INTERNATIONAL MUNICIPAL LAWYERS ASSOCIATION



Work Session: Municipal Finance

Title: Disclosure and Liability Under Federal Securities Law

by

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DISCLOSURE AND LIABILITY UNDER THE FEDERAL SECURITIES LAWS

I. Securities Laws Generally

A. Registration and reporting requirements of ’33 Act and ’34 Act do not apply

B. Anti-fraud provisions do apply

1. Section 17(a) of ’33 Act (applies only to certain transactions)

2. Section 10(b) of ’34 Act and Rule 10b-5

II. Material Statements and Omissions under Rule 10b-5

A. Rule prohibits:

1. The making of any untrue statement of a material fact or

2. Any omission to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading

B. Application of Rule: When an issuer provides information pursuant to an offering of securities (*e.g.*, in the official statement) or a contractual obligation (*e.g.*, the annual report required by Rule 15c2-12) or chooses to provide voluntary information, it becomes responsible for assuring that the information is accurate and complete in all material respects.

C. Liability under Rule 10b-5

1. Regulatory actions brought by the SEC

2. Private actions brought by investors

D. Cases: (The following case summaries were extracted from National Association of Bond Lawyers’ Securities and Tax Law Materials).

1. City of Syracuse. This action was brought against a city, its deputy finance commissioner and a senior accountant in the city's finance department for false and misleading statements in official statements pertaining to bond anticipation notes issued in December 1995 and February 1996. The city's finance department was overburdened and, because audited financial statements had not been completed, the city presented summary financial information for 1995. The city failed to account for property tax revenues in accordance with GAAP, resulting in an overstatement of some fund balances by 355% and an understatement of other fund balances by 19%. The city also labeled summary information for 1994 as "audited" without disclosing the fact that the audit report contained qualified opinions. Finally, the city used the same financial information in both official statements (as opposed to updating the February 1996 official statement with more current figures). *In re City of Syracuse, New York, Warren D. Simpson, and Edward D. Polgreen,* Release Nos. 7460, 39149 (September 30, 1997).

2. AHERF. This matter is notable because it was premised on misstatements and omissions in the borrower's annual "15c2-12" filings. The borrower's annual financial statements and annual information disseminated pursuant to "15c2-12" undertakings: (i) overstated a subsidiary's 1996 net income by approximately $40 million by failing to adjust the subsidiary's bad debt reserves to account for uncollectible accounts receivable; (ii) overstated a subsidiary's and the organization's 1997 net income through the

inappropriate transfers of approximately $99.6 million in reserves that were utilized to address the bad debt reserve shortfall not addressed in 1996, as well as an additional shortfall in 1997; and (iii) overstated its 1997 net income by misclassifying certain restricted trust funds. Both the borrower and its subsidiary would have posted substantial net losses for fiscal year 1997 without the fraudulent activity. The organization declared bankruptcy in 1998, after the 1997 continuing disclosure report was disseminated. The settled final order against AHERF cites Section 10(b) of the Exchange Act and Rule 10b-5, together with *SEC v. Texas Gulf Sulphur Company*, 401 F.2d 833 (2d Cir. 1968), and the 1994 Interpretive Release, as controlling legal authority. *In re Allegheny Health, Education and Research Foundation ("AHERF")*, Release Nos. 1283, 42992 (June 30, 2000) (settled final order); *see* related actions *In re Spargo*, Release Nos. 1252, 42742 (May 2, 2000) (settled final order) and *SEC v. McConnell*, Litigation Release No. 16534 (May 2, 2000) (settled final order).

3. Maricopa County. This action was brought against a county for false and misleading statements in official statements used in connection with the issuance of general obligation bonds in July 1993. The official statements contained the county's financial statements for the year ended June 30, 1992, but did not disclose that the county's financial position materially declined during the following fiscal year. In addition, the official statements failed to disclose that the county intended to use the bond

proceeds to finance its cash-flow deficit pending their use to finance the projects specified in the official statement. *In re Maricopa County*, Release Nos. 7345, 37748 (September 30, 1996) and Release Nos. 7354, 37779 (October 3, 1996). This action highlights the fact that an issuer can incur securities fraud liability even if its bonds are not in default, its financial statements were accurate (but stale), and the source of payment for its bond is secure.

4. City of Miami. This action was brought by the SEC against a city, its city manager and a finance director for omissions and misstatements in the city's 1994 comprehensive annual financial report (CAFR) and in three official statements distributed in 1995. Although the city's rating was downgraded and its financial condition had steadily worsened after the close of its 1994 fiscal year, the city (i) made representations that no material adverse changes occurred subsequent to the issuance of the 1994 financial statements, (ii) failed to disclose that S&P downgraded the city after the close of the 1994 fiscal year, (iii) failed to disclose its cash flow crisis in the 1995 official statements, and (iv) in certain 1995 official statements, failed to disclose that bond proceeds would be used to finance operating expenditures. *In re City of Miami, Florida, Cesar Odio and Manohar Surana*, Release Nos. 33-8213; 34-47552 (March 21, 2003) (final order); *see also* Initial Decision Release No. 185 (June 22, 2001).

5. Orange County. In the early 1990s, Orange County became increasingly dependent on its investment pools as a source of income to balance its

discretionary budget. The increased use of interest income was due to a decline in revenue from other sources, particularly property taxes. The SEC found the county was able to balance its budget, and avoid implementing other fiscal measures, by budgeting increased projected interest revenue. The county continued to issue bonds and notes during this period. The SEC found that the official statements for these offerings variously contained material misstatements and omissions regarding the county's investment strategy and investment results and the county's financial condition, including its economic reliance on the investment pools as a source of funds to repay its obligations. *Report of Investigation in the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors*, Release No. 36761 (January 24, 1996).

