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Federal Regulation of Municipal Securities Disclosure Requirements and Related Securities Acts Issue

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Key Laws – 1934 Act-Section 10(b)

Critical Anti-Fraud provision: Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (the “1934 Act”) prohibits fraud in the purchase or sale of securities and authorizes SEC to make enforcement rules.

Rule 10b-5

- **“It shall be unlawful** for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
 - (a) To employ any device, scheme, or artifice to defraud,
 - (b) **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 the light of the circumstances under which they were made, not misleading, or**
 - (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security”

Key Laws – 1933 Act – Section 17(a)

- Critical Anti-Fraud Provision: Section 17(a) of the Securities Act of 1933 [15 U.S. Code § 77q(a)] contains a similar anti-fraud provision:
- **“It shall be unlawful** for any person in the offer or sale of any securities ... by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly (1) to employ any device, scheme, or artifice to defraud, or (2) **to obtain money or property by means of any untrue statement of a material fact or any omission 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**; or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.”

Differences Between 10(b) and 17(a)

- While Section 10(b) and Section 17(a) are, at least superficially similar, there are some key differences:
 - Claims under Section 17(a) may be based solely on negligent conduct, while claims under Section 10(b) require proof of scienter, or evidence that the party against whom the claim is asserted knew the actionable statement or act was wrong when made
 - On the other hand, there is a private right of action under Section 10(b), meaning investors can assert a claim on their own, while claims under Section 17(a) must be brought by the Securities Exchange Commission (“SEC”)
 - In certain enforcement actions, the SEC may bring claims under both Section 10(b) and Section 17(a)

Key Regulatory Provision – 1934 Act Rule 10b-5

- Anti-Fraud provisions-1934 Act Rule 10b-5 [17 CFR §240.10b-5]
- **“It shall be unlawful** for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
 - (a) To employ any device, scheme, or artifice to defraud,
 - (b) **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 the light of the circumstances under which they were made, not misleading, or**
 - (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,in connection with the purchase or sale of any security”

The “Materiality” Standard

- “[w]hether or not there is a substantial likelihood that a reasonable investor or prospective investor would consider the information important in deciding whether or not to invest.”
 - SEC ALJ Decision on City of Miami, FL, citing U.S. Supreme Court decisions in *Basic, Inc. v. Levinson* and *TSC Industries Inc. v. Northway, Inc.*
- Materiality is determined in context of all the facts and circumstances, but usually on a retroactive basis
- Would a reasonable investor (in the eyes of the SEC) view the obligation or term important in light of the total mix of available information about the Issuer?

Key Regulatory Provision – 1934 Act – Rule 15c2-12

- For almost 60 years after the passage of the Securities Act of 1933 and the Exchange Act of 1934, the municipal securities market was exempted from virtually all of the provisions of both acts except Section 17(a) and Section 10(b)
 - In fact, in 1975, Congress passed amendments to the Securities Act expressly limiting the ability of the SEC and Municipal Securities Rulemaking Board (“MSRB” to require municipal issuers to file any application, report, document, or information with the SEC or MSRB prior to any sale of securities
- What the Commission could not achieve through the front door, it achieved through the back door in 1989 by adopting Rule 15c2-12.
 - Rather than regulate municipal issuers directly, the Commission required broker-dealers, over whom they have broad authority, to require issuers to provide certain disclosures before the broker-dealers could purchase municipal securities

Continuing Disclosure

1934 Act Rule 15c2-12 : regulates underwriters (directly) and governmental issuers (indirectly)

- Designed to address fraud by enhancing disclosure in the municipal securities market by establishing standards for obtaining, reviewing and disseminating information about municipal securities by their underwriters
- Requires underwriters to obtain and review an offering document before offering municipal securities
- Amended in 1994 and thereafter, to require underwriters to (a) obtain contractual undertaking from Issuers to update their financial and operating data annually and give timely notice of certain events and (b) obtain and review an offering document that describes each material breach of prior undertakings in the previous 5 years

Rule 15c2-12 Requirements - Primary Market Disclosure

Rule 15c2-12: New Issue Disclosure

- Preliminary Official Statement (POS)
 - Must contain:
 - Information concerning the terms of the securities
 - Financial information or operating data material to an evaluation of the securities
 - Must be reviewed by underwriter before it bids for, offers/purchases/sells bonds
 - Must be “deemed final” by the issuer
- Official Statement (OS)
 - Same as the POS except it includes pricing-related information
 - Delivered to underwriter within 7 business days after pricing and in time to accompany buyer confirmations

