

# Municipal Bond Disclosure – Including SEC Rule 10b-5 and SEC Rule 15c2-12

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#### Federal Securities Disclosure Laws

#### Securities Act of 1933 (the 1933 Act)

- Requires broad, accurate and complete disclosure in connection with <u>primary</u> offer and sale of securities
- Section 17(a): unlawful to employ any device, scheme or artifice to defraud, or to engage in any transaction which operates as a fraud or deceit upon a purchaser of securities

#### Securities Exchange Act of 1934 (the 1934 Act)

- Requires disclosure of information to investors in <u>secondary</u> markets
- Section 10(b): unlawful to use or employ, in connection with the purchase or sale of any security, any manipulative or deceptive device or contrivance

#### SEC Rule 10b-5

- Adopted in 1942 to implement Section 10(b) of the 1934 Act
- Prohibits misstatements of material fact or misleading omissions of material fact in offer, purchase, or sale of securities

#### • SEC Rule 15c2-12

- Adopted in 1990
- Regulates municipal securities brokers and dealers and requires municipal issuers to provide continuing disclosure

#### 1933 Act (primary offer and sale)

- Section 5 Registration: corporate issuers must file registration statements with SEC for public offerings of corporate securities.
- 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.

- Bottom line: Municipal issuers are not required to file disclosure documents with the SEC or wait for SEC staff review before selling its securities to investors.
- Why Exempt? Absence of significant abuses, sophistication of investors, constitutional difficulties in applying federal securities law to municipal issuers; costs of regulation.

- 1934 Act (secondary market)
  - Section 4 of the 1934 Act created the SEC to enforce federal securities laws.
  - Bonds issued by municipal issuers constitute "<u>securities</u>" under the 1933 Act and the 1934 Act.
- While 1933 Act registration is not applicable to municipal securities, the antifraud provisions of Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act, as well as Rule 10b-5, certainly do apply. In addition, the practical necessities of marketing municipal securities requires a baseline level of disclosure. We will discuss the process for preparation of municipal securities disclosure documents (Preliminary Official Statement and Official Statement) later in this presentation.

#### SEC 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 . . . ."

# SEC Rule 10b-5, continued

#### Materiality

- Covers both (i) materially <u>incorrect</u> information as well as (ii) the <u>omission</u> of material information.
- Information is "material" if there is a substantial likelihood that a reasonable investor would consider it important to an investment decision.
- For examples of material information, look at disclosure requested by the "buy side" (e.g., National Federation of Municipal Analysts, rating agencies), information required in registered transactions, facts an issuer would not want to disclose, facts that would look bad in a complaint, etc.

### SEC Rule 10b-5, continued

#### Scienter/Recklessness

- "Scienter" is the intent to deceive, manipulate or defraud.
- Some courts (e.g. DC Circuit) recognize mere recklessness (extreme departure from ordinary care) to be sufficient basis for Rule 10b-5 violation.
- ➤ Negligence is not sufficient for Rule 10b-5, but the SEC can penalize negligent violations of the antifraud provisions of Section 17(a)(2) and 17(a)(3) of the 1933 Act.

### SEC Rule 10b-5, continued

#### Sanctions

- SEC enforcement actions include:
  - (i) injunctions and cease-and-desist orders prohibiting future violations of the securities laws;
  - (ii) disgorgement of improperly obtained funds, if any; and
  - (iii) civil fines.
- Private litigants (aggrieved investors) also have the right to pursue violations of Rule 10b-5, individually and as a class, for monetary damages.
- DOJ enforcement actions for egregious criminal violations of Rule 10b-5 include:
  - (i) criminal fines
  - (ii) imprisonment

# Municipal Securities Disclosure Documents– POS and OS

#### Preliminary Official Statement and Official Statement

- ➤ The Official Statement is the municipal analog to the Prospectus in corporate finance it is the disclosure document that the issuer provides to prospective investors in a public offering of securities
- Preliminary Official Statement or "POS" refers to the disclosure document before pricing details are included
- Final Official Statement or "OS" refers to the disclosure document containing all final pricing terms
- In unusual circumstances, a POS or OS can be "stickered" which means it is amended or supplemented

