

Why Should You Care About Disclosures?

Debt Issuance, Primary and Secondary Market Disclosure Requirements and Recent Regulatory Developments

Ryan Pollihan, ZB, National Association dba Zions Bank

James Snyder, Ice Miller LLP

Kyle Harding, Chapman and Cutler LLP

LeeAnn Gaunt – SEC’s Municipal Enforcement Division Head

1. The SEC “remains interested” in issuer officials and others participating in deals in which there were violations — no longer just cease and desist orders — now monetary penalties on issuers and individuals.
2. Does not matter if there is a bond default – SEC will focus on adequacy of disclosure.
3. Small issuers cannot get by because they are small and unsophisticated; big issuers cannot rely on a multitude of attorneys, accountants and advisors.
4. Control Person Liability is a strong tool for the SEC. A person is a control person if he exercises control over the entity or has the ability/authority to direct the entity.

Source: Remarks and questions from NABL TSLI meeting (March 9-10, 2017)

Growth of SEC Enforcement Actions

- Since early 2013 alone, the SEC has brought enforcement actions against 76 state or local government entities (including 4 U.S. states), 13 obligated persons and 16 public officials. Additionally, the MCDC Initiative (resulted in \$18 million in fines against 72 underwriters (96% of the market) and enforcement actions against 71 municipal issuers and other obligated persons. In contrast, for the entire 10-year period from 2002 to 2012, there were enforcement actions brought against 6 government entities, 6 obligated persons and 12 public officials.
- In the 3 years from 2013 and 2016, the SEC levied \$180,000 in civil penalties on eight officials. In contrast, five officials (in only two actions) paid \$85,000 in civil penalties in the 15 years from 1998 through 2012.

Why Scrutiny Over Municipal Disclosure?

- Retail investor market participation
- 2007-2013 Financial Crisis [“Great Recession”]
- A few bad, public bankruptcies
- Congressional pressure [Dodd-Frank Act]

Who Is Investigating Municipal Disclosure?

- SEC Public Finance Abuse Unit
 - The Unit investigates and litigates cases involving violations of the federal securities laws, specifically those matters concerning municipal bonds and public pensions.
 - The Unit is made up of approximately 30 attorneys, experts, and staff from SEC offices around the country (with 4 people in Chicago).
- Department of Justice

Department of Justice Involvement

- Why might DOJ get more involved?
 - Success of Ramapo
 - Standard in Public Corruption Cases
 - Traditional criminal public corruption charges require a “quid pro quo”
 - Federal securities laws don’t require a “quid pro quo”; withholding a material fact might suffice

Primary Market Disclosure - Overview

- The official statement is a document prepared by, or on behalf of, the Issuer in connection with a primary offering of its bonds.
- The official statement discloses all material information on the offering for potential investors.
- The official statement is the main source of anti-fraud liability in a municipal transaction.

Disclosure Obligation

- The obligation for the accuracy and completeness of the disclosure lies with the Issuer.
 - Experts help, but cannot completely discharge the District's obligation
 - Issuer, underwriter, financial advisor and attorneys all have potential anti-fraud liability for material misstatements or omissions in official statements
- Obligation goes beyond paying bonds - the SEC can bring an enforcement action even if debt service on bonds is being paid.
- The process of revising and updating disclosure should not be viewed as a mechanical insertion of more current numbers.

Legal Framework – SEC Law & Rules

- Anti-Fraud Provisions under Securities Act of 1933 and the Securities Exchange Act of 1934
- SEC Rule 15c2-12

Anti-Fraud Provisions

- Prohibits fraud in the offer, purchase or sale of securities
- Applicable even if Rule 15c2-12 is not (e.g. private placement)
- Securities Act of 1933
 - Section 17(a)
- Securities Exchange Act of 1934
 - Section 10
 - Rule 10b-5
 - Unlawful to make any untrue statement of a material fact or 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

Anti-Fraud Provisions *(cont'd.)*

What is a material fact?

- A fact is material if there is a substantial likelihood that its disclosure would be considered significant by a reasonable investor.
- If known, would it change the price?
- Remember, materiality is often judged in hindsight.

