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Overview
SEC Report on Municipal Securities Market

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Background on SEC Report

- SEC's mission:
  - Protect investors (municipal securities)
  - Maintain fair, orderly and efficient markets
  - Facilitate capital formation
- In furtherance of SEC's mission, during 2010 and 2011 SEC focused on municipal securities markets
  - Effort led by SEC Commissioner Elisse B. Walter
  - Held public field hearings
  - Held staff meetings and conference calls with market participants
  - Solicited public comment
- SEC Report issued on July 31, 2012
  - Comprehensive report (150 pages)

Overview of municipal securities markets

- As of 12/31/11, over one million municipal bonds outstanding, in total aggregate principal amount exceeding $3.7 trillion
- In 2005, 63% of municipal securities were credit enhanced; in 2011, only 17% were credit enhanced
- More than 75% of municipal securities held by individuals ("retail" investors)
- Municipal securities market is primarily a "buy and hold" market
- Risk of payment default relatively low
- Majority of defaults occur in conduit revenue bonds for non-governmental purposes (*e.g.*, multi-family, healthcare, IDBs)

Overview of Federal Regulatory Structure

- Municipal securities market less regulated than other sectors of capital markets
- Broad exemptions for municipal securities under Securities Act of 1933 ("1933 Act") and Securities Exchange Act of 1934 ("1934 Act")
- "Tower Amendment" (1975) limits authority of SEC and MSRB to require filings by municipal issuers prior to sale of municipal securities
  - Dodd-Frank Wall Street Reform and Commercial Protection Act (2010) did not override "Tower Amendment" – did require GAO to review information municipal issuers must disclose for benefit of investors
- As a result, SEC's investor protection efforts primarily through
  - 1934 Act Rule 15c2-12 (adopted in 1994 to provide for continuing disclosure)
  - Amendment to 1934 Act Rule 15c2-12 (adopted in 2008 to establish Electronic Municipal Market Access system or "EMMA")
  - Interpretive guidance
  - Enforcement of "antifraud" provisions
    - Existing law limits ability of IRS to alert SEC to potential fraud
  - Oversight of MSRB (an "SRO")

SEC Report Key Area of Concern – Disclosure Practices*

- Disclosure practices developed through
  - SEC's investor protection efforts (mentioned above)
  - MSRB rules
  - Voluntary guidelines of industry groups
    - GFOA
    - NFMA
    - NASACT
    - NABL
- Despite disclosure practice improvements (*e.g.*, EMMA), there are various key areas of concern addressed in SEC Report

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*Other key area of concern was market structure, which not discussed in this presentation

Key Areas of Concern

- Concerns related to Financial Statements and Financial Information
  - Timeliness – issuance of annual audited financial statements by many issuers is slow
  - Interim financial information (*e.g.*, budgets and cash flow reports) are typically not provided
  - Comparability of financial information
    - Absence of uniformly applied accounting standards
    - Absence of authority for SEC to prescribe standards
    - Adherence to GASB standards advocated by market participants
  - Failure of municipal issuers to comply with continuing disclosure agreements
- Concerns related to Disclosure by Conduit Borrowers
  - Conduit borrowers typically provide less information than municipal issuers
  - Market participants advocated imposing on conduit borrowers same registration requirements and disclosure standards that apply in corporate securities market

Key Areas of Concern

- Concerns Related to Pension Funding and OPEBs
  - Significant impact upon municipal issuer's financial health and ability to pay debt service
  - Area of intense focus
  - 2006 SEC action against City of San Diego; 2010 SEC action against State of New Jersey
- Concerns related to Derivatives
  - Significant increase in use of derivatives
  - Though potentially beneficial, derivatives do create special risks for municipal issuers
  - Conflicts of interest may lead to disadvantageous derivative transactions
  - SEC actions against Orange County and Jefferson County

