CDIAC Ongoing Debt Administration Seminar – September 4, 2019

Session 2: Continuing Disclosure Responsibilities

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Why is Disclosure Necessary?

- Investors in municipal securities have rights under federal securities laws
- All “material” information must be disclosed
- Policy: Parties buying and selling municipal securities should have access to information necessary to make an informed investment decision

The Federal Securities Acts

- Securities Act of 1933 - registration requirement for most securities, but municipal bonds are not included
- Securities Exchange Act of 1934 - creates ongoing disclosure requirements for public companies, and regulates brokers and dealers
- Both 1933 Act and 1934 Act contain antifraud provisions, which do apply to municipal securities

Rule 10b-5

"It shall be unlawful for any person . . .

- to employ any device, scheme or artifice to defraud,
- 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
  - SEC has not provided guidance on what constitutes a “material” misstatement of facts outside of SEC enforcement cases

When do disclosure rules apply?

- Rule 10b-5 applies whenever an issuer is “speaking to the market”
  - new offerings
  - reporting under Continuing Disclosure Agreement
  - voluntary filings on EMMA
  - other circumstances
    - ✓ Public statements by officials -- whether this will be considered “speaking to the market” will depend on the official making the statement, and the audience. “Political speech” has in the past been viewed as OK, but recent SEC actions suggest using greater caution.
    - ✓ Investor website

Rule 15c2-12

- Originally enacted in 1989
  - Prevents a dealer from underwriting an issue of municipal bonds unless the underwriter has been able to “obtain and review a preliminary official statement that the issuer of such securities or an obligated person deems final as of it date”
- Amended in 1994
  - Includes continuing disclosure
  - Underwriter must reasonably determine that the issuer or an obligor has entered into a binding commitment to provide continuing disclosure
    - ✓ Annual Reports, Listed Events, and notices of Failure to file on time
- Amended in 2010
  - Additional Listed Events, more specific timing requirement for reporting Listed Events, and reporting requirements for new variable rate debt.

Annual Reports and Listed Events

Annual Reports

- Audited Financial Statements
- Financial information and operating data as specified in the continuing disclosure agreement; essentially updates key financial and operating data contained in the original offering document which is available from the issuer or the obligor's records
- Filing required annually by a fixed date specified in the continuing disclosure agreement up to 1 year after the end of the fiscal year

Listed Events

- Listed events notices must be filed "not in excess of 10 business days after the occurrence of the event"
- Note that some of the events have a materiality qualifier, others do not (they are deemed automatically material)
- In addition, the issuer or obligor must file a notice of failure to provide a filing at the time or with the information required by the CDA

Listed Events Notices

- Listed Events that require notification within ten (10) business days:

1) Principal and interest payment delinquencies;
2) Nonpayment related defaults, ***if material;***
3) Unscheduled draws on reserve reflecting financial difficulties;
4) Unscheduled draws on credit enhancement reflecting financial difficulties;
5) Substitution of credit or liquidity provider or failure to perform;
6) Adverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other ***material*** notices or determinations with respect to the tax status of the security, or other ***material*** events affecting the tax status of the security;
7) Modification to rights of security holders, ***if material;***

Listed Events Notices

8) Bond calls, ***if material,*** and tender offers;

9) Defeasances;

10) Release, substitution or sale of property securing repayment of the security, ***if material;***

11) Rating changes;

12) Bankruptcy, insolvency, receivership, or similar event of an obligated person;

13) The consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, ***if material***;

14) Appointment of a successor trustee or change in name of a trustee, ***if material.***

New “Listed Events” adopted by SEC

- In August 2018, the SEC amended the Rule 15c2-12 to add two (2) new Listed Events to the prior 14 and to add on definition.
- **Compliance Date: February 27, 2019**
- These two new events must be included in any new Continuing Disclosure Agreement (“CDA”) executed on or after the Compliance Date
- The two new events **do not apply** retroactively to CDAs in existence prior to the Compliance Date, although some aspects of the new Listed Events are retroactive.