Control Person Liability

- Securities Exchange Act of 1934–Section 20(a)
- Any person who directly or indirectly “controls” another person found liable for a violation of the ‘34 Act is jointly and severally liable, to the same extent as the controlled person, to any person to whom the controlled person is liable

SEC Rule 15c2-12

- Requires underwriters of municipal securities to:
 - Obtain, review and disseminate an official statement
 - Ensure that issuer or obligated person has undertaken (contracted) to provide certain continuing disclosures to the market (Continuing Disclosure Undertaking or CDU)

SEC Rule 15c2-12 (cont'd.)

- Establishes a system for dissemination of certain important information through requirements placed on broker-dealers
 - SEC cannot impose this Rule on municipal issuers (Tower Amendment)
- When applicable
 - Underwritings (does not apply to direct or private placements unless broker-dealer involved in transaction)
 - Par amount must be in excess of \$1,000,000
 - Limited requirements for (1) securities with a stated maturity \leq 18 months, or (2) obligated person has \leq \$10M aggregate amount of outstanding municipal securities

The EMMA System

- Goals:
 - Improve investor protection through faster, more transparent, information delivery
 - Municipal market equivalent of the SEC's EDGAR system
- Receives electronic submissions of documents and other information and make them publicly available for free on the EMMA website (emma.msrb.org).
 - Primary Market Information from OS/ARD
 - Pricing Information (primary and secondary)
 - Continuing Disclosure information

SEC Municipal Enforcement Actions

City of Harrisburg, Pennsylvania

- However, in May 2013, the SEC for the first time charged a municipality for misleading statements made outside of its securities disclosure documents. The City of Harrisburg, PA, was obligated to submit financial information to EMMA. Allegedly, the City never submitted its financial information to EMMA. Therefore, the public could not verify the material misrepresentations and omissions with respect to the City's credit ratings when, for example, the mayor gave an annual address, which was then reproduced on the City's website.

SEC Municipal Enforcement Actions

Town of Ramapo, New York

- **First Federal criminal securities fraud prosecution and conviction involving municipal bonds**
- **Convicted:** Christopher St. Lawrence, the former Director of Finance for Ramapo, New York, was found guilty of 20 counts of conspiracy, securities fraud and wire fraud.
- **Disclosure Problem:** Not properly disclosing deteriorating financial situation in general bond offering documents; fabricating receivables; misleading a rating agency about the town's general fund balance
- St. Lawrence told a credit rating agency on a phone call that Ramapo experienced "increased fund balances across the board, and had a stable balance in the general fund" for fiscal year 2012. Immediately after the call, St. Lawrence said to Ramapo officials, "Listen I'm going to tell you this right now. We need to do this [upcoming] refinancing of the short term [RLDC] debt as fast as possible, because ... **we're going to have to all be magicians to get to some of those numbers.**"

Town of Ramapo, New York

(cont'd.)

- Jury rejected two of St. Lawrence's arguments that no investors were harmed as all of the bonds were at all times fully and timely paid, and that St. Lawrence received no personal financial gain in connection with the alleged fraudulent activity.
- Andrew J. Ceresney, Director of the SEC Enforcement Division, stated, **"We won't stand for public officials and employees who resort to alleged accounting trickery to mislead investors who are investing in their financial futures as well as the future betterment of our communities."**
- On December 13, 2017, St. Lawrence received a 30-month prison sentence.

Additional SEC Municipal Enforcement Actions

- **West Clark Community Schools, Sellersburg, Indiana-**
 - District liable after affirmatively stating in an offering document that it had not failed, in the previous five years, to comply in all material respects with any prior disclosure undertakings when in fact no contractually required disclosures had been submitted.
- **City of Miami, Florida**
 - City and Budget Director liable after transferring from the Capital Projects Fund to the General Fund to mask General Fund deficits, but not fully disclosing the effect or amounts of the transfers in bond offering documents. This was the first federal jury trial by the SEC against a municipality or one of its officers for violations of federal securities laws.