# Municipal Securities Disclosure Documents, continued

#### Certain Key Disclosure Elements in POS and OS:

- <u>financial information</u>, typically including the Comprehensive Annual Financial Report of the issuer;
- operating data relating to the tax revenues or project revenues available to pay debt service;
- <u>security for the bonds</u>, including provisions of the bond Indenture, funds and accounts, covenants, events of default, remedies, reserve funds, bond insurance, etc.; and
- <u>risks</u> to the repayment of the bonds.

# Municipal Securities Disclosure Documents, continued

#### Preparation of the POS and OS

- Recognize the importance of good disclosure "marketing document" or "insurance policy"?
- Make sure to review disclosure documents in their entirety
- Maintain a record of the sources of the material being included in the Official Statement
- Read and draft from the investor's point of view (i.e., what would you like to receive if you were the prospective investor?)
- Gather various contributors to Preliminary Official Statement for a page by page collective review

# Municipal Securities Disclosure Documents, continued

- Due Diligence Review
  - Document Review Sessions
  - Due Diligence Meeting/Conference Call
  - Due Diligence visits to issuer's offices or facilities by counsel, underwriters, rating agencies

#### SEC Rule 15c2-12

- Continuing Disclosure Obligations of Municipal Issuers After the Bonds Have Been Sold
  - ➤ Rule 15c2-12 governs underwriters' conduct and requires underwriters in primary offerings to:
    - 1. obtain, review and distribute a "deemed final" Official Statement (which contains a description of any instances in the previous five years in which the obligated persons failed to comply with Rule 15c2-12); and
    - obtain a written <u>undertaking</u> of the municipal issuer or obligated person that it will (a) provide "annual financial information" as required by Rule 15c2-12 and (b) file timely notices of certain enumerated events.

- Contrast this with the more stringent disclosure regime of Form 10-K Annual Reports, Form 10-Q Quarterly Reports and Form 8-K Current Reports for corporate issuers of registered securities
- "Obligated persons" include conduit borrowers and pooled borrowers but do not include bond insurers or liquidity providers
- Although the direct impact of Rule 15c2-12 is on underwriters, the indirect impact (and direct purpose) is to impose continuing disclosure obligations on municipal issuers
- Some municipal transactions are excluded from Rule 15c2-12: certain private placements, issues less than \$1 million in principal amount, certain issues sold in \$100,000 minimum denominations that mature in nine months or less from date of initial issuance

- In summary, Rule 15c2-12 requires municipal issuers to agree to a continuing disclosure undertaking to:
  - provide annual updates of financial information and operating data from the OS;
  - provide audited financial statements for the most recent fiscal year;
  - provide prompt disclosure of specified post-issuance material events.

#### Key "Listed Events" under Rule 15c2-12:

- Principal and interest payment delinquencies
- Non-payment related defaults
- Unscheduled draws on debt service reserves or 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
- Bond calls, tender offers, defeasances
- Release, substitution or sale of property securing repayment of the securities
- Rating changes
- Bankruptcy, insolvency or receivership
- Merger, acquisition or sale of all issuer assets
- Appointment of successor trustee

#### Common Pitfalls

- Dissemination Agent lapses
- 10-day timeframes for listed events
- rating changes include upgrades as well as downgrades
- rating changes include bond insurer and liquidity provider ratings

- Municipalities Continuing Disclosure Cooperation ("MCDC")
   Initiative
  - Announced by SEC on March 10, 2014, MCDC represented largest mass enforcement of Rule 15c2-12 in SEC's history ("enforcement sweep")
  - Addressed widespread noncompliance with Rule 15c2-12 by both issuers and underwriters
  - MCDC followed typical pattern of SEC enforcement sweeps: Self-report misstatements in OS regarding Rule 15c2-12 compliance and agree to predetermined penalties, including fines and cease-and-desist orders, by the December 1, 2014 deadline OR ELSE!