Rule 15c2-12 Requirements - Primary Market Disclosure (cont'd)

Primary Market Disclosure: Preliminary Official Statement

- The POS typically includes the following information:
 - Description of the securities being offered, including authorization, purpose, and sources and uses of funds
 - Security for the bonds, such as revenues from the System
 - Credit enhancement, such as letters of credit supporting payment of the bonds
 - Description of the issuer, including most recent financial information
 - Tax exemption of the bonds
 - Continuing Disclosure: any material failures in the last 5 years to comply with obligations under Continuing Disclosure Agreements
 - Credit ratings

Securities Law Enforcement: A Case Study – Orange County

- SEC Report: issued “to emphasize the responsibilities under the federal securities laws of local governmental officials...”
- Supervisors were aware of County’s financial condition and budgetary reliance on investment returns generated by County Pools
- Supervisors knew that the investment strategy was tied to debt issuance
- Supervisors failed to take “steps appropriate under the circumstances” to assure that the County’s financial situation was adequately disclosed to potential investors
- “Public official who approves issuance of securities and related disclosure documents may not authorize disclosure that the public official knows to be materially false or misleading”
- “Public official may not authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading”

Securities Law Enforcement: A Case Study – The City of Miami

City of Miami; Cease and Desist Order

- In fiscal year 1995, Miami was facing a severe cash shortage and issued bonds to finance current operating cash needs
- Miami's Comprehensive Annual Financial Report and Official Statements during this time did not accurately note the scope of its liquidity difficulties
- 2003 Cease and Desist Order: "The City Manager actually admitted he wasn't familiar with disclosure requirements ... and dismissed importance of bond offering documents" (citing reliance on its accountants, ratings and bond insurance)
- 2013 Complaint: City and former Budget Director charged with fraud and with violating 2003 Cease and Desist Order. SEC sought an order to command compliance with the 2003 Cease and Desist Order and civil financial penalties against both the City and Budget Director
- September 14, 2016 Jury Verdict: Both City and former Budget Director made misleading statements in connection with the offer or sale of securities, negligently engaged in transactions that operated as frauds on the purchasers, and used a "device, scheme or artifice to defraud" when purchasing or selling securities
- October 2016 Miami agreed to pay \$1 million to settle case; former budget director was fined \$15,000

Rule 15c2-12 Requirements - Continuing Disclosure

Rule 15c2-12: Continuing Disclosure

- Two types of reporting:
 - Annual report
 - Financial information or operating data of the type included in the OS
 - Audited financial statements, when and if available
 - Event Disclosure within ten business days of occurrence of event
 - Failure to file annual report
 - 16 listed events including
 - Principal and interest payment delinquencies
 - Rating changes
- Method of Filing: MSRB's EMMA System

Rule 15c2-12 Requirements - Continuing Disclosure (cont'd)

Notice Events

- Notice of 16 listed events must be given “in a timely manner not in excess of ten business days after the occurrence of the event” of:
 - Principal and interest payment delinquencies
 - Non-payment related defaults, *if material*
 - Unscheduled draws on debt service reserves reflecting financial difficulties
 - Unscheduled draws on credit enhancements reflecting financial difficulties
 - Substitution of credit or liquidity providers, or their failure to perform
 - Adverse tax opinions or events affecting the tax-exemption
 - Modifications to rights of security holders, *if material*
 - Bond calls, if material, and tender offers
 - Defeasances
 - Release, substitution, or sale of property securing repayment of the securities, *if material*
 - Rating changes
 - Bankruptcy, insolvency, receivership or similar event
 - Consummation of a merger, consolidation or acquisition involving the issuer, *if material*
 - Appointment of successor or additional trustee or the change of name of a trustee, *if material*
 - Incurrence of financial obligation, *if material*
 - Default under a financial obligation

Rule 15c2-12 Requirements - Continuing Disclosure (cont'd)

Effective February 27, 2019, Rule 15c2-12 was amended to add two listed events:

- “Incurrence of a financial obligation of the obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material”
 - “Financial obligation” is defined broadly: “to mean (i) debt obligation; (ii) derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or (iii) guarantee of (i) or (ii). The term financial obligation shall not include municipal securities as to which a final official statement has been provided to the MSRB consistent with the Rule.”
 - Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, any of which reflect financial difficulties”