III. Rule 15c2-12

A. Prior to 1990's, no continuing disclosure obligations

B. Rule 15c2-12 promulgated in 1990, but continuing disclosure is still not required

C. 1995 amendment requires continuing disclosure

1. Generally: It is unlawful for a Participating Underwriter to act as an underwriter in a Primary Offering of municipal securities with an aggregate principal amount of $1,000,000 or more unless the Participating Underwriter complies with the Rule. The Rule requires, among other things, continuing disclosure.

2. Continuing Disclosure Requirements: A Participating Underwriter shall not purchase or sell municipal securities in an Offering unless the

Participating Underwriter has reasonably determined that the Issuer or an Obligated Person has undertaken in a written agreement for the benefit of the holders of such securities to provide:

a. Yearly audited financial statements to the Nationally Recognized Municipal Securities Information Repositories ("NRMSIR") and the State Information Depository ("SID")

b. Yearly updated Annual Financial Information from the official statement to the NRMSIR and SID

c. A report of the occurrence of a material "listed event" to the NRMSIR or MSRB and SID

3. Applicability of the Rule:

a. Rule applies to Underwriters not issuers. However, as stated above, an action can be brought against the issuer for material misstatements or omissions in the annual report.

4. Defined Terms:

a. Participating Underwriter: more than just investment bankers

b. Primary Offering: initial offering by Issuer and any remarketing

c. Obligated Person: any person committed to support the payment of the municipal securities

(1) Excludes insurers and liquidity providers

(2) May change from time to time based upon objective criteria

d. Annual Financial Information: financial information or operating data of the type included in the Final Official Statement

(1) Should all financial information or operating data be updated?

e. Final Official Statement: a document that is complete as of the date delivered to the Participating Underwriter and that sets forth information concerning the proposed issue

(1) Must include a description of the undertaking

(2) Must include a description of any instances in the last five years in which the Obligated Person failed to satisfy its undertaking

(3) If an Obligated Person has failed to update, how can the Participating Underwriter reasonably determine that the Issuer or Obligated Person will provide information in the future?

5. Exemptions from Continuing Disclosure

a. Offering is less than $1,000,000

b. Offerings of municipal securities in authorized denominations of $100,000 or more AND

(1) Sold to no more than 35 sophisticated investors without a view to distribute (Get certification from Participating Underwriter at closing) OR

(2) Have a maturity of nine months or less (beware of TAN's) OR

(3) May be put by the holder at least every nine months

c. Issuer has less than $10,000,000 of outstanding municipal securities; provided, however, the Issuer must:

(1) Provide notice of material events AND

(2) Provide customary financial information or operating data to a SID or any holder who requests such information AND

(3) Include a contact person's name, address, etc. in the Final Official Statement

d. Securities mature in 18 months or less; provided, however, the issuer must provide notice of material events

e. SEC has exemptive authority

IV. Duty to Speak

A. Generally: No duty to speak/disclose except in connection with a primary offering or an annual filing required by Rule 15c2-12.

B. Does the Issuer have a duty to update everything if it has to file a material event notice?

V. Electronic Disclosure

A. Incorporation by reference and hyperlinks: An issuer may incorporate information by reference.

B. Web pages: Information on web pages should be consistent with the information filed in the annual report required by Rule 15c2-12. Does disclosure on a web page give rise to a duty to speak?

C. Investor Relations Programs: May be a good idea, but an issuer should not give information to investors or select investors unless it gives it to the entire market.

D. Nationally Recognized Municipal Securities Information Repositories: The repositories change from time to time. A current list of repositories can be found at www.sec.gov. In lieu of filing the annual report with all the repositories, an issuer may file the annual report with DisclosureUSA at www.disclosureusa.org, and DisclosureUSA will forward it to the repositories. DisclosureUSA will also send the issuer a reminder that the annual report is due.

E. Private sector vendors: May be retained to assist with the filing of the annual report.

VI. Miscellaneous Issues

A. Disclosure of Derivatives: Derivatives (*e.g.*, interest rate swaps) need to be disclosed in the issuer's audit and in its offering materials. *GASB Technical Bulletin 2003-1* (June 2003) and *NFMA White Paper on Disclosure for Swaps* (February 2004) provide guidance on these issues.

B. Auditor's Comfort or Agreed Upon Procedures Letters: The issuer's auditor is engaged to (i) give "comfort" that the financial information in the disclosure document is correct or (ii) perform certain procedures to establish that the financial information in the disclosure document is correct. These generally help the underwriter establish a defense, but may also be useful to the Issuer in an antifraud action.

C. Unfunded Pension Liability: San Diego failed to disclose that it had an unfunded pension liability. As a result, San Diego hired a law firm to evaluate its disclosure practices. The firm prepared a report, which is summarized below. Make sure that the issuer discloses any such liabilities.

D. The San Diego Report:

1. Shortcomings: The Report found, among other things, the following shortcomings in San Diego's disclosure practices

   a. The City had a "check the box" mentality, emphasizing updating data without pausing to consider its implications.

   b. The disclosure did not receive critical review by senior management.

   c. The City did not place a premium on the quality of the disclosure.

   d. Its disclosure was impeded by "balkanization" and poor lines of communication.

   e. Neither the staff nor the council had any formal training in disclosure practices.

   f. The City used a number of different disclosure counsels.

   g. The City did not have any procedures to evaluate its financial reporting and disclosure practices.

2. Recommendations: The report made the following recommendations.

   a. Establish a Financial Reporting Oversight Board.

   b. Establish a Disclosure Practices Working Group.

   c. Require that City officers make certain certifications to the Council.

   d. Hire and retain a single, well-qualified disclosure counsel.