

Borrowing with Bonds: New SEC Developments and Related Practical Considerations

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Securities Law / SEC Post-Issuance Compliance

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What is Continuing Disclosure?

- Continuing disclosure consists of important information about a bond issue (and bond issuer) that arises after the bonds are initially issued to the public.
- This information generally reflects the financial health or operating condition of the issuer as it changes over time.



Goals of this session

- Help you understand the ongoing disclosure requirements for municipal bond issues as required by the federal securities law
- Explain the recent changes to the federal securities law with respect to continuing disclosure
- Discuss recent securities and exchange commission (SEC) enforcement actions

Continuing Disclosure Undertaking (CDU)

- SEC Rule 15c2-12
 - Requires an underwriter to enter into an agreement with issuers to provide certain financial information and event disclosures to the market
 - SEC believes this information is important for market transparency and to promote a fair and efficient market
- Filings must be made electronically at the EMMA (Electronic Municipal Market Access) portal [www.emma.msrb.org]
- Word-searchable PDF format

CDU Filing Requirements

- If new issue is sold directly to a bank: No CDU (generally)
- If new issue is less than \$1,000,000: No CDU
- If new issue is at least \$1,000,000 and issuer has less than \$10,000,000 of debt, issuer must agree to provide:
 - Audited financial statements
 - Reportable events
- If new issue is at least \$1,000,000 and the issuer has over \$10,000,000 of debt, issuer must agree to provide:
 - Annual financial information
 - Audited financial statements
 - Reportable events



CDU Filing Requirements (continued)

- “Annual Financial Information” (AFI)
 - Defined in reference to certain information and charts in the Official Statement, such as:
 - Debt Service Extension Base (DSEB)
 - Financial Information and Economic Characteristics: Trend of EAV, Tax Rates, Tax Extensions and Collections, Outstanding Debt, Debt Ratios
 - Summary of Operating Funds: Changes in Fund Balance, General Fund Revenue Sources, Budget
- Audit (and AFI, if applicable) must be filed with EMMA typically 210 days after fiscal year close, or in some cases within 30 days after adoption, whichever is first

CDU Filing Requirements (continued)

- Reportable Events – must be filed within 10 business days after the occurrence of the event
- Prior to February 27, 2019, there were 14 Reportable Events
- Most common:
 - Rating changes
 - Bond calls
 - Payment delinquencies
 - Non-payment defaults



2 New Reportable Events

- August 20, 2018: SEC issued Release No. 34-83885, adopting Amendments to Rule 15c2-12, which added two new events to the list of reportable events
- As of February 27, 2019 (only for new bond issues), the additional events must be added to the CDU signed by the issuer in a primary offering of municipal securities
- Why the change?
 - SEC wanted increased transparency, because investors in the past may not have had “any access or timely access” to disclosure about the incurrences of certain financial obligations, such as direct placements

2 New Reportable Events (continued)

- Local Governments subject to the new amendments will now be required to disclose:
 - (1)
 - (a) the incurrence of a financial obligation, if material, or
 - (b) an agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation, any of which affect security holders, if material; and
 - (2) a default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation, any of which reflect financial difficulties



2 New Reportable Events (continued)

- “Financial obligation” means: (a) a debt obligation, (b) a derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation and (c) a guarantee of a debt obligation or a derivative
 - Does not include municipal securities that are issued under an Official Statement that has been posted on EMMA
 - Includes leases that “operate as vehicles to borrow money” (*i.e.* financing leases)
 - Includes both short-term and long-term debt obligations
 - Includes borrowings that are exempt from statutory debt limits

2 New Reportable Events (continued)

- The materiality of a financial obligation or its terms is determined under general securities law standards (*i.e.*, would the information be important to a reasonable investor in making an investment decision?)
 - Any term of a financial obligation that gives its holder preferential or priority rights over the issuer's publicly-held bonds is material information that must be disclosed
- The material terms of a financial obligation that should be disclosed include the following:
 - date incurred,
 - principal amount,
 - maturity dates and amortization,
 - interest rate, if fixed, or method of computation, if variable, and default rates, and
 - such other terms as are appropriate under the circumstances