#### MCDC Initiative

- ➤ Not every instance of self-reporting resulted in enforcement action, but in 2016 SEC charged 72 broker-dealers under MCDC, representing 96% of the market for municipal underwriting in the country
- On August 24, 2016, SEC announced enforcement actions against 71 municipal issuers arising from MCDC Initiative
- Later enforcement actions against Rule 15c2-12 violators who did not self-report show harsher penalties
- Message received loud and clear: take Rule 15c2-12 requirements seriously!

#### **SEC Enforcement**

- SEC enforcement 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)

- SEC's enforcement tools include:
  - subpoenas, investigations and reports
  - cease and desist orders (puts party on hair trigger for future enforcement action)
  - injunctive relief (remedies can be burdensome)
  - disgorgement of ill-gotten gains
  - civil fines

- County of Orange Scrutiny on Board of Supervisors (1996)
  - Treasurer and Assistant Treasurer caused Orange County Investment Pools to engage in dangerously risky investment strategy, leading to County's bankruptcy.
  - SEC brought successful enforcement action against Treasurer and Assistant Treasurer, who also faced criminal charges from County DA for their actions.
  - SEC issued broad-ranging Report of Investigation, concluding that:
    - Board of Supervisors should have investigated and ensured adequate disclosure of County's finances in Official Statements for taxable note issues, whose proceeds were invested in the County Pools;

- 2. Board of Supervisors cannot rely on professional advisors for information within Board members' personal knowledge, such as budget information and
- 3. public officials cannot authorize disclosure known to be false or in reckless disregard of the facts.

- City of San Diego Scrutiny on High Level Staff (2006)
  - San Diego failed to disclose material information regarding persistent and material underfunding of pension plan over period of several years and numerous bond issues
  - Result:
    - Loss of public market access for several years
    - Civil and criminal proceedings against senior staff
    - Required remedial undertakings that are still in effect today

- State of Illinois Systemic Scrutiny (2013)
  - Illinois failed to disclose material information regarding persistent and material underfunding of pension plan over period of several years and numerous bond issues
  - SEC stated that misleading disclosures in the Preliminary and final Official Statements resulted from, among other things:
    - failure to adopt or implement sufficient controls, policies or procedures designed to ensure that material information was assembled and communicated to individuals responsible for disclosure determinations;
    - 2. failure to train personnel involved in the disclosure process adequately; and
    - 3. failure to retain disclosure counsel.

- City of Harrisburg, PA Misstatements/Omissions Not Limited to Preliminary or Final Official Statements (2013)
  - SEC initiated an enforcement against the City of Harrisburg for posting materially misleading statements on its <u>website</u> at a time when the City was <u>not</u> issuing bonds
  - Special Fact #1 City was in financial distress
    - City had guaranteed bonds issued by an authority for a failed waste-to-energy facility, and this guarantee would lead to the City's near bankruptcy and State receivership
    - City's website postings intentionally downplayed the significance of the guarantee

- Special Fact #2 City was in material noncompliance with its continuing disclosure obligations
  - During 2009-2011 City routinely failed to file its required annual reports and notices of listed events under Rule 15c2-12 in a timely manner
  - SEC in its Cease and Desist Order noted that as a result of this failure, the market was deprived of current information and was forced to seek out public statements made by city officials

- Issuer and Individual Fines and Penalties
  - Greater Wenatchee Regional Events Center Public Utilities District (2013)
    - SEC for the first time imposed a fine (\$20,000) on a municipal issuer for making misleading statements in an Official Statement.
  - Westlands Water District (2016)
    - SEC fined a California water district and two of its top officers for violating the federal securities laws by inflating revenues using an accounting adjustment that was approved by the District's auditors. SEC imposed a civil fine of \$125,000 on the District and individual fines of \$50,000 on its General Manager and \$20,000 on its Assistant General Manager.

- Issuer and Individual Fines and Penalties
  - City of Miami, FL (2016)

SEC imposed the largest civil penalty ever against a municipality: \$1 million against the City of Miami, FL after securing a guilty verdict against the City in a federal jury trial. SEC charged the City and its Budget Director with violating the federal securities laws by making inter-fund transfers of restricted moneys to mask a severe General Fund deficit.