Additional SEC Municipal Enforcement Actions *(cont'd.)*

- **Westlands Water District, California**

- District officials sanctioned after falsely representing that the District met or exceeded the 1.25 debt service coverage ratio for water bonds

- **City of Harvey, Illinois**

- Mayor sanctioned after City officials told investors that their money would be used to develop and construct a Holiday Inn but diverted bond proceeds to fund the City's payroll and other operational costs unrelated to the hotel project
- Unique because the SEC received an emergency court order to halt an unrelated bond offering when it became clear that the City intended to issue additional bonds while the SEC as conducting its investigation.

Additional SEC Municipal Enforcement Actions *(cont'd.)*

- **City of Allen Park, Michigan**

- Municipal officials liable after the SEC discovered that offering documents contained false and misleading statements about the scope and viability of the proposed project and the overall financial condition of the City.

Additional SEC Municipal Enforcement Actions *(cont'd.)*

- **Beaumont Finance Authority, California**
 - Beaumont Financing Authority had issued approximately \$260 million in municipal bonds in 24 separate offerings from 2003 to 2013. The community facilities district established by Beaumont agreed to provide investors with annual continuing disclosures and regularly failed to provide investors with the promised information. The Authority failed to disclose this poor record of compliance when it conducted the 2012 and 2013 offerings totaling more than \$32 million.

Additional SEC Municipal Enforcement Actions *(cont'd.)*

- The SEC charged the Authority's executive director who agreed to settle the charges without admitting or denying the allegations, pay a \$37,500 penalty and be barred from participating in any future municipal bond offerings. The Underwriter and its individual co-founder agreed to settle the charges. The Underwriter agreed to pay a \$150,000 penalty and individual co-founder agreed to pay a \$15,000 penalty and serve a suspension from the securities industry for six months.

Disclosure Best Practices

- **Due Diligence Calls**

- **Process:**

- Issuer is provided a copy of the Preliminary Official Statement in advance of the call for review
 - Underwriter/Financial Advisor, Counsel and the Issuer on the call
 - Review/acknowledge completed Due Diligence Questionnaire

- **Questions regarding:**

- Accuracy of POS
 - Changes in financial affairs since Financial Statements
 - Audits, investigations, litigation
 - Employees and employee relations
 - Major taxpayer/employer status
 - Compliance with prior continuing disclosure undertakings
 - Issuer should raise “material” issues not covered by questions

Disclosure Best Practices

(cont'd.)

- Adopt Disclosure policies and procedures
 - Main components: Designating a disclosure officer; adopting procedures for primary disclosure (official statements), producing and filing annual financial information on EMMA and filing Reportable Events on EMMA.
 - Incorporating robust disclosure practices/procedures and demonstrating a solid disclosure track record benefits an issuer by encouraging regulatory compliance and by enhancing credibility among investors, credit rating agencies and the public.

Disclosure Best Practices

(cont'd.)

In private or direct placement:

- Have purchaser sign an investor letter

In public offering subject to Rule 15c2-12:

- Establish (and follow) disclosure procedures
- Reliance on municipal finance professionals
- Underwriter's Counsel, Disclosure Counsel and "Customary 10b-5 opinion"
 - Underwriter's Counsel/Disclosure Counsel are adding due diligence calls/meetings as a regular practice for all issuances to evidence compliance with due diligence responsibilities.

Outlook 2018: SEC's Enforcement Priorities

The Chief of the SEC's Public Finance Abuse Unit expressed that municipal market enforcement activities will focus on offering and disclosure fraud, broker-dealer abuses, municipal adviser misconduct and breaches of fiduciary duty, public corruption, and pay-to-play abuses. Current chair Jay Clayton said he expects the SEC's emphasis going forward to be on fewer, but higher quality, enforcement cases.

Outlook 2018: SEC's Enforcement Priorities *(cont'd.)*

Clayton's testimony before Congress earlier this year indicated that he is interested in punishing individual bad actors so market participants should not be surprised to see a continued focus on enforcement actions against individuals in the coming year.

Questions?

This document has been prepared by Chapman and Cutler LLP and Ice Miller LLP attorneys for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material.