

SESSION ONE

Why is Disclosure Important?



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A Review of the Basics

- An issuer has a large capital project and decides to issue and sell bonds to investors as a way to borrow money
- Bonds are securities that evidence a loan from individual investors to the issuer
- The money raised from selling bonds to investors is paid back to investors over time with interest
- The issuer describes its proposed bond issuance to investors in a document called an Official Statement (OS)
- The OS has all material information regarding the bonds and the issuer needed to invest in the bonds
- Bond investors are supposed to base their investment decision in the bonds on the OS
- Information regarding the issuer in the OS is provided by issuer employees with guidance from its counsel
- About one month before bonds are issued and sold in a bond closing, a Preliminary Official Statement (POS) is circulated to potential investors (investment decision really based POS)
- This one-month period is known as the offering or sale period

Securities Act of 1933

GENERAL

- The Securities Act requires that investors receive financial and other information about securities being offered for sale to the public
- The Securities Act prohibits deceit, misrepresentations, and fraud in the sale of securities to the public
- Securities Act Amendments of 1975 created the Municipal Securities Rulemaking Board (MSRB)

REGISTRATION EXEMPTION FOR “EXEMPT SECURITIES”

- Section 5 of the Securities Act imposes a registration requirement for securities – except for exempt securities or exempt transactions
- Section 3(a)(2) of the Securities Act exempts from this registration requirement securities issued by any State or any political subdivision of a State, including the City

ANTIFRAUD

- Notwithstanding this registration exemption, municipal securities are subject to the antifraud provisions of the Securities Act

Securities Act of 1933

ANTIFRAUD PROVISIONS

SECTION 17(A) UNDER THE 1933 ACT

Section 17(a) (most commonly cited provision)

- It shall be unlawful for any person in the offer or sale of any securities...by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly —
 - (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading
 - (3) engage in transactions with fraud/deceit on buyer
- Legal Standard: Scierter (a mental state embracing intent to deceive, manipulate or defraud) or negligence
 - Recklessness - an extreme departure from the standards of ordinary care - may establish scierter
- Similar language to Rule 10b-5 (to be covered in slide 6)

Securities Exchange Act of 1934

GENERAL

- Created the Securities and Exchange Commission (SEC)
- Established a system of broker-dealer registration and regulation

REPORTING REQUIREMENTS FOR REPORTING COMPANIES

- Section 13(a) requires annual and quarterly reports
- Section 13(b) gives the SEC authority to prescribe accounting standards, recordkeeping rules and rules regarding maintenance of internal controls

MUNICIPAL EXEMPTION; ANTIFRAUD

- Under Section 12(g)(1) of the 1934 Act, municipal securities are exempt from the (i) registration requirements, (ii) reporting requirements, and (iii) accounting standards, books and records and internal control requirements
- Municipal securities are subject to the antifraud provisions of the 1934 Act

Securities Exchange Act of 1934

ANTIFRAUD PROVISIONS

SECTION 10(B) & RULE 10B-5 UNDER THE 1934 ACT

Rule 10b-5 (most commonly cited provision)

➤ It shall be unlawful:

- ❖ 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.

Scienter (e.g., fraudulent intent or recklessness) required

Materiality

- Case law has established that information is material if there is a “substantial likelihood that, under all the circumstances, the omitted factor would have assumed actual significance in the deliberations of a reasonable [investor]”
- The “reasonable” investor is an objective standard
- For future events, materiality depends upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event
- A misstatement or omission may be material if it affects rating, yield, risk of early redemption, etc., even if it does not present a risk of default
- Confidentiality, business concerns, and political sensitivity are not exceptions to application of disclosure rules

Disclosure Contexts

PRIMARY DISCLOSURE

- Preliminary and final Official Statements

SECONDARY MARKET DISCLOSURE

- Rule 15c2-12
 - Annual Report
 - Event Disclosure
- Voluntary filings
 - Examples: notices to investors pursuant to bond documents, litigation or enforcement actions, and other disclosures not required by Rule 15c2-12 [*e.g.*, COVID-related disclosures]

OTHER DISCLOSURES “REASONABLY EXPECTED TO REACH INVESTORS”

- Investor webpages
- Public statements by officials of the issuer
- Budget materials
- Press releases

Rule 15c2-12

- SEC Rule that applies to broker-dealers acting as municipal securities underwriters; does not apply directly to issuers
 - 1989 – Primary Disclosure
 - 1995 – Continuing Disclosure

Rule 15c2-12 Requirements

TWO PRINCIPAL RULE REQUIREMENTS ARE:

- Receipt and review by the underwriter of a “deemed final” official statement (generally a *preliminary official statement*) before commencing the offering of the municipal securities [Rule 15c2-12(b)(1)]
- An underwriter must reasonably determine that there is a contractual undertaking of the issuer (*or an obligated person*) to provide (i) annual financial information and (ii) in a timely manner, notice of specified material events [Rule 15c2-12(b)(5)]

SEC Enforcement Powers

INVESTIGATIONS

- The SEC is authorized to conduct investigations and issue reports under Section 21(a) of the Exchange Act