New “Listed Events” adopted by SEC

New “Listed Events” adopted by SEC

15) incurrence of a “financial obligation” of the obligated person, ***if material***, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, ***if material*** (emphasis added)

16) default, event of acceleration, termination event, modification of terms or other similar events under a financial obligation of the obligated person, any of which ***reflect financial difficulties*** (emphasis added)

New “Listed Events” adopted by SEC

- According to SEC News Release, the adopted amendments “focus on material financial obligations that could impact an issuer’s liquidity, overall creditworthiness, or an existing security holder’s rights.”
- Better inform investors and market participants about financial condition of issuers of municipal securities and obligated persons
- Provides more timely information about “financial obligations” which previously were not reported on EMMA, particularly private placements and bank loans.
- The SEC issued and Adopting Release in August 2018 which provides a lot of additional explanation of the meaning of the terms used in the expanded Rule.
- Even with this Adopting Release and informal SEC staff guidance in subsequent webinars and conferences, there remain many open issues in the interpretation and implementation of the new events

Financial Obligation

New Defined Term – "Financial Obligation"

"Financial Obligation" is defined as a: (i) debt obligation; (ii) derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or (iii) a guarantee of either (i) or (ii)

- According to the Release, the term focuses on debt, debt-like or debt-related obligations of issuers/obligated persons
- The term does not include municipal securities as to which a final official statement has been provided to the MSRB consistent with the Rule (e.g. posted on EMMA and having an effective CDA). This exception is designed to avoid duplication of regulations.

Listed Event (15)

(15) incurrence of a "financial obligation" of the obligated person, *if material*, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, *if material*

Scope of Event Reporting: Under CDAs entered on or after the Compliance Date, applies to new, material financial obligations incurred on and after the date the CDA was entered

Also applies to material agreement to new covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation agreed to by the issuer, which may affect security holders of debt to which the CDA relates. This second part of event (15) can be retroactive, and require reporting of material changes to any financial obligation whether incurred after or before the date of new post-compliance CDA

Incurrence of Financial Obligation: A Financial Obligation generally should be considered to be incurred when it is enforceable against an issuer or obligated person

- Disclosure will provide investors with important information about current financial condition and potential liabilities, including potential impacts to the liquidity and overall creditworthiness of the issuer or obligated person or which may otherwise affect security holders of the debt to which the CDA relates

Listed Event (15)

Materiality – Materiality qualifier has appeared in the Rule since it was amended in 1994

- Qualifier operates as a framework for issuers and obligated persons to assess their disclosure obligations in the context of the specific facts and circumstances
- Not every incurrence of a financial obligation or agreement to terms is material
- Materiality determinations under (15) should be based on whether the information would be important to the total mix of information made available to the reasonable investor – compliance with the new event requirements will be evaluated using the "total mix" of information available
  - Consider potential impacts on the issuer's liquidity or creditworthiness or the rights of security holders to which the CDA relates
- Determination of whether to file a notice under (15) requires the same analysis regularly made by parties when preparing offering documents
- Commission adopted narrower definition of "financial obligation" than proposed, which it expects will reduce the burden on issuers, obligated persons and dealers
- Issuers/Obligated Persons should memorialize materiality analysis when making a decision not to disclose an event under (15), or in setting a particular dollar amount as a materiality threshold

Listed Event (15)

Timing – Event Notices must be filed within ten business days of date the "financial obligation" is incurred

- Series of Financial Obligations – consider all relevant facts and circumstances
  - Shared authorizing document; same/similar purpose; same source of security
- Lines of credit, draw down bonds or commercial paper only need to be reported once, when the debt is legally enforceable (whether or not any funds are immediately drawn or borrowed) and not on each draw or CP issuance, as long as the initial reporting contains all the material terms of the borrowing program.
- One open question is how to report a standby credit obligation that has not yet been used.
- Debt obligations are reported when actually issued, not when sold.

