SESSION TWO
Continuing Disclosure

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Why Is Disclosure Necessary?

- Issuers of municipal securities have obligations under federal securities laws
- All “material” information must be disclosed:
  - SEC Rule 405
    - The term material, when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a ***substantial likelihood*** that a ***reasonable investor*** would attach importance in determining whether to purchase the security registered
    - The rule is from an investor perspective, not the issuer’s or the borrower’s

What Is A Reasonable Investor?

- Objective
  - A reasonable investor is one that is objectively focused on the investment decision
  - Does not consider emotional or subjective elements that are not related to the investment decision
  - Most importantly, legal standard of materiality assumes reasonable investors are not influenced by political or policy factors that are unrelated to the investment decision (for good or for bad)
- ***Unclear what level of sophistication***
  - Cannot assume an institutional investor (such as professional investors who maintain bond funds who are engaged in the business of investing)

Why Did The SEC Create Continuing Disclosure Requirements?

- ***It is helpful to know why Congress adopted the federal securities laws and created the United States Securities and Exchange Commission***
  - Securities presented quite the conundrum to Congress in the early 1930's
    - They were not like goods or services because they were just investments and thus the quality of the security couldn't be objectively evaluated from a legal perspective; BUT
    - The one thing an investor needs is accurate, complete and timely information about the security to make a good investment decision
  - Congress adopted the federal securities laws to recognize that the purchase and sale of a security is a different economic transaction than others and thus required laws to ensure that investors receive the information they need to make good investment decisions.
  - In many regards, the SEC's entire mission is to ensure that these laws are enforced but also that investors of securities receive the kind of information they need to make informed investment decisions

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 certain SEC actions suggest using greater caution)
    - Investor websites

Four Legal Foundational Principles For Investor Communications Outside Of Offerings

- Know when you are “speaking” to the market

- Know when you are altering the “total mix of information”

- Know the “circumstances” of your statements

- Have a reasonable process for ensuring that your statements are complete and accurate, under the circumstances

Legal Basics Of Secondary Market Disclosure

THE BASICS:

- 1994 Interpretative Release:

  "…when [a municipal issuer] releases information to the public that is ***reasonably expected*** to reach investors and the trading markets, those disclosures are subject to the antifraud provisions. The fact that they are not published for purposes of informing the securities market does not alter the mandate that they not violate antifraud proscriptions." (emphasis added)

  - Before the SEC amended Rule 15c2-12 in 1994, issuers and borrowers of municipal securities had no obligation to provide updates to investors concerning their financial and operating condition

Legal Basics Of Secondary Market Disclosure (Continued)

What should we take away from this?

- Secondary market statements are as much subject to the Federal antifraud laws as primary offering statements
- The circumstances of the statements govern what those statements need to contain:
  - Primary offering documents purport to describe all factors material to an investment decision and the Federal antifraud laws test those statements in that light.
  - Secondary market disclosures, though, can vary
  - Annual reports can purport to provide a comprehensive updating of the financial and operating condition
  - Other filings will be evaluated based on their circumstances

Rule 15C2-12 Listed Events

- Listed events that require notice not in excess of 10 business days after the occurrence of the event
  (1) Principal and interest payment delinquencies;
  (2) Non-payment 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;

Rule 15C2-12 Listed Events (Continued 2/4)

(7) Modifications to rights of security holders, ***if material***;

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

(9) Defeasances;

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

(11) Rating changes;

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

Rule 15C2-12 Listed Events (Continued 3/4)

(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 or additional trustee or the change of name of a trustee, ***if material***;

(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***; and

(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.

Rule 15C2-12 Listed Events (Continued 4/4)

- The listed events in (15) and (16) define “financial obligation” as “(i) a 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 (i) or (ii).”
- Adopted in response to an increasing concern by investors relating to timing and quality of disclosure in the municipal securities markets about bank loans and other debt obligations incurred by an obligated person in transactions not subject to Rule 15c2-12

What Do Good Continuing Disclosure Practices Look Like?

- ***What should obligated persons do to comply with the amendments?***
  - Adopt policies and procedures that:
    - Identify categories of financial obligations that obligated persons are likely to incur and the departments that are likely to incur financial obligations;
    - Monitor material amendments to financial obligations;
    - Monitor covenants and defaults of financial obligations; and
    - Create an internal tickler process to ensure that personnel responsible for filing event notices are aware of the occurrence of events that need to be reported.

What Do Our Continuing Disclosure Undertakings Require Us To Do?

- What do our continuing disclosure undertakings require us to do?
  - File annually:
    - Audited financial statements; and
    - Audited financial statements; and
    - File within 10 business days' notice of the occurrence of listed events
    - This requires
      - Systems to meet calendar deadlines for annual filings;
      - Procedures to ensure everything is included in annual financial reports; and
      - Procedures to track potential listed events

What Do Our Continuing Disclosure Undertakings Require Us To Do? (Continued 2/3)

- ***This requires:***
  - Good process to make sure everything that the issuer or borrower states in a filing is accurate; and
  - Good process to ensure that the filing does not omit important information which entails:
    - Knowing the "circumstances" of the filing.
    - Good "internal due diligence" to make sure that all individuals who have key information are appropriately involved in the filing to ensure that the filing does not omit a material fact that would render the filing misleading.

What Do Our Continuing Disclosure Undertakings Require Us To Do? (Continued 3/3)

- ***What many issuers and borrowers do not know:***
  - ***All continuing disclosure filings also are "statements" tested under the federal antifraud laws!***
  - Issuers and borrowers should also take reasonable steps to ensure that the information contained in any continuing disclosure filing satisfies the federal antifraud laws….
  - Which means:
    - The issuer or borrower needs to take reasonable steps to ensure that the information in the filing…
      - Does not make a material misstatement…and
      - Does not omit a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

Underwriter Considerations

- Underwriters are required to independently investigate an issuer's compliance with its continuing disclosure undertaking

- Underwriters may want to see or have an understanding of the policies and procedures in place to confirm appropriate internal controls

Consequences of Failure to Comply

- Generally, non-compliance is not an event of default under bond documents, but bondholders have a right to sue for compliance
- In an offering, failures over the past five years must be disclosed
- No clear guidance on what is a "material" failure to comply

Enforcement Actions Relating To Continuing Disclosures Pre-municipalities Continuing Disclosure Cooperation Initiative ("MCDC")

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
  - When Harrisburg realized it was becoming insolvent, it cut off all information flow to everyone – which included no longer sending out their promised continuing disclosure updates to investors. The SEC then used information provided on the city's website to charge the city – included the mayor's state of city address – even though none of that information was intended to investors. The SEC's point was that the investors had no other information to inform their investment decisions

- 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

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 Disclosures (Continued)

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 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. 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

What Do Good Continuing Disclosure Practices Look Like? — Part Two

- ***Written policies and procedures that address:***
  - Good calendaring/tickler/create a template or chart for annual reports and event filing;
  - Clear identification of a coordinator;
  - Clear identification and assignment of responsibilities to the right people;
  - Clear procedures to ensure the right people meet together at the right times and ask the right questions;
  - Good compliance check to ensure the filing includes all required information; and
  - Good listed event procedures
  - Training

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

QUESTIONS?

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