Key Areas of Concern

- Concerns related to Disclaimers for Information in Official Statements
  - Often, counsel advocates use of disclaimers to limit antifraud liability
  - SEC position – “specific disclaimers of antifraud liability are contrary to the policies underpinning the federal securities laws”
  - Underwriters must have a reasonable basis for recommending municipal securities
- Concerns related to Conflicts of Interest
  - 1994 Interpretive Release and SEC enforcement actions should make clear that certain financial/business relationships or practices may be critical to investors
    - Undisclosed payments
    - Political contributions
    - Bid rigging

Recommendations relating to Disclosure

- Legislation
  - Authorized SEC to require preparation and dissemination of official statements and disclosure during outstanding term of municipal securities (timeframes, frequency, minimum requirements and enforcement tools)
    - No corporate style “line-item” disclosure, registration or periodic reporting
    - No SEC review of disclosure prior to sale – no repeal of “Tower Amendment”
    - It is intended as a “more principles-based approach”
  - Amend 1933 Act and 1934 Act to eliminate exemptions for conduit borrowers who are not municipal entities (represents approximately 70% of municipal securities defaults)
    - Limited offering exemptions would remain
    - 501(c)(3) exemption would remain
  - Authorize SEC to establish form and content of financial statements of municipal issuers, including authority to recognize standard of designated private-sector body, and grant SEC attendant authority over such private-sector body
    - SEC wants the power to require GASB standards (or new standards) to be used in connection with municipal securities and the power to set/approve those standards

Recommendations relating to Disclosure (continued)

- Authorize SEC, as it deems appropriate, to require municipal issuers to have financial statements audited
    - This legislative proposal could be a scaled or tiered requirement, beginning with the largest issuers
- Provide safe-harbor from private liability for forward-looking statements of repeat municipal issuers under certain conditions
    - SEC could still bring an enforcement action
    - Would be available only to municipal issuers that provide ongoing public disclosures on a current and timely basis
- Permit IRS to share with SEC information from tax returns, audits and examinations related to municipal securities, particularly in instances of suspected securities fraud
- Provide mechanism to enforce compliance with continuing disclosure agreement and authorize SEC to require trustees (and others) to enforce such agreement
    - Such agreements are private contracts and are not enforceable directly by the SEC

Recommendations relating to Disclosure (continued)

- Regulatory
  - SEC could host annual conferences on municipal securities markets
    - Market participants and SEC would be able to discuss important issues
  - SEC could issue updated interpretive guidance regarding disclosure obligations of municipal issuers
    - The SEC has suggested it would provide an “update” to the 1994 Interpretive Release for some time
    - NABL has submitted memoranda suggesting areas that the SEC might address in a new release
  - SEC could amend Rule 15C2-12 to further improve disclosures
    - Mandate more specific types of disclosures in official statements and ongoing disclosures, including additional event disclosures (such as the incurrence of additional debt), more initial disclosure about the risks of the municipal securities, and disclosures about underlying obligors (regardless of the existence of credit enhancement or insurance)

Recommendations relating to Disclosure (continued)

- Addressing noncompliance issues with regard to continuing disclosure undertakings, “including possibly by adding conditions that would require that issuers have disclosure policies and procedures in place regarding their disclosure obligations, including those arising under continuing disclosure undertakings”
- Modifications regarding application of the rule to demand securities and underwritten municipal fund securities offerings
- Improve the accessibility of disclosures through the use of summary official statements and increased use of websites
- On October 19, 2012, SEC Commissioner Walter reported to have suggested codifying into Rule a “three-strike” system

- SEC should work with MSRB to strengthen and enhance EMMA
  - One of EMMA enhancements mentioned is listing issuers that have not complied with continuing disclosure obligations and facilitating analysis of disclosure data by type of security, both of which might prove to be extremely difficult and labor intensive

- Municipal Market Initiatives
  - Municipal market participants should pursue “best practices” initiatives to enhance disclosure practices in municipal securities market

Biographies



Jerry E. Turner

Jerry has over 37 years of experience in public finance and has served as senior attorney in connection with the representation of various public clients, including state agencies, university systems, cities, counties, transit authorities and other political subdivisions. His public finance practice includes serving as bond counsel and underwriter's counsel in connection with municipal bond offerings. In addition, Jerry represents various public funds and endowments in connection with their investment activities.

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