ADMINISTRATIVE PROCEEDINGS

- The SEC may initiate administrative proceedings, which usually involve negligence-based charges

CRIMINAL PROCEEDINGS

- The securities laws allow for criminal prosecutions for “willful” violations through a referral to the Department of Justice

THE SEC MAY SEEK ENFORCEMENT ACTIONS AGAINST:

- Governmental issuer (e.g., a city, a school district, a county)
- Governmental officials and employees (senior city officials; CFO, treasurer, other financial staff)
- Individual members of issuer’s legislative body
- Third parties (e.g., underwriters, financial advisors, bond counsel, conduit issuers)

Enforcement Lessons:

No Debt Service Default Necessary for Securities Law Violation

- Misstatements and omissions concerning an issuer's financial condition can be the basis for an enforcement action, regardless of whether such condition would affect negatively the ability of an issuer to pay principal and interest in a timely fashion (*Maricopa County, 1996*)
 - General obligation bond issue
 - Secured by unlimited ad valorem tax
 - County was current in the payment of debt service on all outstanding general obligation bonds
- Failure to disclose a trend, not a particular amount, can be the basis of an enforcement action - “the City materially misrepresented its financial condition and results of operations” in that the official statements showed a surplus for FY 1995 of \$0.4 million when there was a deficit of \$9.4 million (*City of Syracuse, 1997*)

Enforcement Lessons:

Documents That May Create Liability

- Misstatements in Annual Comprehensive Financial Report and transmittal letter that were voluntarily filed (*City of Miami, 2001*)
- An issuer's misleading information that is incorporated into or restated in a second issuer's offering document can create liability for the issuer that is the source of the information (*Massachusetts Turnpike Authority, 2003*)
- Misleading statements were made in budget report, annual and mid-year financial statements and a State of the City address that were published on the City's website (*City of Harrisburg, 2013*)
 - First time that the SEC charged a public agency of misleading statements made outside of its disclosure documents
- Materially misleading omissions in tax certificate and loan agreement not provided to investors nor reasonably expected to reach investors (*City of South Miami, 2013*)

Enforcement Lessons:

Disclosure of Projections

- An issuer's delay in disclosing cost increases, on argument that increases were speculative and not quantified, can create liability. (*Massachusetts Turnpike Authority, 2003*)
 - Two choices – (1) delay the bond offering, (2) disclose and place estimates of cost increases in proper context
- Where no other projections exist, the failure to provide informal estimates can create liability. Rating agency analysts had asked whether any projections existed. Staff had asked financial advisors (not actuaries) to reverse engineer an estimate of future funded ratios and annual required contributions. Staff did not provide such informal estimates to the rating agencies. (*San Diego, 2006*)

Limited Offering Exemption Enforcement Actions

- September 2022 – First time SEC brought charges against underwriters who failed to meet legal requirements of limited offering exemption as provided for in Rule 15c2-12.
 - The Rule does not apply to primary offerings of municipal securities in authorized denominations of \$100,000 or more, if such securities:
 - (i) Are sold to no more than thirty-five persons each of whom the Participating Underwriter reasonably believes:
 - (A) Has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the prospective investment; and
 - (B) Is not purchasing for more than one account or with a view to distributing the securities.
- According to the settlements, underwriters failed to do sufficient diligence to support reasonable belief that securities that were purchased for sophisticated investors.
- The SEC has announced additional settlements in these limited offering exemption cases (enforcement priorities could be shifting but more of these cases could be in the pipeline).

Some Recent Enforcement Actions

SEC v. City of Rochester, NY

- Official statement used outdated financial statements and did not disclose unusual financial distress and deficits for School District (withheld from working group too)

Town of Sterlington, Louisiana

- False financial projections used in gaining approval for bond issuance from local bond commission

Sweetwater Union High School District

- Positive trends consistently shown; deficit hidden in interim reports; came out in audit

Crosby Independent School District

- Fraud in audited financials; financial emergency ultimately declared

Some Recent Enforcement Actions (cont.)

- Other recent actions (the vast majority of them):
 - Municipal advisor enforcement cases
 - General investment adviser and broker-dealer cases

Other Considerations/Takeaways

- Good disclosure is stressed by the SEC and expected by market participants
- In fact, disclosure policies and procedures are consistently recommended by SEC and imposed as a condition of settling SEC enforcement actions
 - Minimize risk of misleading disclosure
 - Defend against charge of negligence or recklessness
 - Best practice; better reception in the marketplace

Other Considerations/Takeaways (cont.)

- Recognize the importance of good disclosure
- Do I have knowledge of a potentially material fact that the working group may not be aware of?
- Consider disclosure as a whole and don't narrowly focus on simply updating dates and numbers
- Maintain a record of the sources of the material being included in the disclosure documents
- Read and draft from the perspective of an investor (i.e., what would you like to receive if you were the prospective investor?)
- Bring any underwriter or investor inquiries to the attention of the financing team; revisions to the disclosure might be appropriate

QUESTIONS?



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