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SEC Disclosure Obligations and Enforcement

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I. Securities Law Background

While bonds, certificates of participation and other municipal securities are generally exempt from the obligation to register securities offerings with the United States Securities and Exchange Commission (the "SEC"), such securities remain subject to federal securities laws administered by the SEC, including, most notably, the disclosure obligations often referred to as the "anti-fraud" provisions.

A. Section 17(a) of the Securities Act of 1933 (the "Securities Act"), Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5.

1. In connection with the purchase of securities, both Section 17(a) of the 1933 Act and Rule 10b-5 (issued under Section 10(b) of the Exchange Act) prohibit fraud or deceit, and make it 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 light of the circumstances under which they were made, not misleading.

2. Violations of Rule 10b-5 require a showing of scienter. "Scienter" can be described as (a) intentional or knowing deception, or (b) recklessness (i.e., a highly unreasonable act or omission that is an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known or is so obvious that it must have been known by the actor).

3. By contrast, an issuer may be liable under Section 17(a) based on mere negligence (e.g., a negligent failure to be informed about or to disclose a material piece of information).

B. Materiality. Under the anti-fraud provisions, a fact is material if there is a substantial likelihood that the information would affect the decision of a reasonable investor. An omitted fact is material if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonably investor as having significantly altered the "total mix" of information made available.

C. The Tower Amendment - TOWER AMENDMENT Section 15B(d)(1) of the Exchange Act. Neither the SEC nor the Municipal Securities Rulemaking Board (the "MSRB") is authorized, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the SEC or the MSRB prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities.

II. Potential Penalties for Violating the Anti-Fraud Provisions

In recent years the SEC has increased its enforcement actions against municipal issuers, and has expressed interest in enhancing municipal disclosure requirements, including the possibility of requiring the registration of municipal securities with the SEC. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 created a

separate municipal securities office within the SEC, strengthening the SEC's ability to pursue investigations and enforcement actions against municipal issuers. Most notably, the SEC has pursued significant enforcement actions against municipal issuers as well as individual members of public bodies. These enforcement actions have demonstrated that individual officials and staff members of issuers may be held personally liable for violations of the anti-fraud provisions of the securities laws. Official immunity will not protect individual officials and staff members from SEC action. The primary penalties for such violations are:

A. Permanent Injunction. The SEC may bring an action to enjoin any person engaged in a violation of the securities laws. In most cases, injunctive actions are concluded with a consent decree in which the defendant neither admits nor denies the allegations, but is enjoined from violating the anti-fraud provisions.

B. Cease and Desist Orders. If the SEC determines that a risk of future securities law violations exists, the SEC may order a person to cease and desist from committing securities law violations.

C. Civil Penalties. The SEC may request a court to impose monetary penalties on any person who violates the securities laws.

D. Ancillary Relief. Although ancillary relief is rare, it sometimes augments an injunction in extraordinary circumstances. In the municipal securities context, ancillary relief has resulted in disgorgement of profits or other remedial actions, such as requiring an issuer to hire an independent consultant to review its disclosure practices and follow the consultant's recommendations.

E. Other. In addition to the statutory penalties described above, issuers that violate the anti-fraud provisions are also likely to suffer practical consequences, such as civil suits for damages, diminished investor confidence, substantial costs defending against SEC or private investigations or suits, and rating agency downgrades.

III. Disclosure Procedures for New Bond Issues

A party's best defense against claims that it has violated the anti-fraud provisions of the securities laws regarding the sale of securities is a properly prepared Official Statement.

A. Purpose of Official Statement. In addition to serving as a marketing tool, the Official Statement provides potential investors with all the information necessary for each reader to make an informed investment decision. The investor is not expected to look for information from any other source outside of the Official Statement and publicly available documents incorporated by reference.

B. Content of Official Statement. The Official Statement typically describes the terms and conditions of the securities (amounts, maturities, interest rates, redemption features, tax status, etc.), the security and source of repayment for the securities, the issuer's financial condition and other information about the issuer and the projects to be financed with the proceeds of the securities. The Official Statement may also describe certain risks associated with an investment

in the securities, and the potential remedies available to holders of the securities in the event of a default.