Listed Event (16)

(16) default, event of acceleration, termination event, modification of terms or other similar events under a financial obligation of the obligated person, any of which *reflect financial difficulties* (emphasis added)

Scope of Event Reporting: An event that occurs under the terms of a financial obligation pursuant to (16) that occurs on or after the Compliance Date must be disclosed regardless of whether such financial obligation was incurred before or after the Compliance Date

"Reflect Financial Difficulties" – concept used since adoption of the Rule; existing disclosure events including unscheduled draws on debt service reserves (3) and unscheduled draws on credit enhancements (4)

- As used in connection with new events, concept covers a broad potential series of actions and implies an element of materiality
- Analysis for reporting (similar to event (15), consider whether the event may have potential adverse impact on the liquidity and overall creditworthiness of the issuer/obligated person or affect security holders

Default – can be monetary default (failure to pay principal/interest or other funds due) or failure to comply with specific covenants; does not have to be an "event of default" as defined in bond documents

"Other Similar Events" – broad concept to capture circumstances that reflect financial difficulties even if they do not qualify under any of the prior types of events

What is a “Financial Obligation”

“Financial Obligation” is defined as a: **(i) debt obligation**; (ii) derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or (iii) a guarantee of either (i) or (ii)

Debt Obligation: any short-term or long-term debt obligation under the terms of an indenture, loan agreement, lease, or similar contract which represents a borrowing of money to be repaid at a later date

- Focus on obligations and terms that could adversely affect rights of existing security holders or impact the liquidity or creditworthiness of an issuer or obligated person
- The term is *broader than state law definition of debt*. Not limited to general obligation or ad valorem tax debt. Includes revenue transactions and subject to appropriation financings
- *Examples*: direct purchases, private placements, direct loans, commercial paper and leases that operate as vehicles for borrowed money (including lease revenue and certificates of participation transactions)

– Analysis of leases or installment purchases has been an area of some confusion. SEC staff weighs looking at the financial structure to determine if a transaction is a form of borrowing. Although GASB will eliminate the concept of “capital” and “operating leases”, this could be a useful starting point.

– SEC believes this analysis will result in excluding ordinary financial and operating liabilities incurred in the normal course of business. Also, many small leases, as for office equipment, will simply not be material.

What is a “Financial Obligation”

“Financial Obligation” is defined as a: (i) debt obligation; (ii) **derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation**; or (iii) a guarantee of either (i) or (ii)

- Any swap, security-based swap, futures contract, forward contract, option or similar instrument (or combination) to which an issuer or obligated person is a counterparty
- Focus on exposure to contingent liquidity risk (e.g. collateral postings and termination payments) which could adversely impact liquidity or creditworthiness or affect interests of security holders
- “Planned” – At the time the issuer or obligated person incurs the related derivative, would a reasonable person view it likely or probable that the issuer or obligated person will incur the related debt obligation at a future date?
  - » Based on objective assessment of facts and circumstances
  - » Relevant factors include documents evidencing assumptions about future debt, preliminary or final actions authorizing debt obligation and hiring of professionals to assist with debt issuance
- Does not cover derivative instruments designed to mitigate investment risk not related to a particular debt issue
- Note that on long-dated forward purchase contracts could be a derivative, even though the bond will not be a “debt” until actually delivered, where the dividing line between “normal” delivery and a forward contract is unclear.

What is a “Financial Obligation”

“Financial Obligation” is defined as a: (i) debt obligation; (ii) derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or (iii) **guarantee of either (i) or (ii)**

- Reporting requirement applies to any guarantee of a debt obligation or of a derivative instrument related to an existing or planned debt obligation. May trigger two reporting requirements:
  - When an issuer or obligated person is acting as a guarantor for the payment of a financial obligation; and
  - When an issuer or obligated person is the beneficiary of a guarantee of a third party relating to a financial obligation, may be reportable as a material term of the financial obligation

What is a “Financial Obligation”

“Financial Obligation” does not include municipal securities as to which a final official statement has been provided to the MSRB consistent with the Rule.

