

# **CDIAC MUNICIPAL DEBT ESSENTIALS**

Ongoing Administration:  
Continuing Disclosure Responsibilities

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# SPEAKER



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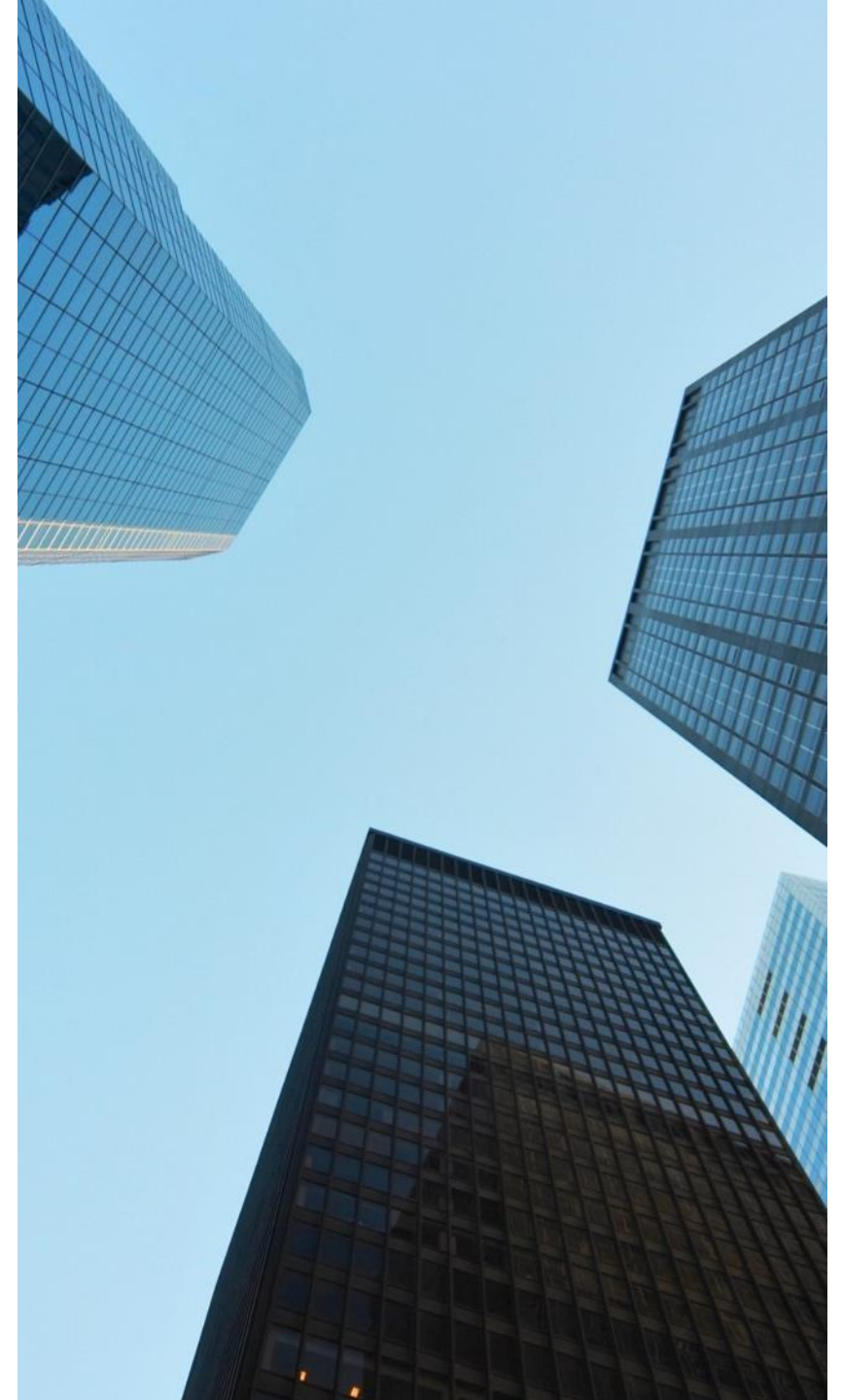
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# WHY IS DISCLOSURE NECESSARY?

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

# FEDERAL SECURITIES LAWS

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



# WHEN DO DISCLOSURE RULES APPLY?

- Rule 10b-5 applies whenever an issuer is “speaking to the market”
  - / New offerings
  - / **Reporting under Continuing Disclosure Undertakings (“CDUs”)**
  - / **Voluntary filings on EMMA website**
  - / Other circumstances
    - Public statements by officials—“speaking to the market” will depend on who is 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 websites

# CONTINUING DISCLOSURE AND RULE 15C2-12

**Originally enacted in 1989** to prevent dealers from underwriting an issue of municipal bonds unless the underwriter has been able to “obtain and review a preliminary official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 its date”

**Amended in 1994** to add continuing disclosure requirements. Underwriters must reasonably determine that the issuer or an obligor has entered into a binding commitment to provide continuing disclosure.