C. Procedures for Preparing Official Statement. The SEC has recommended that municipal issuers adopt written procedures for the preparation of Official Statements or other disclosure documents. Written procedures may be helpful to the extent that they are followed. However, failing to consistently follow written procedures may provide support to a claim against an issuer. The essential point is to have a practical functioning plan or procedure in place, whether written or unwritten, that is followed in practice to help ensure timely, accurate and complete disclosure in each Official Statement.

1. Coordination: Ideally, one particular officer will be designated to oversee and coordinate the preparation, review and delivery of the Official Statement. This officer will coordinate with, and be provided with assistance from, other officials and staff, as well as professionals assisting with the financing (financial advisors, bond counsel, underwriters, etc.).

2. Compilation:

a) Designate individuals with knowledge of relevant information to review and update applicable sections of the Official Statement. Provide the applicable sections of the Official Statement to each such person with sufficient time to permit each to perform a thoughtful and thorough review or preparation of information for that applicable section. If helpful, consider also providing each reviewing person with a memorandum, checklist or other communication specifying his or her responsibilities with respect to the disclosure contained in that applicable section.

b) Once information and comments are received, incorporate the information into the draft Official Statement. Then re-circulate the updated draft Official Statement to each contributor to confirm the accuracy and completeness of the applicable disclosure.

c) When reviewing an Official Statement based on one from a prior transaction, the individual contributors should not view the process of revising and updating the Official Statement as a mechanical insertion of more current numbers. While often there is not a need for major changes in the form and content of the official Statement at the time of each update, the individuals involved in the process should consider the need for revisions in the form and content of the sections for which they are responsible at the time of each update.

d) At the outset of a new transaction, or at other regular intervals, schedule a meeting of appropriate officials and staff, including any reviewers of information, as applicable, to consider "big

picture" items that may be material to one or more sections of the Official Statement, including financial status generally, audited financial statements and any other issues that may be material to investors. For example, each participant should ask:

(1) Do I know anything that would cause me to question the accuracy or completeness of the disclosures in the Official Statement or that would indicate that any information therein is misleading?

(2) Do I know of any potentially material issues that should be brought to the attention of the financing team or for which a potential investor would reasonably like a further explanation?

(3) What are the basic economic drivers that support the State's financial position and/or the repayment of the bonds? What could go wrong or cause a default in the short or long term? At this point, what is the likelihood that any of those events will occur?

D. Other Public Statements. Issuers often make statements or provide information to the investing public outside of the statements and information contained in the Official Statement, including the disclosures summarized below. These statements and information are also subject to the anti-fraud provisions described above, and therefore should be reviewed for accuracy and completeness and for consistency with the disclosures contained in the Official Statement.

1. Rating Agencies and Investor Road Shows. Statements or information provided by or on behalf of the issuer to rating agencies providing a rating on the securities, or, during the marketing process, to groups of potential investors.

2. Investor Queries. Occasionally an issuer may receive calls directly from investors with questions regarding a securities financing or the issuer's operations or finances. To avoid providing uneven disclosure of material information, the issuer should (a) direct all such calls to one person, so that the responses are consistent over time, and (b) if possible, respond to the question with information that is already available to the public.

3. Website Postings. Statements and information provided by officials or posted on the issuer's website that can be expected to reach and be material to potential investors.

IV. Continuing Disclosure – Required and Voluntary Disclosures Post-Issuance

A. Required Filings; SEC Rule 15c2-12. The legal basis for issuers' obligation to provide continuing disclosure derives from Rule 15c2-12, promulgated by the SEC under the Exchange Act. While Rule 15c2-12 does not directly obligate

issuers, it does prohibit underwriters from purchasing or selling municipal securities unless the issuer has undertaken in a written agreement to make certain ongoing financial and operating information available to bondholders at least annually, and to provide timely notice of certain significant events.

1. The annual information required by Rule 15c2-12 updates certain information contained in the Official Statement and is also subject to the anti-fraud provisions of the securities laws. As a result, it should be prepared with the same diligence as is done for primary securities offerings.

2. Continuing disclosure undertakings also obligate issuers to provide bondholders with notice of certain designated "significant events", which notice must be provided "in a timely manner not in excess of ten business days" after their occurrence.

