 Registration and registration statements.
  - Exemptions from Registration:
    - Section 3(a)(2): security issued or guaranteed by (A) United States or any territory thereof; (B) any State or any political subdivision of a State or territory, or any public instrumentality of one or more States or territories .
    - Section 3(a)(4): security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal or charitable purposes and not for pecuniary profit.
    - Why Exempt? Absence of significant abuses, sophistication of investors, constitutional difficulties in applying federal securities law to municipal issuers; costs of regulation.

## Federal Statutes, continued

- Section 17 prohibits making materially false or misleading statements of sellers (but not purchasers).
- **Securities Act of 1934 (secondary markets)**
  - Section 10(b): unlawful to use manipulative or deceptive devices in connection with the purchase or sale of securities.
- **Section 17 (1933 Act), Section 10(b) (1934 Act), and Rule 10b-5**
  - Prohibit the making of any untrue statement of material fact or omitting to state a material fact in the offer, purchase, or sale of securities.

## Rule 10b-5

- “It shall be unlawful for any person . . . 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 . . . .”
- Materiality
  - Substantial likelihood that fact disclosed or omitted would be considered significant by a reasonable investor under the circumstances.
  - Look at disclosure required in registered transactions, facts an issuer would not want to disclose, facts that would look bad in a complaint, etc.

## Rule 10b-5, continued

### Additional Elements

- Omission: where omission of the material fact would make the remaining statements misleading in light of the circumstances under which they were made .
- Scienter: intent to deceive, manipulate or defraud, although some courts (e.g. DC Circuit) recognize mere recklessness (extreme departure from ordinary care).
- Reliance of plaintiff: must be actual and reasonable.
  - Presumed under “fraud on the market” theory.
- Damages: out of pocket loss? Expected gain? Courts differ.
- Standing: actual purchase or sale; mere ownership is not enough.

## Rule 10b-5, continued

- Private cause of action: courts originally looked to common law fraud, but modified the common law elements.
  - Primary liability: issuer, underwriters, etc.
  - Secondary liability: bond counsel, underwriter counsel, etc.
- Aiding and abetting liability. Only SEC and federal prosecutors may bring action, not private plaintiffs.
  - Primary violation,
  - Defendant provided substantial assistance,
  - Scierer or duty to inquire regarding primary violation.
- Aiding and abetting: Attorneys.
  - SEC v. Frank: attorney as mere scrivener.
  - Matter of Ira Weiss: head in the sand approach.



## Rule 10b-5, continued

- Aiding and Abetting: Local Government Officials.
  - “We relied on the staff and the lawyers to put together the disclosure.”
  - Orange County, CA Cases: “steps appropriate under the circumstances.”
- Limitations under Sarbanes-Oxley (2002): claims may be brought no later than: (A) two years after discovery of facts constituting violation; or (B) five years after such violation.

## Rule 15c2-12

- Underwriter required to ensure that issuer or other “Obligated Person” enter into binding commitment to make annual disclosure filings (Continuing Disclosure Agreements or CDA)
  - “Obligated Person.” Not Bond Insurer or liquid facility provider. Any person generally obligated to support debt service.
  - Additional requirements:
    - Update financial and operating information from OS;
    - Audited financial statements for most recent fiscal year;
    - Prompt disclosure of post-issuance material events.
- 2009 Amendment. Brokers and dealers must reasonably determine that issuer or “Obligated Person” has agreed:
  - To provide information under CDA to the MSRB in electronic format as prescribed by MSRB.
  - Creation of EMMA.
- 2010 Amendment. Expands event notices to cover both (A) material events and (B) events that must be reported regardless of materiality.

# Compliance with the Law: Key Principles

- **Importance**
  - Recognize the importance of good disclosure.
- **Perspective**
  - Make sure to review disclosure documents in their entirety.
- **Accountability**
  - Maintain a record of the sources of the material being included in the Official Statement.
- **Investor's Perspective**
  - Read and draft from the perspective of an investor (i.e., what would you like to receive if you were the prospective investor?).
- **Group Review**
  - Gather various contributors to Official Statement for a page by page collective review.