This includes: Annual Reports, Listed Events, and notices of failure to file Annual Reports on time

**Amended in 2010** to add additional Listed Events, more specific timing requirements for reporting Listed Events, and reporting requirements for new variable rate debt

# CONTINUING DISCLOSURE AND RULE 15C2-12

## Amended in 2018

- ✓ Additional two (2) Listed Events; must be included in new CDUs but do not apply retroactively to CDUs in existence prior to *February 27, 2019* (the “Compliance Date”)
- ✓ 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 the financial condition of issuers of municipal securities and obligated persons
- ✓ Provides more timely information about “financial obligations” that previously were not reported on EMMA, particularly private placements and bank loans

# TIMING OF 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 that 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 one (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 an annual report on or before the time required by the CDU



# LISTED EVENTS NOTICES

Listed events that require notification within ten (10) business days (emphasis added):

1. Principal and interest payment delinquencies;
2. Nonpayment-related defaults, *if material*;
3. Unscheduled draws on debt service reserves reflecting financial difficulties;
4. Unscheduled draws on credit enhancements reflecting financial difficulties;
5. Substitution of credit or liquidity providers, or their 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

## Listed events that require notification within ten (10) business days:

8. Bond calls, *if material*, and tender offers;
9. Defeasances;
10. Release, substitution, or sale of property securing payments 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 additional trustee or the change of name of a trustee, *if material*;

# 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***;
16. Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, any of which ***reflect financial difficulties***.

# INCURRENCE OF A FINANCIAL OBLIGATION: LISTED EVENT (15)

## Key Takeaways:

- / Disclosure will provide investors with important information about current financial conditions and potential liabilities, including potential impacts on the liquidity and overall creditworthiness of the issuer or obligated person or which may otherwise affect security holders of the debt to which the CDU relates
- / A financial obligation generally should be considered to be incurred when it is enforceable against an issuer or obligated person
- / Applies to CDUs entered on or after the Compliance Date; and new, material financial obligations incurred on and after the date the CDU was entered.
- / The second part of event (15) can be retroactive, and requires reporting of material changes to any financial obligation whether incurred before or after the date of a new CDU
- / Does not include municipal securities as to which a final official statement has been provided to the Municipal Securities Rulemaking Board (“MSRB”) consistent with Rule (e.g., posted on EMMA and having an effective CDU) this exception is designed to avoid duplication of regulations

# INCURRENCE OF A FINANCIAL OBLIGATION: LISTED EVENT (15)

## Key Takeaways:

- ✓ A “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)
- ✓ A debt obligation is any short-term or long-term debt obligation under the terms of an indenture, loan agreement, lease, or similar contract that represents a borrowing of money to be repaid at a later date; the term is broader than the state law definition of debt and focuses on impacts to liquidity or creditworthiness of the issuer
- ✓ 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 consider potential impacts on the issuer’s liquidity or creditworthiness or the rights of security holders to which the CDU relates
- ✓ Lines of credit, draw-down bonds, or commercial paper only needs 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

# ... REFLECT FINANCIAL DIFFICULTIES: LISTED EVENT (16)

## Key Takeaways:

- / 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)
- / 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



# UNDERWRITER CONSIDERATIONS

Understand the 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 CDU reporting over the past five (5) years
- ✓ For an issuer's first deal after the Compliance Date, 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 were reported within the requisite ten (10) business days

# CONSEQUENCES OF FAILURE TO COMPLY

- / Non-compliance is not an event of default under bond documents or continuing disclosure agreements but bondholders have the right to sue for compliance with continuing disclosure obligations
- / Must disclose a material failure to comply in future official statements for five (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 cases, barred from participating in municipal securities offerings
- / In one instance, an individual sentenced to jail for 2 1/2 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 DISCLOSURES

Continuing Disclosure – Pre-Municipalities Continuing Disclosure Cooperation Initiative (“MCDC”) Cases

## City of Harrisburg (2013)

- ✓ May of 2013, the SEC charged the City of Harrisburg, Pa. (“City”) with securities fraud for its misleading public statements when its financial condition was deteriorating and financial information available to municipal bond investors was either incomplete or outdated
- ✓ SEC investigation found that the City made misleading statements in the City’s budget report, annual and mid-year financial statements and a State of the City address and also failed to comply with continuing disclosure requirements to provide certain ongoing financial information and audited financial statements for the benefit of investors from 2009 to 2011
- ✓ The City was nearly bankrupt, under state receivership, and as of March 2013, had missed approximately \$13.9 million in general obligation debt service payments, and was the obligated person for approximately \$455 million of outstanding debt for several of its component units
- ✓ Significant because this was the first time the SEC charged a municipality for misleading statements made outside of its securities disclosure documents
- ✓ The City settled with the SEC and was ordered to cease and desist from committing or causing violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.