2 New Reportable Events (continued)

- “default” includes both payment and non-payment defaults, but distinguishes between those that do not reflect financial difficulties (such as failure to provide timely notice of a change in address) and those that do (such as a failure to maintain coverage requirements)

Consequences for Failure to Comply with CDU Obligations

- Rule 15c2-12 requires issuers to disclose CDU non-compliance in official statements (five year look back)
- Issuers that repeatedly fail to make CDU filings may not be able to access the public market
- Current Bondholders may sue for specific performance
- Issuers that fail to make CDU filings may also face SEC action for other statements that reach the market, if materially misleading

CDU Post-issuance Compliance Tips

- Review your CDUs for deadlines and filing requirements
- Implement policies and procedures and training for bond issuance and post bond issuance, especially in light of the new continuing disclosure requirements
- Identify individuals responsible for CDU items and have a succession plan
- For annual filings consider including the required tables in your audit
- Subscribe to EMMA for email reminders (ticklers)
- Consider hiring a Third Party or Dissemination Agent

Post Issuance Suggestions (Local Government View)

- Talk and work with financial advisor and/or bond counsel
 - Inform them about any new financial obligations, default, termination/modification event
 - Determine if need to disclose on EMMA
- Don't hesitate to ask questions
- Inform underwriters of material changes <25 days after closing
- Understand requirements in bond ordinance
- Include debt deadlines on a Community Calendar
- Review, update and approve debt policies on an annual basis
 - As a reminder, note disclosure requirements in the policies
- Submit annual report and any significant events on EMMA
 - Review and understand disclosure filing information



Federal Securities Law Overview

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The Laws That Govern the Securities Industry

- Securities Act of 1933
- Securities Exchange Act of 1934
- Trust Indenture Act of 1939
- Investment Company Act of 1940
- Investment Advisers Act of 1940
- Sarbanes-Oxley Act of 2002
- Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
- Jumpstart Our Business Startups Act of 2012
- Rules and Regulations

Legal Framework — SEC Law & Rules

▪ Anti-Fraud Provisions

- '33 Act – Section 17(a); '34 Act – Section 10 and Rule 10b-5
- Prohibit fraudulent and deceptive practices in the offer or sale of securities
 - 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
- No finding of scienter is required to establish a violation of Sections 17(a)(2) and 17(a)(3); negligence is sufficient
 - Negligence is a failure by an actor to conform conduct to the standard of “a reasonable [person] under like circumstances”
 - The SEC has held that the “knew or should have known” standard is appropriate to establish negligence
- A misrepresentation or omission is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision

Legal Framework — SEC Law & Rules

(cont'd)

- Control Person Liability
 - '34 Act – 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 that the issuer deems final, and
 - ensure that the issuer has undertaken (contracted) to provide certain continuing disclosures to the market (Continuing Disclosure Undertaking or CDU)

Obligations of Issuers

- The Official Statement is the issuer's document
- The obligation for the accuracy and completeness of the disclosure lies with the issuer
- The process of revising and updating disclosure should not be viewed as a mechanical insertion of more current numbers. While it is not anticipated that there necessarily will be major changes in the form and content of the disclosure at the time of each update, everyone 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.
 - It is critical that the issuer read the entire offering document, since it bears responsibility and has liability for material misstatements and omissions (and, unlike the underwriter, the issuer may not have a "due diligence" defense)
- An issuer's obligations go beyond just paying its bonds. Even if debt service on bonds is being paid, the SEC can bring an enforcement action.