## Compliance with the Law, continued

- **Disclosure Documents**

- Official Statement—“marketing document or “insurance policy”?
- Other Documentation.
- Disclosure over the Internet.
- Shifting the burden—private placements with investor’s letters.

- **Due Diligence Review**

- Document Review Sessions.
- Due Diligence Meeting/Conference Call.
- Due Diligence visit to borrower by counsel.

## Compliance with the Law, continued

- **New Developments**
  - EMMA
  - Credit Rating Proposals
  
- **Continuing Disclosure**
  - Continuing Disclosure Agreement
  - Annual Reports
  - Material Events
  
- **Voluntary Disclosure**
  - Information “reasonably expected to reach investors”
  - Investor information web page

## SEC Actions

- May be brought against:
  - Governmental issuer
  - Individual members of issuer's legislative body
  - Governmental officials and employees
  - Third parties (underwriters, financial advisors, bond counsel)
- Include:
  - Investigations
    - Formal and informal
    - Subpoena powers

## Enforcement, continued

- Injunctive actions in Federal Court
  - Stop illegal activity
  - Disgorge ill-gotten gains
  - Maintain integrity of the marketplace
  
- Administrative proceedings
  - Monetary penalties (broker dealers)
  - Cease and desist orders: temporary and permanent
  
- Criminal referrals to Justice Department
  - Securities law violations, mail and wire fraud, money laundering, extortion and racketeering

## Enforcement, continued

### **Private enforcement actions**

- Securities class action litigation
- Private attorneys general
- Whistleblower actions

### **Internal Revenue Service Actions**

- Section 6700 penalties for abusive transactions

### **State Attorney General Actions**



## Enforcement, continued

### Examples of Enforcement Actions

- Orange County Report (1996)
- Maricopa County (1996)
  - Omissions basis of enforcement, even if not affect ability to pay
- City of Miami (2001)
  - Denied reliance on professionals defense
- Mass Turnpike Authority (2003)
  - While investigating cost increases and improving disclosure practices, still found to violate law
- City of San Diego (2006)
  - Failed to disclose material information regarding pension plan
  - Lost market access
  - Civil and criminal proceedings
  - Required remedial undertakings
- Other
  - State of New Jersey (2010)

## Recent Developments

- **Dodd-Frank Act of 2010**
  - Changes regarding “municipal advisors”
    - Must register with SEC and MSRB
    - Fiduciary duty to municipality
  
- **SEC Enforcement Unit**
  - 2010 unit focuses on municipal securities and public pensions
  
- **SEC Report of 2012 (issues for possible future regulation)**
  - Timeliness and comparability of financial information disclosed
  - Absence or insufficiency of conduit borrower continuing disclosure
  - Disclaimers of responsibility for disclosure information
  - Undisclosed or inadequately disclosed conflicts of interest

## Summary

- **Three contexts of disclosure**
  - Primary offering – official statements
  - Secondary market – continuing disclosure undertakings
  - Any information reasonably expected to reach investors
- **Standards**
  - Materiality
  - Negligence, recklessness, intent
- **Causes of Action**
  - SEC administrative action
  - SEC civil action in Federal District Court
  - Criminal referral to Justice Department
  - Private plaintiffs

## Summary, continued

- **Five key principles**
  - Make good disclosure
  - Perspective – big picture
  - Accountability – source documentation
  - Investor's perspective
  - Group review

## Questions?



**Harriet M. Welch, Partner**  
Squire Sanders

555 South Flower Street, 31st Floor  
Los Angeles, California 90071  
Phone: +1 213 689 5158  
Email: [harriet.welch@squiresanders.com](mailto:harriet.welch@squiresanders.com)