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Session 1

Why Is Disclosure Important?

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Why is Disclosure Important?

Fundamental Concepts: Federal Securities Laws Relating to Municipal Bond Issuance

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Why Is Disclosure Necessary?

- Municipal entities issue securities in the public capital markets
- Investors in municipal securities have rights under federal securities laws
- All “material” information must be disclosed

The Securities Act Of 1933

- 1933 Act has two substantive rules:
 - Registration requirement
 - Antifraud rule
- Municipal securities are exempt from the registration requirement, but are subject to antifraud rule
- Section 17(a)(2) prohibits any person from, directly or indirectly, obtaining money or property by means of any untrue statement of a material fact or by a misleading omission.

Securities Exchange Act Of 1934

Rule 10b-5

- 1934 Act creates ongoing disclosure requirements for public companies
- Regulates brokers and dealers
- Also contains antifraud provisions
- 1975 amendments to 1934 Act made it clear that antifraud provisions apply to government issuers

Rule 10b5

“It shall be unlawful for any person . . .

a) To employ any device, scheme or artifice to defraud,

b) 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”

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. In a recent voluntary “self-reporting” program, SEC staff consistently refused to provide advance guidance on what constitutes a “material” misstatement of facts

What Should Be Disclosed?

- Unlike corporate securities, there is no “line item” set of rules for what goes into an Official Statement (“OS”)
- Starting in 1975, leaders in municipal market created a set of Guidelines for OS content
- Other groups have suggested disclosure for particular market segments
- Look at practices in the industry; recent developments (e.g. New Jersey, Pension, Continuing Disclosure Compliance)
- In the end, the Issuer must use its own good judgment

When Do Disclosure Rules Apply?

- New offerings
- Annual Report under Rule 15c2-12
- Any other circumstance where an Issuer is “speaking to the market”
 - **Speeches and other public statements**
 - **Investor communications**
 - **Website**

Content of Annual Reports Under 15c2-12

- Audited Financial Reports
- Information (i.e. tables) identified in Continuing Disclosure Undertaking
- Additional voluntary information
- Consider Rule 10b5 implications – is there more you should be saying?
- Has anything happened since the date of the audited financial reports that has materially impacted your financial condition?

Event Reporting Under Continuing Disclosure Undertakings

- Original 14 events

2019 Revisions:

- (15): Incurrence of a financial obligation of the [Issuer], if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the [Issuer], 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.

Issuer Disclosure

- Official Statement is offering document to investors
 - equivalent to prospectus
- Must contain all material information for the particular bond sale
- Official Statement is the Issuer's document
- Underwriters, financial advisers and lawyers can help develop the Official Statement but the Issuer is ultimately responsible for content

Disclosure Principles

- Broad description of Issuer's financial and economic condition (for General Fund backed transactions)
- Description of budget process, major revenue sources and expenditure programs
- Information on recent and current budgets – “structural” deficit?
- Information on debt – types and amounts
- Information on derivatives
- Litigation

Disclosure Principles – Revenue Bonds

- Description of enterprise
- Description of capital improvement program
- Historical and projected revenues, expenses and debt service coverage
- Rate covenant and additional bonds test
- Regulatory issues
- Information on debt – types and amounts
- Information on derivatives
- Litigation

Disclosure Principles – *(cont.)*

- Provide main points but do not overwhelm readers with detail
- Highlight important developments “up front”
- Determine appropriate level of importance for any particular event or budgetary item
- Bringing all these factors together into final product is ongoing process of give and take

Timing Considerations For Bond Sale

- Progression of an offering
 - POS/sale/final OS/closing
- Supplements are possible
 - Relatively rare and disruptive after sale
- Be mindful of public actions or releases likely to occur
 - State budget, Issuer budget, mid-year reports
 - Permit issuance (for revenue issuers)

Process

- Input from involved departments;
- Empower staff at all levels;
- Issuer coordinates, with assistance from Municipal Advisor;
Counsel helps pull information together and maintains document
- Drafts reviewed by working group
- “Due diligence” meeting before distribution of Preliminary Official Statement

Current Hot Topics

- Lingering Impacts of COVID-19 pandemic
- Potential impact of recession
- Does issuer have a structural deficit?
- Status of fund balance and reserves
- Expected increases in retirement related payments; unfunded liabilities (pension and OPEB); possibility of changes in actuarial assumptions
- Changed or unusual accounting practices or adjustments
- Continuing Disclosure Compliance

Disclosure Considerations

- Tomorrow's "hot topic" may be different than today's
- Disclosure must evolve to reflect changing circumstances
- Read the disclosure with "fresh eyes"
- If you think something may be a concern, raise the issue with colleagues and the working group
- There are no "stupid questions"
- Political sensitivity and confidentiality considerations are not exceptions to disclosure

When Should Projections Be Disclosed?