Speaking to the Market / Selective Disclosure

- Rule:

- Any disclosure of material non-public information by any municipal official about the municipality to anyone outside of the municipality must be disclosed to the public at the same time.
- The SEC has noted that the phrase “speaking to the market” refers to any disclosure by an issuer of municipal securities to the public that is reasonably expected to reach investors and the trading markets (whether or not such disclosure is published for the purpose of providing information to the securities markets). “Material” information is information that a reasonable investor in the municipality’s bonds would consider important. Information is “non-public” if it has not been previously released in a way that is designed to reach the investing public, such as a filing made through EMMA.

Speaking to the Market / Selective Disclosure (cont'd)

- Exception:
 - Disclosing information to persons who have previously agreed in writing to maintain confidentiality, such as the Village's attorneys, accountants, investment bankers, municipal advisors, and other entities that are subject to confidentiality agreements (such as the rating agencies) or are required to maintain confidentiality as a matter of professional responsibility.
- Note:
 - Officials of the municipality speaking to the public, even if not for the purpose of releasing financial information to the public, could be deemed to be "speaking to the market" and therefore subjecting themselves and the municipality to securities laws violations if such officials make a material misrepresentation or omission in their statements to the public.

Speaking to the Market / Selective Disclosure (cont'd)

- The State of Illinois remains subject to the SEC cease-and-desist order dated March 11, 2013, with respect to certain disclosure failures in connection with the underfunding of its pension systems. The order requires the State to “cease and desist from committing or causing any violations and any future violations of Section 17(a)(2) and 17(a)(3) of the Securities Act.
- Violation of an existing cease-and-desist order has serious consequences. Such a violation by the **City of Miami** resulted in an SEC action against Miami and its officers. After losing at a federal trial, Miami in 2016 agreed to pay \$1 million to settle its securities fraud charges. The penalty is the largest paid by a governmental entity.
- On January 10, 2017, the SEC issued a cease-and-desist order to the Port Authority of New York and New Jersey (Port Authority) under which the Port Authority acknowledged that it acted negligently in failing to disclose certain risks in official statements for over \$2.3 billion of bonds issued between January 2012 and June 2014. The Port Authority is the first municipal issuer to admit wrongdoing in an SEC enforcement action. The Port Authority paid a civil penalty of \$400,000 to the SEC, the second largest paid by a governmental entity.

Speaking to the Market / Selective Disclosure (cont'd)

▪ MSRB's Market Advisory on Selective Disclosure

- On September 13, 2017, the Municipal Securities Rulemaking Board (MSRB) published a market advisory to draw attention to the practice of selective disclosure.
- “Issuers of municipal securities and their financial professionals share a responsibility to protect the integrity of the municipal market by making full and fair disclosures to all investors,” said MSRB Executive Director Lynnette Kelly. “When selective disclosures occurs – often inadvertently – certain investors can be disadvantaged.
- Question-and-answer sessions during investor phone calls and invitation-only meetings with analysts are common scenarios in which selective disclosure can arise. “These types of events are not inherently problematic,” says Kelly. “However, issuers should make it a practice to consider whether material nonpublic information was shared in these circumstances and take steps to make that information public promptly after the event.”
- Selective disclosure, while not unique to the municipal market, is specifically prohibited in the corporate market under the SEC's Regulation Fair Disclosure (FD). Municipal issuers are not subject to Regulation FD, but the MSRB's advisory cautions about the potential for federal fraud liability if, for example, known material information is omitted from required public disclosures. Further, if an investor were to make a trade based on improperly disclosed material nonpublic information, that could constitute insider trading.