3. While the failure of an issuer to make a continuing disclosure filing will not result in a violation of any securities laws (since Rule 15c2-12 is binding on underwriters rather than issuers), it is not without consequence to an issuer. For example, most continuing disclosure undertakings provide bondholders with a private right of action to seek specific performance by the issuer of its continuing disclosure obligations. Of even greater importance is the obligation of underwriters to disclose in Official Statements any material violations by issuers of their continuing disclosure obligations during the last five years. Ultimately, if an underwriter cannot reasonably conclude that an issuer is likely to perform its continuing disclosure obligations going forward, the underwriter is not permitted to underwrite securities for that issuer, effectively foreclosing the issuer from access to the municipal securities market.

B. Voluntary Filings. An issuer is also permitted, although not obligated, to provide on-going disclosure not specifically required by their continuing disclosure undertakings. Since voluntary disclosures are also subject to the anti-fraud provisions of the securities laws, they should be carefully reviewed to be sure they are accurate and complete. In addition, an issuer should be consistent in its approach to voluntary disclosure filings. For example, if an issuer regularly provides voluntary disclosure for certain types of information, the securities market could reasonably conclude that such voluntary disclosures will continue. If the issuer then omits to make a subsequent disclosure, it opens itself to potential claims that, under certain circumstances, the omission was a material omission under the anti-fraud provisions. If an issuer makes a voluntary disclosure, the issuer should include appropriate disclaimers that the issuer has no obligation to provide subsequent disclosure.

V. SEC Enforcement

A. How has the SEC gone about the enforcement business in the past?

1. Seminal enforcement action in 1996 was Orange County, CA

a) *Takeaway:* Governing body is responsible for the review and approval of the offering document.

b) Additional enforcement actions including Maricopa County, Arizona; Allegheny Health, Educational and Research Foundation; City of Miami (Version 1); and Massachusetts Turnpike Authority.

B. City of San Diego, November 14, 2006:

1. $260 million in bond offerings in 2002 and 2003

2. City was facing a looming financial crisis, resulting from:

a) intentional underfunding of its pension plan for 5 years;

b) retroactive increases in pension benefits; and

c) use of surplus earnings to pay additional benefits to plan beneficiaries.

3. City failed to disclose these problems in its bond offerings.

4. In 2008, the SEC charged five former San Diego officials with securities fraud based upon the inadequate disclosures.

5. *Takeaways:*

a) Policies and Procedures and training of your officials.

b) Personal liability by officials is likely to become more common.

c) Actions against Municipal Officials.

6. *San Diego* was a bridge between the former era and the current era.

7. "Municipal officials responsible for municipal bond disclosure play a key gatekeeper role in protecting investors," said Linda Chatman Thomsen, then-Director of the SEC's Division of Enforcement. "It is therefore imperative that they honor the public's trust by ensuring that investors are provided with accurate, material information about the issuer's fiscal health."

VI. Recent Enforcement Examples

A. *State of Illinois*, March 2013

1. Failed to disclose the systematic underfunding of its pension plans.

2. Alleged that the information was omitted from bond offering documents between 2005 and 2009.

3. Contribution schedule calculations resulted in underfunded pension obligations, increased unfunded pension liability, and deferral of public pension contributions.

4. In the offering documents, the state disclosed that its pension obligations are funded under a statutory plan and provided details of the plan:

    a) However, the state failed to disclose that the plan could threaten its budget and financial conditions; and

    b) Although the State of Illinois disclosed pension holidays and other legislative amendments to the plan, the State did not disclose the effect of those changes on the State's ability to meet its pension obligations.

5. *Takeaways:*

    a) Pension fund disclosure needs to be drafted diligently by the preparer(s) most familiar with the pension program and with the circumstances that affect the State of Illinois' pension funding obligations.

    b) Pension fund disclosure also requires a thorough review, and not just on whether the disclosure tracks state law requirements for funding. Preparers should be proactive in considering the likely impact of any expected changes (economic or legislative) in drafting pension disclosure.

B. *City of Victorville*, April 2013

1. Complaint against the City, the City's Director of Economic Development, and the Airport Authority, among others.

2. Tax increment bonds issued by the Authority in 2006, 2007, and 2008.

3. Proceeds used to fund redevelopment projects on a former Air Force base located in San Bernardino County, CA.

4. Redevelopment projects undertaken by the Authority included four new airplane hangars:

    a) In constructing the hangars, the underwriter, one of the investment bankers, and the developer misappropriated $2.75 million in bond proceeds;

    b) Proceeds were used to pay excessive construction and management fees; and

c) Calculations of the tax increment and debt service ratio were based on inflated valuation of new hangars.