#### Control Person Liability

- City of Allen Park, MI (2014)
  - SEC for the first time imposed "control person" liability on an elected official under Section 20(a) of the 1934 Act, which provides that a control person may be held jointly and severally liable for the securities law violations of the persons over whom he or she exercises control.
- Town of Ramapo, NY (2016)
  - "Control person" liability changed against Town Supervisor (and Development Corp. President), as well as Assistant Town Attorney (and Development Corp. Executive Director). They were also charged with criminal securities fraud.

- Control Person Liability
  - City of Harvey, FL (2016)
    - "Control person" liability charged against Mayor, who exercised control over city operations and signed important offering documents used by the city to market bonds.
  - Town of Oyster Bay, NY (2017)
    - "Control person" liability charged against elected Town Supervisor, who was also charged with criminal securities fraud.

# SEC and DOJ Enforcement and Criminal Liability

- Criminal Liability Ramapo and Oyster Bay
  - Town of Ramapo, NY (2016)
    - In April 2016, the SEC charged the Town of Ramapo, NY, the Ramapo Local Development Corp. ("RLDC") and four town officials with securities fraud for presenting inflated general fund balances in the offering materials for 16 municipal bond offerings covering fiscal years 2009 to 2014.
    - The officials "cooked the books" by failing to fully disclose the financial strain caused by the \$60 million cost to build a baseball stadium as well as the town's declining sales and property tax revenues.

# SEC and DOJ Enforcement and Criminal Liability, continued

- Christopher St. Lawrence, who served as the town's elected Supervisor and as well as RLDC's president, and Aaron Troodler, a former RLDC executive director and assistant town attorney, not only faced civil securities fraud charges and control person liability, but also criminal charges for securities fraud filed by the U.S. Attorney's Office in a parallel action with the SEC's enforcement efforts.
- In 2017, Troodler pled GUILTY to fraud and conspiracy charges in the first ever criminal conviction for federal securities fraud involving municipal securities
- In 2017, St. Lawrence was found GUILTY of 20 counts of criminal fraud and conspiracy and was sentenced to 30 months in federal prison

# SEC and DOJ Enforcement and Criminal Liability, continued

- Criminal Liability Ramapo and Oyster Bay
  - Town of Oyster Bay, NY (2017)
    - More recently, in November 2017 the SEC filed a lawsuit in the U.S. District Court against the Town of Oyster Bay, NY and its former elected Supervisor, John Venditto, for failure to disclose the town's indirect guarantees of a private vendor's debt that created a contingent liability of \$16 million, or approximately 16% of the town's operating budget.
    - Venditto was charged with "control person" liability for the securities fraud committed by the town, and with aiding and abetting such violation.
    - In a parallel action, the U.S. Attorney's Office also filed criminal securities fraud charges against Venditto.

# SEC and DOJ Enforcement and Criminal Liability, continued

- While the specific actions that constituted securities fraud in the Ramapo and Oyster Bay enforcement actions are different, the two cases share many similarities.
- Both are recent cases that involve small towns near New York City.
- Both, as noted above, involve the SEC imposing "control person" liability on top elected officials.
- Finally, both involve criminal charges for securities fraud filed against such "control persons" in addition to the civil fraud charges filed by the SEC.

#### SEC Enforcement Activity On the Rise

- Since beginning of 2013, SEC has brought enforcement actions against 76 state or local governmental entities (including 4 states), 13 obligated persons and 16 public officials
- In contrast, for the entire 10-year period from 2002 to 2012,
  SEC brought enforcement actions against 6 governmental entities, 6 obligated persons and 12 public officials

- Recommended Best Practices
  - The SEC's enforcement actions, settlement terms, and commentary advocate:
  - a. adoption of disclosure policies and procedures;
  - b. regular training of supervisors and staff;
  - c. seeking expert advice as warranted; and
  - d. continuously updating disclosure practices.

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