Public Finance Abuse Unit

(Previously — Municipal Securities and Public Pension 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)
- It is one of 5 specialty units created in 2010 in response to the financial crisis
- Priorities of the Unit
- How investigations are started

SEC Municipal Enforcement Actions

“Municipalities Continuing Disclosure Cooperation (MCDC) Initiative”

- MCDC Initiative (2014 to 2016)
 - 1st market-wide enforcement action
 - Materially false statements about CDU compliance violate the anti-fraud provisions
 - SEC enforcement efforts in the municipal securities area in 2015 and 2016 were dominated by actions it initiated in March 2014 pursuant to the MCDC Initiative
 - Virtually all municipal underwriting firms are currently operating pursuant to a “cease-and-desist” order brought about by the MCDC Initiative

SEC Municipal Enforcement Actions

MCDC Initiative (*cont'd*)

- SEC Rule 15c2-12
 - Requires an underwriter to enter into an agreement with an Issuer (or “obligated person”) to provide certain financial information, operating data and event disclosures to the market
 - “Obligated person” means any person committed by contract or other arrangement to support payment of all or a portion of the debt service on municipal securities
 - “Obligated persons” do not include conduit Issuers, bond insurers or banks providing credit/liquidity support
 - SEC believes this information is important for market transparency and to promote a fair and efficient market
- Filings must be made electronically at the EMMA (Electronic Municipal Market Access) portal: www.emma.msrb.org
- Statements that are reasonably expected to reach the securities market, even if not prepared for that purpose, cannot be materially misleading

SEC Municipal Enforcement Actions

MCDC Initiative (*cont'd*)

- On February 2, 2016, the SEC completed its MCDC enforcement actions against underwriters by issuing its third round of cease-and-desist orders:
 - **\$18 million** in fines as a result of actions against 72 underwriters (comprising 96% of market share for municipal underwritings)
- On August 24, 2016, the SEC continued its MCDC enforcement actions by issuing cease-and-desist orders to 71 municipalities issuers and obligated persons (state-wide issuers as well as counties, school districts, colleges and universities, small towns and non-profit healthcare providers from 45 states)
- On August 23, 2017, the SEC charged an issuer, an issuer's official (\$37,500), an underwriting firm (\$150,000 penalty) and underwriter (\$15,000) in first post-enforcement actions

SEC Municipal Enforcement Actions

Harvey Public Library District (2019)

- SEC alleges that Mississippi-based municipal advisor failed to protect its client in January, 2015 bond offering, and did not advocate on the Library's behalf
- SEC settled a similar proceeding against IFS Securities, the bond underwriter, alleging that the underwriter did not act with reasonable care when it had a hard time finding investors and sold the bonds to another broker-dealer at a price that the SEC believed was not fair and reasonable
- Troubles of City of Harvey impacted the Library's ability to market its own bonds
- Library bonds were approved by referendum, had an underlying investment grade rating, and carried municipal bond insurance, but had the highest coupon (7.10%) of any comparable security issued in Illinois that year
- Underwriter had recommended municipal advisor to the Library and municipal advisor had asked underwriter to advocate to Library to increase advisor's fee

SEC Municipal Enforcement Actions

Edward Jones Cease-and-Desist Order (August 13, 2015)

- Failure to make bona fide public offerings to its customers and failure to ensure reasonable markups were charged to customers in the secondary municipal securities market
 - First SEC case against an underwriter for pricing-related fraud in the primary market for municipal securities
- Between February 2009 and December 2012, Edward Jones participated in several negotiated offerings as a co-manager
 - Underwriter obtained municipal securities for its own portfolio and, in turn, improperly offered the same securities to its customers for prices higher than the negotiated initial offering price
 - Customers paid at least \$4.6 million more than would have been paid during the underwriting period using the initial offering price
- Between January 2011 and October 2013, Edward Jones failed to establish an adequate supervisory system to identify and review certain of the underwriter's customer orders to buy and sell municipal securities

SEC Municipal Enforcement Actions

Edward Jones (*cont'd*)

- SEC charged the underwriter with violating Section 17(a)(2) and (3) of the Securities Act of 1933, Section 15(B)(c)(1) of the Securities Exchange Act of 1934, and MSRB Rules G-17, G-11, G-30 and G-27
- In determining sanctions, SEC took into account Edward Jones' remedial efforts
 - After settlement, Edward Jones disclosed the percentage and dollar amount of markups on all fixed income retail order trade confirmations in principal transactions
- **Edward Jones agreed to pay more than \$20 million to settle the SEC charges**
- **Edward Jones exited the public finance market at the end of 2015**