5. Due to the non-disclosure of the unauthorized and excessive fees, 2007 and 2008 Official Statements contained material misstatements and omissions.

6. Further Authority's 2008 Official Statement was false and misleading because it misstated the tax increment available to repay bondholders and the debt service ratio for the bonds.

7. *Takeaways:*

a) Personal liability by officials and other transaction participants is likely to become more common.

C. *City of Harrisburg*, May 2013

1. First SEC action against a municipality based upon statements made publicly as opposed to in the securities disclosure documents.

a) City was charged with misleading investors about its financial health in the annual State of the City address, as well as in financial and budget reports, each of which were posted on the City's website.

b) During a time in which the City failed to comply with its continuing disclosure obligations.

2. "Total mix" of information analysis.

3. As no information on EMMA, investors looked to other sources.

4. No public officials were named in the action, but, according to the SEC's press release announcing the action, the case should "emphasize to public officials who wish to avoid personal liability under federal securities laws that they should take steps to reduce the risk of misleading investors."

5. *Takeaways:*

a) Elected officials should review disclosure or set up proper delegations of responsibility (and know they can't fully delegate potential liability exposure).

b) Declining credits need to pay particular attention to good disclosure.

c) Policies and Procedures and training of your officials and employees.

d) Municipal issuers have an obligation to make sure that information that is released to the public that is reasonably expected to reach investors and the trading markets, even if not specifically published for that purpose, does not violate the anti-fraud provisions.

Commissioner Daniel Gallagher recently cited to Harrisburg as an action in which individuals should have been held responsible, stating to *The Bond Buyer* that "[m]unicipalities don't commit frauds, people do."

D. *City of Miami*, July 2013

1. First action against a state or local government alleging a violation of a cease and desist order.

2. SEC focused on alleged improper conduct involving interfund transfers.

a) Transfers, totaling $37.5 million, made from capital project funds (which comprised monies restricted to specific purposes) to a general use fund to mask deficits in the general fund.

b) Transfers falsely inflated the general fund balance, which led to more favorable ratings by credit ratings agencies on the City's 2009 bonds.

c) Alleged former budget director arranged the transfers, misrepresented the true nature of transfers to City officials and others, and falsified justification for transfers in the City's internal records.

3. Alleged City made numerous material misrepresentations and omissions about the interfund transfers in its bond offering documents and its 2007 and 2008 annual financials, including:

a) failure to disclose the full amount or effect of the transfers to the general fund's budget and balance;

b) the misstatement that transferred project funds were "unexpended" or "unused" when in fact the funds were allocated to and needed for specific projects; the failure to disclose that a portion of the transferred funds were restricted from interfund transfer; and

c) failure to disclose that the City had not adjusted its capital projects funds budget to reflect the transfers to the general fund.

4. *Takeways:*

a) Recidivist bad behavior will be punished.

b) Personal liability by officials and other transaction participants is likely to become more common.

E. *In the Matter of the Greater Wenatchee Regional Events Center Public Facilities District*, November 2013

1. For the first time, SEC assessed a financial penalty against a municipal securities issuer.

2. Issuer charged with negligently misleading investors in a bond offering that financed the construction of a regional events center and ice hockey arena.

3. According to SEC, the Official Statement:

a) Failed to warn investors that the District's obligation to pay off the BANs could be constrained by the City's debt limit;

b) Wrongly stated there had been no independent reviews of the financial projections for the events center; and

c) Failed to inform investors that the Mayor and the senior staffer had influenced the financial projections, rendering them unduly optimistic.

4. *Takeaway:* Historically, the SEC has been reluctant to assess fines against municipal issuers for violation of federal securities law but that may change.

F. *U.S. Securities and Exchange Commission v. City of Harvey, Illinois and Joseph T. Letke,*

1. On June 25, 2014, the SEC announced that it had obtained an emergency order from the Federal District Court for the Northern District of Illinois against the City of Harvey to stop a fraudulent bond offering that the City was marketing.

2. The SEC alleges that the City of Harvey ("City") and its comptroller, Joseph Letke ("Letke"), engaged in a scheme to divert the proceeds of the City's 2008, 2009 and 2010 bonds for improper purposes and now, in connection with the sale of the 2014 bonds, failed to disclose the diversion of the proceeds of those earlier bonds to undisclosed uses.

