

GOOD DISCLOSURE PRACTICES — WHY THEY MATTER



JULY 23, 2015

INTRODUCTION: DISCLOSURE OBLIGATIONS OF MUNICIPAL ISSUERS GENERALLY

- Primary disclosure – when bonds first issued or sold
 - Preliminary and Final Official Statement; and
 - Remarketing Circular and Reoffering Memoranda.
- Secondary disclosure – during life of the bonds
 - Rule 15c-2-12 continuing disclosure requirements;
 - Voluntary disclosure filings; and
 - Statements “reasonable expected to reach investors.”

INTRODUCTION: HOW DOES THE LAW REGULATE MUNICIPAL BOND DISCLOSURES?

- The Federal antifraud laws regulate primary and secondary disclosures by issuers of municipal securities.
 - They prohibit making material misstatements or omissions of **material** facts.
 - Statements must be true and accurate and must not leave anything **material** out if necessary to avoid a misleading statement.
 - Statements that are technically accurate can violate the Federal antifraud laws if they are misleading.
 - Issuers can violate the Federal antifraud laws even if they did not intend to deceive anyone if they negligently make materially inaccurate or misleading statements.
- Materiality – the alleged misstatement or omission must be something a reasonable investor would have considered in making an investment decision



INTRODUCTION: HOW DOES THE LAW REGULATE MUNICIPAL BOND DISCLOSURES?

- Section 10b-5 of the Securities Exchange Act.
 - Material misstatements or omissions of material fact
 - Requires scienter – intent to deceive, manipulate or defraud must be proven
 - recklessness - highly unreasonable conduct involving an extreme departure from the standards or ordinary care and which presents a danger of misleading investors that is either know to the issuer or is so obvious that the issuer must have been aware of it.
 - Requires materiality
- Section 17(a) of Securities Exchange Act
 - SEC – not bondholders – can use Section 17(a)
 - Requires a finding of negligence
 - Requires materiality



INTRODUCTION: HOW DOES THE LAW REGULATE MUNICIPAL BOND DISCLOSURES?

– Rule 15c2-12

- Rule applies to broker-dealers acting as underwriters in a primary offering.
- Paragraph (b)(5) – underwriter must reasonably determine an issuer will provide for the life of the bonds “annual financial information” and notices of specified events respecting the bonds being issued.
 - If an issuer were not to comply or has not complied with its agreement to provide such information and an underwriter may not be able to reach a “reasonable” determination for future bond offerings.
 - Disclosure of issuer non-compliance with Rule 15c2-12 is material (West Clark Schools).
 - Requires a “deemed final” official statement – issuer must deem the POS final meaning it includes all required disclosure information and only omits pricing information.
 - No material changes between POS and OS.



WHAT ARE SOME WAYS THAT SOME ISSUERS HAVE VIOLATED THE FEDERAL ANTIFRAUD LAWS?

— City of San Diego

- What happened?

- The City's costs to its pension system were expected to increase by a substantial amount each year for the indefinite future and that was expected to create a major structural deficit.
- The City had several bond offerings and filed several annual reports after learning about these mounting pension costs and did not tell investors of these facts.

- What did the SEC conclude?

- The SEC concluded that the City violated the Federal antifraud laws because they misled investors when they prepared official statements and annual reports that purported to comprehensively describe the financial and operating condition of the City's general fund and did not tell the investors about the mounting pension costs.



WHAT ARE SOME WAYS THAT SOME ISSUERS HAVE VIOLATED THE FEDERAL ANTIFRAUD LAWS?

— State of New Jersey

- What happened?
 - SEC checks into items in the municipal world that attract attention – NY Times articles focusing on confusion between pension and OPEB disclosures.
 - The State also had mounting pension costs.
 - The State provided a lot of information in its offering documents but it did not clearly lay out what the State owed to its pension plans and why that mattered to investors. The State also confused investors by making it sound like there was a separate fund that was there to pay the State's pension costs, when that wasn't the case.
- What did the SEC conclude?
 - The SEC concluded that the State violated the Federal antifraud laws because it was not careful in its disclosure; that is, the SEC did not conclude that the State had any bad intent or knowledge of wrongdoing. The State just did not follow a careful process to make sure investors were told the whole credit story related to the bonds.



WHAT ARE SOME WAYS THAT SOME ISSUERS HAVE VIOLATED THE FEDERAL ANTIFRAUD LAWS?

— City of Harrisburg

- What happened?
 - The City had guaranteed the debt of an enterprise fund and it became clear to the City in late 2008 that it did not have enough revenues to pay the payments it owed under its guarantees.
 - The City reacted to this information by not complying with its continuing disclosure obligations for over two years and kept the investment community as well as the general public in the dark about the serious financial issues facing the City.
- What did the SEC conclude?
 - The SEC concluded that the City had violated the Federal antifraud laws because when it did not comply with its continuing disclosure undertakings, investors were forced to go to reports that the City posted on its website and those reports were misleading because they did not explain the City's serious financial condition.