15c2-12 Enforcement: West Clark Community School District

- School District issued bonds in 2005, entering into a standard continuing disclosure undertaking
- School District issued bonds again in 2007 noting in the Official Statement that the School District had not failed to comply with a 15c2-12 undertaking for the prior five years and certified to the same statement at closing
- In fact, School District had failed to file any information between 2005 and 2010 [thus in order—but post 2007 failure not relevant to misstatement in 2007 official statement, except perhaps as evidence of intent to violate undertaking]
- SEC charged School District with securities fraud under 17(a) and underwriter for lack of due diligence
- School District settled with the SEC and agreed to, with the assistance of counsel, ensure all disclosures were current and accurate and to implement policies and procedures to prevent future noncompliance

15c2-12 Enforcement: City of Harrisburg

- Harrisburg Authority, a municipal authority of the City of Harrisburg, issued bonds to construct a waste-to-energy facility
- The City of Harrisburg agreed to guarantee the bonds issued to construct the facility
- As a result, the City was considered a “materially obligated person” for purposes of Rule 15c2-12 and entered into a continuing disclosure undertaking for purposes of the Rule
- The City failed to comply with the continuing disclosure undertaking for over two years
- In the absence of current information disseminated pursuant to the undertaking, investors sought out material elsewhere, including the CAFRs, the City Budgets and Mid-Year Fiscal Reports
- Most of these documents included misrepresentations, including failure to disclose payments made under the guarantee, ratings downgrades and rating misrepresentations, including a note that the City’s credit rating from Moody’s was “Aaa”
- The SEC’s order noted that, in the absence of 15c2-12 filings, investors may have to rely on statements made by public officials
- SEC issued a cease and desist order and required a written disclosure policy

Rule 15c2-12 – Issues

What does “timely manner not in excess of ten business days” mean?

- Adverbs are not your friend!
- Do words “timely manner not in excess of” mean anything? Do they create an additional standard in some contexts?

What does “business day” mean?

- Market open?
- Banks open?
- State Government open?
- County Government open?
- Federal Government open?

No knowledge carve out:

- Rule requires reporting within 10 business days of occurrence, not discovery, of event

Rule 15c2-12 – Compliance History

Disclosure about Disclosure

- SEC staff have stated that they believe that the history of an Issuer's compliance with previous continuing disclosure undertakings during the five-year period preceding the publication of a preliminary official statement in connection with a bond offering is **material information** for potential buyers of bonds
- This led to the SEC's Municipalities Continuing Disclosure Cooperation ("MCDC") Initiative in 2014

Rule 15c2-12 – Compliance History (cont'd)

- The MCDC Initiative provided an opportunity for issuers and underwriters to self-report potential violations of their disclosure duties during the preceding five years in exchange for standard settlement terms that were more lenient than otherwise might be available from the Commission
- As a result of the MCDC Initiative,
 - 72 underwriters (representing 95% of the public offering market for municipal securities)
 - 71 issuers

self-reported and accepted settlements. Although neither the issuers nor the underwriters were required to admit the alleged violations detailed in the settlements, each received a cease-and-desist from future violations as part of its settlement

Duties and Obligations of Management and The Board

- Review sections of the offering document that are in your area
- **WORDS MATTER** Make sure that the words you use in the Official Statement are accurate
- Do not hesitate to comment on the Preliminary Official Statement, whether on your section or other sections
- Be careful of public and private statements
- There is no such thing as confidentiality in public offerings
- Be careful of the records that you keep as they could be evidence down the road

Elon Musk  Following 

@elonmusk

Am considering taking Tesla private at \$420. Funding secured.

9:48 AM - 7 Aug 2018

6,749 Retweets 31,392 Likes 

 3.4K  6.7K  31K 

 Tweet your reply

Elon Musk  @elonmusk · 10m 

Shareholders could either to sell at 420 or hold shares & go private

 355  445  2.2K 

Final Thoughts

Primary market disclosure is expected to satisfy regulatory requirements by identifying information that is **material** for investors

Good disclosure:

- communicates this information effectively
- lowers borrowing costs
- promotes good investor relations

Bad (deficient) disclosure:

- subjects the Issuer to regulatory actions and/or monetary fines
- impedes access to public debt markets
- increases borrowing costs



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