- “Consistent with the Rule” means that if an issuer voluntarily posts an Official Statement on EMMA for a transaction which is in some way exempt from annual reporting under the Rule (e.g. commercial paper or certain VRDOs), the issuer must agree to make annual reports and otherwise comply with the requirements of Rule 15c2-12(b) in order to use the exclusion.
  - » This exclusion covers only the municipal securities and does not extend to instruments or obligations (contingent or otherwise) related to the municipal securities
  - » In the CDA, the issuer or obligated person is still required to make related disclosures under new (15) and (16) with respect to any such instruments or obligations (e.g. any derivatives or guarantees)

Underwriter Considerations

- Issuer awareness of underwriter considerations – Understand approach of underwriters to verifying that issuers have complied with the new rules once deals are offered after February 27, 2019:
  - » Rule 15c2-12 requires underwriters to independently investigate an issuer's compliance with its CDA reporting over the past 5 years.
  - » For first deal after March 2019, when event notices (15) and (16) have not yet been in place, underwriters may want to see new policies and procedures to confirm appropriate internal controls will be in place
  - » For subsequent deals, they will need to determine if event (15) or (16) have occurred and was reported within 10 business days

Underwriter Considerations

- There may be disagreement about whether an event was material or reflected financial difficulties. It will be helpful if the issuer can explain why it made a decision not to report, based on a memorandum to the file at the time the possible event occurred
- If in doubt, better to report. Underwriters are still gun shy after MCDC because they are under SEC consent decrees and risk large fines if found to have failed in their obligations.

Considerations for New Listed Events

- Prepare for implementation of the two new Listed Events
- Note the two events will only become operative after the issuance of new, public debt and the execution of a new continuing disclosure agreement after February 27, 2019.

Considerations for New Listed Events

- Examine the debt and financial portfolio (starting with the audited financials) to identify all existing “financial obligations.” Make an inventory/spreadsheet, if practicable. Remember this excludes public debt already subject to a CDA.
- Establish policies and procedures, and assign staff to monitor the inventory list of financial obligations so responsible person for CDA compliance (CFO, Treasurer, etc.) is notified whenever there is a change (e.g. amendment) or adverse event (e.g. default) in any existing financial obligation.
- In larger organizations where a single list of obligations is not practical, it is vital for the staff which would be aware of new private loans, leases, etc. or amendment to existing debt (i.e. public works, budget, etc.) to be trained in the new Rule and to coordinate with the finance or treasury staff which overseas CDA compliance. Remember, time is short so its important for there to be advance notice of upcoming events.

Considerations for New Listed Events

- When feasible, prepare an inventory / spreadsheet of outstanding financial obligations:
  - Identify counterparty, par amount, amortization schedule, interest rate, default provision, security pledge, etc.
  - Determine which financial obligations are deemed “material”
  - Maintain and update list accordingly for new “financial obligations” and changes to existing “financial obligations”

Considerations for New Listed Events

- Discuss in advance how to report on a new, material financial obligation:
  - provide a summary of material terms; or
  - post a copy of the complete loan document with deletion of confidential terms (e.g. phone or fax numbers, account numbers, etc.)
- Experience since March 2019 is that a vast majority of event (15) filings just attach the relevant loan document, although if this is lengthy, it is not as useful to investors.
- Preparing a summary creates legal risks, unless the entire document is also posted (which is permitted)

Consequences of Failure to Comply

- Non-compliance is not an Event of Default under bond documents or continuing disclosure agreements but bondholders have right to sue for compliance with continuing disclosure obligations
- Must disclose a material failure to comply in future Official Statements for 5 years following the failure
- Can give rise to a securities law fraud case if there is a misstatement about past compliance in a later offering document
- No clear guidance on what is a “material” failure to comply, especially as to late filings. Underwriters now insist on listing any non-compliance, even if seemingly trivial

Types of SEC Enforcement Actions

Since the mid-2000's, the SEC has ramped up enforcement focused on the municipal market

- Inadequate Pension Disclosures
- Misleading or Incomplete Financial Disclosures
- Failure to disclose the use of unusual accounting actions
- Failure to disclose shortcomings in economic development projects
- Failure to disclose financial or legal risks
- Failures of Continuing Disclosure