- Apply Disclosure Rules – Are the projections “material”?
- Disclosure Rules do not require that projections be created
- However, if projections are prepared and identify significant negative trends, need to assess to determine if material and therefore should be disclosed
- Projections contained in an OS do not have to be updated in Annual Reports disclosure

SEC Enforcement Actions

- Inadequate Pension Disclosures
 - City of San Diego (2006)
 - State of New Jersey (2010)
 - State of Illinois (2013)
 - State of Kansas (2014)
 - In these cases, SEC focused on failure to disclose funding shortages and the potential impact pension funding pressures would have on future budgetary flexibility, as well as misstatements on remedial plans.
 - SEC also highlighted lack of training and internal procedures which resulted in disclosure lapses.

Recent Enforcement Actions *(cont.)*

- Misleading or Incomplete Financial Disclosures
 - City of Miami II – interfund transfers to mask budget gaps allegedly not disclosed
 - Victorville, CA – alleged inflated valuation of property in taxing district, other conflicts of interest
 - City of Allen Park, MI – failure to disclose budget gap

Recent Enforcement Actions *(cont.)*

- **Town of Ramapo, NY – officials over many years allegedly hid financial strain and deficits caused by baseball stadium project as well as declining sales and property tax revenues; two officials charged with “controlling person” liability and also charged in a separate criminal case; they and two other officials charged by SEC with “aiding and abetting” violations; defendants contesting in court (2016)**
- **Westlands Water District SEC alleged that District undertook extraordinary accounting transaction to meet debt service coverage. SEC also alleged that District did not disclose a prior period accounting adjustment which would have adversely affected debt service coverage. No allegation that the accounting was improper. District, General Manager and Chief Financial Officer all entered into settlements in which they neither admitted nor denied allegations but paid fines of \$125,000, \$50,000 and \$20,000, respectively.**

Recent Enforcement Actions *(cont.)*

- Failed Economic Development Projects
 - **Greater Wenatchee Regional Events Center, WA – did not disclose prior, less favorable projections; project failed to generate expected revenues; settled (2013)**
 - **City of Allen Park, MI – failure to disclose collapse of movie studio project which was expected to generate revenue to cover budget gaps; settled (2014)**
 - **City of Harvey, IL – nondisclosure of failed hotel project; also fraud by City Controller; settled (2014)**
 - **Rhode Island Economic Development Corp. – alleged failure to disclose funding shortfall for startup software company; two officials settled; issuer and underwriter contesting (2016)**
 - **Also see Ramapo, NY, above – baseball stadium**

Recent Enforcement Actions *(cont.)*

- Disseminating False Statements
 - On March 27, 2019, the Supreme Court issued its opinion in *Lorenzo v. SEC*. The Court held that "dissemination of false or misleading statements with intent to defraud can fall within the scope" of SEC Rule 10b-5(a) and (c) even if the disseminator did not "make" the statements. The "dissemination" consisted of someone (Lorenzo) sending two emails to investors containing false information, but which were composed by someone else. The Court emphasized that Lorenzo disseminated the emails knowing the information was false and with an intent to defraud. In holding Lorenzo primarily liable, the Court highlighted that (1) he communicated directly with investors; (2) he invited investors to ask him follow-up questions; and (3) he sent the emails "in his capacity as vice-president of an investment banking company".

Recent Enforcement Actions *(cont.)*

- Failure to Disclose Risk
 - **Port Authority of New York and New Jersey – SEC alleged that PA official statements failed to disclose the risk that certain proposed uses of bond proceeds to fund highway and bridge improvements in New Jersey were not authorized by its statutes and bond resolution. Issuer settled, conceding correctness of SEC’s statements of fact (first case where issuer was not allowed to neither admit or deny the allegations), agreed to outside monitor of disclosure procedures, and paid \$400,000 fine.**

Consequences of SEC Actions

- Levying fines against issuers: Wenatchee, Westlands
- Increasingly charging issuer officials along with the issuer: Miami, Allen Park, Harvey, Wenatchee, Victorville, Westlands, RIEDC, Ramapo
- Levying fines against individual defendants: San Diego, Allen Park, Harvey, Westlands, RIEDC
- Officials barred from future involvement in municipal finance: Allen Park, Harvey; sought in Ramapo
- Loss of Market Access
- Rating Downgrade

Summary

- Full and transparent disclosure is essential
- Investors must be provided all material information when making their investment decision
- Officials participating in the disclosure process must be in a position to know material information (i.e., “the right people must be in the room”)
- Vigorous disclosure program requires buy-in and encouragement from top levels
- Empower everyone in the organization
- Be careful when making public statements
- When in doubt, disclose