3. In obtaining an injunction against the sale of the 2014 bonds, the SEC alleged, in part, that the City's offering document "omits to state that the City of Harvey had misused a portion of the proceeds of the three previous bond offerings … [that] purportedly were for the purpose of providing funding for a redevelopment project within [a redevelopment district in the City]."

4. *Takeaways:*

a) The SEC is willing to aggressively pursue what it perceives as fraud in the municipal marketplace.

b) Personal liability by officials and other transaction participants is likely to become more common.

c) Careful consideration needs to be taken when electing whether or not to self-report under the MCDC Initiative described below.

*"*Individuals tempted to commit wrongdoing must understand that they risk it all if they do not play by the rules. When people fear for their own reputations, careers or pocketbooks, they tend to stay in line."

-SEC Chairwoman Mary Jo White, September 26, 2013

VII. Municipalities Continuing Disclosure Cooperation Initiative

A. On March 10, 2014, the SEC's Enforcement Division introduced an initiative to the Municipalities Continuing Disclosure Cooperation Initiative (the "MCDC Initiative"), an initiative to encourage self-reporting by municipal securities issuers, obligated persons, and underwriters of possible securities law violation related to misrepresentations in offering documents concerning an issuer's or obligated person's prior compliance with its continuing disclosure obligations. On July 8, 2014, the SEC announced its first cease and desist order under the MCDC Initiative.

B. Before 2013, despite reports of widespread issuer noncompliance with at least some continuing disclosure obligations, the SEC had not brought a related enforcement action against an issuer or emphasized SEC Rule 15c2-12 in its enforcement actions against underwriters.

C. In July 2013, the SEC set a groundbreaking precedent by undertaking enforcement actions against Indiana's West Clark Community Schools and the school district's underwriter based on statements in offering documents that the school district was compliant with its previous continuing disclosure agreement.

D. **The clock for this voluntary self-reporting ended at midnight EDT on September 10, 2014 (unless extended).**

E. *Kings Canyon Joint Unified School District,*

On July 8, 2014, the SEC announced its first cease and desist order under the MCDC Initiative.

1. The Issuer accepted an Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order").

2. Without providing detailed analysis, the SEC found that the Kings Canyon Joint Unified School District of California (District) made a material misstatement in a 2010 official statement. The SEC alleged that the District represented that it had not failed to comply in all material respects with its continuing disclosure agreements in the previous five years. According to the SEC, the District failed to provide "some" of the disclosure between 2008 and 2009 required by continuing disclosure agreements. The SEC did not provide further detail about the nature of the District's noncompliance, and largely appears to have assumed that the fact of the District's noncompliance was material to investors.

3. It is widely known that, at the time of some of the District's noncompliance, investors had limited access to continuing disclosure before the SEC designated the Electronic Municipal Market Access (EMMA) system as the sole, official repository for continuing disclosure, effective July 1, 2009. In its adopting release approving EMMA, the SEC stated: "Specifically, we believe that municipal securities disclosure documents should be made more readily and more promptly available to the public and that all investors should have better access to important market information."

4. *Takeaway*: Although the expectations of a "reasonable" investor regarding continuing disclosure have changed substantially post-EMMA, the SEC's order does not draw a pre- versus post-EMMA line to determine the materiality of a misstatement.

TOP TAKEAWAYS

1. Crucial that each participant with delegated responsibility for preparing and reviewing disclosure be diligent and proactive.

2. Recidivist bad behavior will be punished.

3. Issuers facing economic headwinds need to pay particular attention to good disclosure.

4. Pension fund disclosure needs to be drafted diligently by the preparer(s) most familiar with the pension program and with the circumstances that affect the issuer's pension funding obligations.

5. Pension fund disclosure also requires a thorough review, and not just on whether the disclosure tracks state law requirements for funding.

6. Policies and Procedures for training officials and for disclosure compliance are good practice and helpful for defense if necessary.

7. SEC isn't looking to regulate political speech, but it can provide the basis for a fraud claim in absence of proper disclosure compliance.

8. Personal liability by officials may become more common.

9. Due diligence by issuers and underwriters should be thorough, including with respect to continuing disclosures.