WHAT ARE SOME WAYS THAT SOME ISSUERS HAVE VIOLATED THE FEDERAL ANTIFRAUD LAWS?

— West Clark Community Schools

- What happened?
 - The school district issued bonds in 2005 and in 2007.
 - In 2005, the school district entered into a continuing disclosure undertaking pursuant to which it agreed to file an annual report updating its financial and operating information and file material event notices. The school district did not file anything pursuant to its continuing disclosure undertaking.
 - When the school district issued bonds in 2007, it told investors that it was in compliance with its undertaking when it clearly was not.
- What did the SEC conclude?
 - “West Clark Community Schools defrauded bond investors by leading them to believe that it had provided the annual financial information contractually required in a prior bond offering, when in fact for five years they failed to submit the required information. This case demonstrates that we will be vigilant in making sure municipal issuers and underwriters comply with their obligations.”—Quote from the Director of the Enforcement Division.



POTENTIAL IMPACTS OF FAILURE TO COMPLY

- Violations of Federal securities laws do not require an issuer to default or experience a ratings downgrade
 - Issuers and officials may be subject to:
 - SEC, Department of Justice and other investigations
 - Civil or criminal penalties
 - Injunctions or cease and desist orders
 - Judgments in civil lawsuits by plaintiffs
 - Issuers may face SEC sanctions, loss of market access, political problems
 - Officials may face dismissal from employment, reputational harm and possible prohibition on future involvement in public securities offerings.

WHAT DOES THIS MEAN THAT ISSUERS ARE SUPPOSED TO DO?

- Throughout the numerous SEC enforcement actions in 2013 and 2014, in addition to the content of the substantive disclosures, the SEC has focused on whether an issuer has a formal set of disclosure policies and procedures which it follows and whether those individuals responsible for preparing disclosure have been properly trained.
- Based on SEC guidance, here are the main actions that issuers should take:
 - Develop, maintain and comply with your disclosure policies and procedures
 - Tell the whole credit story in your offering documents
 - Stay focused on and be aware of your secondary market disclosures

DEVELOP, MAINTAIN AND COMPLY WITH DISCLOSURE POLICIES AND PROCEDURES

— Why is this so important?

- The SEC has found that when issuers do not have a deliberate process of making sure that they involve the right people, think through the disclosure carefully and assign people who are responsible for getting it right, then issuers can lose sight of what investors care about and fail to inform investors of what they need to know.

— What are good disclosure policies and procedures?

- Make clear who is responsible for what
- Make sure the right people are involved
- Make sure that the people who are involved are trained
- Make sure that the disclosure documents comply with policy and procedures.

******It is as bad, if not worse, to have a disclosure policy and not comply with it as it is not to have one at all!!***



TELLING THE WHOLE CREDIT STORY

— What does this mean?

- When an issuer prepares an offering document or an annual report, the issuer needs to be sure that it both provides investors all of the information they need to make a good investment decision and provides that information in a way that investors can understand.
- It means telling the bad news along with the good news
- Discuss the “elephant in the room” – Orange County 21(a) report

— Why is this so important?

- Telling the whole credit story about the bonds is the heart of the requirement of the Federal antifraud laws.
- It is the responsibility of the issuer to communicate to investors an accurate and complete picture of the bonds they are considering purchasing or that they are trading in the secondary market.



STAY FOCUSED ON SECONDARY MARKET DISCLOSURE

- What does this mean?
 - Make sure that all continuing disclosure filings are timely filed, carefully prepared and are accurate and complete, ***under the circumstances.***
 - Pay attention to fundamental credit shifts:
 - When events develop that fundamentally change the credit supporting bonds, investors may still be trading those bonds in the secondary market and can suffer major losses if they purchase without knowing all of the facts.
 - Issuers who experience these kind of fundamental credit shifts (like the City of Harrisburg) should consider providing a full description of the financial developments.



STAY FOCUSED ON SECONDARY MARKET DISCLOSURE (CONT'D)

- Why is this so important?
 - Statements that issuers or their officials make that are “reasonably expected” to reach investors are subject to scrutiny under the Federal antifraud laws. This means that continuing disclosure filings and other statements to investors need to be as accurate and complete as offering documents.
 - Public statements by officials can come under Federal antifraud law scrutiny because they are “reasonably expected” to reach the investment community. But if issuers make sure to keep investors informed of the total credit picture of the bonds, it protects those public statements from the same kind of scrutiny.



SUMMARY

Recognize importance
of good disclosure

Be reasonable in
the preparation

Be careful – review disclosure documents in their entirety

Make sure that appropriate officials and employees are included in the process

- Make sure that the information used to prepare the official statement comes from appropriate sources within the issuer and maintain records of source material
- Make sure experts at the issuer review disclosure that relates to their expertise
- Make sure people in proper authority review the disclosure – Board members too!

Talk to each other

- Bring any underwriter or investor questions to the attention of financing team
- Connect the dots of the disclosure

Be sure everyone is trained and knowledgeable

- Procedures should be designed to ensure to the extent possible that no material mistakes or omissions will occur.



CONCLUSION

QUESTIONS?



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