Results of SEC Enforcement Actions

- Governmental agencies were levied civil fines, up to hundreds of thousands of dollars
- Required to retain outside consultants and/or legal counsel to review disclosure practices
- Individuals working for agencies were fined and, in some case, barred from participating in municipal securities offerings
- In one instance, individual sentenced to jail for 2 ½ years
- Cost of defending cases brought by the SEC can be significant
- Bad publicity, political damage, and possible rating reductions
- SEC doesn't need to prove that allegations resulted in any bond default, loss of value, or harm to investors

Enforcement Actions Relating to Continuing Disclosure

Case on Continuing Disclosure

West Clark Community Schools, IN and City Securities Corporation

- In the summer of 2013, the SEC settled an antifraud case against a small school district in Indiana which stated in its OS that it had not failed to comply in all material respects with any prior disclosure undertakings, but had in fact failed to file any annual reports. SEC alleged this misstatement in the OS was a violation of Section 17(a)(2) of 1933 Act.
- Underwriter paid a $580,000 settlement (disgorgement and penalty) for failing to investigate the issuer's OS statement; and the individual at the underwriter paid approximately $38,475 (disgorgement and penalty) with a one year collateral bar and a permanent supervisory bar.
- The SEC suddenly had a lever over issuers based on their antifraud enforcement powers.
- This case led to SEC's MCDC Program.

Enforcement Actions Relating to Continuing Disclosure

Post MCDC Cases

City of Beaumont, CA (2017) – Beaumont Financing Authority ("BFA") issued approximately $260 million in municipal bonds in 24 separate offerings from 2003 to 2013, each underwritten by O'Connor & Company Securities, Inc. ("O'Connor"). From 2004 to April 2013, BFA regularly failed to provide investors with the promised information (in a complete and timely manner) and failed to disclose this fact when it issued bonds in 2012. BFA and O'Connor didn't voluntarily report to SEC under MCDC. O'Connor was found to have failed to conduct reasonable due diligence on CDA compliance. The sanctions were more severe than under MCDC. The SEC went beyond the MCDC settlements by including individual issuer officers and by requiring that BFA engage an independent consultant.

Significant because (i) BFA required to hire independent consultant on securities procedures and (ii) individual official (city manager) was fined $37,500 and agreed to a permanent injunction against participating in any municipal securities offering. O'Connor was fined $150,000 and was ordered to retain a consultant. It's investment banker was ordered to pay a $15,000 penalty and serve a 6 month suspension from the securities industry.

Enforcement Actions Relating to Continuing Disclosure

Post MCDC Cases

Lawson Financial Corp (2017) – Lawson Financial Corporation ("Lawson Financial") was the underwriter for multiple issues for entities controlled by Richard Brogdon ("Brogdon"), the proceeds of which were to be used for projects for nursing homes, assisted living facilities and retirement housing. The offering documents represented that the borrowers had not failed to comply with any prior CDAs, when in fact they had consistently failed to provide the required information. The SEC found that Lawson Financial conducted inadequate due diligence, did not review EMMA, and solely relied on Brodgen's representations. Lawson Financial and Robert Lawson paid disgorgement of approximately $198,000, Lawson Financial paid a penalty of approximately $198,000, and Robert Lawson paid a penalty of $80,000 and was barred from the securities industry for three years. The SEC separately charged Brogdon with fraud and is seeking an order for Brogdon to repay $85 million to investors. Not reported under MCDC. Significant because it was found that underwriter failed in its role as gatekeeper to conduct reasonable due diligence.

Enforcement Actions Relating to Continuing Disclosure

Post MCDC Cases

Municipal Financial Services, Inc., OK (2017) – SEC brought an administrative action against a municipal advisor for violating its duty to city by failing to advise city that amending the reporting period on three prior CDAs violated the CDAs and did not advise City to notify bondholders of those prior issues that the CDA deadline had been changed.

- Firm was fined $50,000 and each of the two principals were fined $8,000 each


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