# ENFORCEMENT ACTIONS RELATING TO CONTINUING DISCLOSURES

Continuing Disclosure – Pre-MCDC

## West Clark Community Schools, Indiana and City Securities Corporation (2013)

- ✓ In the summer of 2013, the SEC settled an antifraud case against a small school district in Indiana which stated in its Official Statement (2007) that it had not failed to comply in all material respects with any prior continuing disclosure undertakings but had, in fact, failed to file any annual reports—SEC alleged this misstatement in the Official Statement was a violation of Section 17(a)(2) of 1933 Act
- ✓ The underwriter paid a \$580,000 settlement (\$280k disgorgement and \$300k penalty) for failing to investigate the issuer's statements, and the individual at the underwriter paid approximately \$38,475 (\$20k disgorgement and \$18k penalty) with a one-year collateral bar and a permanent supervisory bar
- ✓ Significant because this was the first time the SEC charged (i) a municipal issuer with falsely claiming in an Official Statement that it was fully compliant with annual disclosure obligations and (ii) an underwriter and its principal for not doing the necessary research to attest to the truthfulness of the issuer's claims



# ENFORCEMENT ACTIONS RELATING TO CONTINUING DISCLOSURE

## Post-MCDC Initiative 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 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 and 2013 totaling more than \$32 million.
- ✓ BFA and O’Connor did not voluntarily report to the SEC under MCDC. O’Connor was found to have failed to conduct reasonable due diligence on CDU compliance.
- ✓ The BFA and O’Connor would have been eligible for more lenient remedies had they self-reported during the MCDC Initiative. The SEC went beyond the MCDC settlements by including individual issuer officers and requiring that BFA engage an independent consultant.

# ENFORCEMENT ACTIONS RELATING TO CONTINUING DISCLOSURE

## City of Beaumont, CA (2017) cont'd

Significant because (i) BFA was required to hire an independent consultant on securities procedures and (ii) an individual official (city manager) was fined \$37,500 and agreed to be permanently barred from participating in any future municipal bond offerings.

O'Connor was fined \$150,000 and was ordered to retain a consultant to review its policies and procedures. It's investment banker was ordered to pay a \$15,000 penalty and serve a six 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 CDUs, 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 Brogdon’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. Penalties were approximately double what the firm would have paid under the MCDC Initiative.
- ✓ Lawson Financial’s counsel was also charged and paid nearly \$45,000 and agreed to the entry of an order permanently suspending him from appearing and practicing before the SEC as an attorney.
- ✓ The SEC separately charged Brogdon with fraud and is seeking an order for Brogdon to repay \$85 million to investors.



# ENFORCEMENT ACTIONS RELATING TO CONTINUING DISCLOSURE

## Post-MCDC Cases

### **Municipal Financial Services, Inc., Oklahoma (2017)**

- ✓ SEC brought an administrative action against a municipal advisor for violating its fiduciary duty to the city by failing to advise the city that amending the reporting period on three prior CDUs violated the CDUs and did not advise the city to notify bondholders of those prior issues that the CDU deadline had been changed.
- ✓ Firm was fined \$50,000, and each of the two principals was fined \$8,000 each. Firm was fined because of its contractual duty to help the City with CDU compliance.



# CASE FOR ESTABLISHING POLICIES AND PROCEDURES

- / Shows the organization cares about compliance and is actively managing its compliance
- / Might be a mitigating factor when SEC calls
- / May lessen the risk of personal liability for staff
- / Greater attention to disclosure made for continuing disclosure compliance and for new offerings



# ESTABLISHING POLICIES AND PROCEDURES

- / Establish internal written procedures to comply with CDUs
- / Identify key personnel and their responsibilities for CDU compliance
- / Review annual reports and event notices
- / Review historical compliance with CDU undertakings
- / Assign a coordinator
- / Monitor compliance
- / Information gathering/Internal ticker system/create a template or chart for annual reports and event filings
- / Training

# THANK YOU



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