SEC Municipal Enforcement Actions

Edward Jones (Takeaways)

- Director of SEC Enforcement Division: “This enforcement action, which is the first of its kind, reflects our commitment to addressing abuses in all areas of the municipal bond market.”
- It is critical for underwriters to offer new bonds to their customers at the “initial offering price” which is negotiated with the Issuer of the bonds
- Underwriters having a supervisory system in place that can monitor whether the markups it charges customers for certain trades are reasonable is beneficial to the underwriter

SEC Municipal Enforcement Actions

City of Miami

- In a jury trial, the City of Miami and the Budget Director were held liable for violating federal antifraud securities laws. The City agreed to pay the SEC \$1 million to settle the case. The Budget Director was ordered to pay a \$15,000 penalty.
- Prior to 2009, Miami transferred money from its Capital Project Funds to its General Fund to mask General Fund deficits. In bond offering documents, the City did not fully disclose the effect or the amounts of the transfers to the General Fund, which totaled \$38 million. In addition, the City represented that the transfers from the Capital Project Funds were “unexpended” or “unused” when some funds had already been allocated to specific projects or had already been spent. Such misrepresentations were also included in the City’s CAFRs.

SEC Municipal Enforcement Actions

City of Miami (*cont'd*)

- The first federal jury trial by the SEC against a municipality or one of its officers for violating federal securities laws
- Received the benefit of District and Appellate Court decisions that a municipal official is not entitled in securities law enforcement proceedings to qualified immunity in the performance of discretionary official duties
- **Monetary remedies were severe because Miami was already subject to a cease-and-desist order from a 2003 SEC enforcement action**

SEC Municipal Enforcement Actions

Town of Ramapo, New York

- Christopher St. Lawrence, the former Director of Finance and Town Supervisor for Ramapo, New York, was found guilty of 20 counts of conspiracy, securities fraud and wire fraud in connection with municipal bonds issued by Ramapo and by the Ramapo Local Development Corporation, a development corporation associated with the town (“RLDC”)
- St. Lawrence was sentenced in December of 2017 by a federal judge to 30 months in prison and a \$75,000 fine. The prison term is the longest allowable under federal sentencing guidelines.
- In April 2016, the Securities and Exchange Commission (“SEC”) charged the Town, the RLDC and four Town officials, including St. Lawrence, with fraud for allegedly improperly disclosing a deteriorating financial situation in general bond offering documents. The SEC alleged that Town officials resorted to fraud to hide the strain in the Town’s finances caused by the financing of a controversial minor league baseball stadium and by the Town’s declining sales and property tax revenues.
- N. Aaron Troodler, Executive Director of the RLDC and an Assistant Town Attorney, who was charged alongside St. Lawrence, entered into a plea agreement in March 2017. Troodler, who had previously lost his law license as a convicted felon, was sentenced to 18 months’ probation and a \$20,000 fine. In imposing the less egregious sentence, the court appeared to give credence to Troodler’s assertion that he played a more limited role in the fraud and acted at St. Lawrence’s direction.
- **St. Lawrence is currently serving his 30-month sentence in a federal penitentiary.**

SEC Municipal Enforcement Actions

Town of Ramapo, New York (*cont'd*)

- The SEC cited one prominent example of fraud when St. Lawrence misled a rating agency about the town's general fund balance. St. Lawrence told the 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.**"
- First Federal criminal securities fraud prosecution and conviction involving municipal bonds
- The 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, said, "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."
- After sentencing, Rockland County District Attorney Thomas Zugibe noted that St. Lawrence's "sentence was not only for violating the law, but also for undermining the people's trust and confidence in their elected officials."