

Trends in Local Government Disclosure: The New World We Live In



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Speakers

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- **Ethan Klos - Treasurer, City of Arlington, TX**
 - Ethan is the Treasurer for the City of Arlington. He has been with the City since Aug 2009. As Treasurer, Ethan is responsible for the Cash management, Debt financing, and Investments of the City's portfolio. Other responsibilities include managing the banking relationships, credit card acceptance, capital budget, hotel occupancy tax program, and working closely with economic development.
- **Michael Lacton, West & Associates L.L.P.**
 - Michael assists in managing the Firm's Public Finance Section in the Houston office. He has served as Bond Counsel, Disclosure Counsel, and Underwriter's Counsel. His transactions involve a variety of financing strategies including general obligation bonds, refundings, variable-rate and fixed rate issues, revenue bonds, certificates of obligation, and tax increment financings. Some clients include cities, special districts, school districts, transportation authorities and financial institutions.

Objectives

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- Provide an overview of the Issuer's obligations under federal securities laws
- Discuss lessons from the Securities and Exchange Commission (SEC) against municipal issuers
- Discuss disclosure best practices

An Issuer's Obligations



Purpose of Disclosure Regulation

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- (1) To provide material information about securities to allow investors to make informed decisions;
- (2) To prohibit misrepresentation or other fraudulent conduct in connection with the purchase and sale of securities; and
- (3) Ensure bonds are properly priced based on information provided by the issuers.

Federal Securities Laws

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Antifraud Provisions

- Unlawful to 1) employ any device, scheme or artifact to defraud, 2) to make any untrue statement of a **material** fact, or omit to state a **material** fact, 3) or to engage in any act, practice or course of business which operate as a fraud or deceit upon any person (in the sale or purchase of securities)
Section 17(a)/Rule 10b-5[scienter])

Materiality - substantial likelihood that the information would be viewed by a reasonable investor as having significantly altered the total mix of information available [considered important by a reasonable investor.] (*Basic v. Levinson*) (*TSC Industries Inc v. Northway Inc.*)

Federal Securities Laws

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- Materiality is a facts and circumstances test.
- Some examples of information that the SEC has determined to be material:
 - 1) **misstating compliance history**
 - 2) **failure to disclose intended use of bond proceeds**
 - 3) **failure to accurately disclose financial condition (accounting change, significant transfers)**
 - 4) **failure to disclose financial interest in transaction**
 - 5) **failure to disclose potential taxability of bonds**

Federal Securities Laws

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Antifraud Provisions

Secondary/ Control Person Liability

- SEC may pursue claims of Control Person Liability under 20(a) of the Securities Exchange Act of 1934
 - Liability for individuals who supervise individuals involved with securities offerings, even if they do not have knowledge of the contents of disclosure documents

Federal Securities Laws

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SEC 15c2-12 (the “Rule”)

- Prohibits an Underwriter from purchasing or selling Bonds without first ensuring the Issuer has agreed to enter into a continuing disclosure agreement (CDA).
 - Audited annual financial statements and operating data within ~180 days of fiscal year end.
 - 14 (soon to be 16) Material Listed Events within 10 business days of occurrence
 - File a “failure to file notice” if you are unable to file your (un)audited financials by the date specified
- Cite instances of non-compliance over last 5 years

Federal Securities Laws – Material Listed Events

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- 1) Payment delinquencies
- 2) Non-payment related defaults, if material
- 3) Unscheduled draws on debt service reserves reflecting financial difficulties
- 4) Unscheduled draws on credit enhancements reflecting financial difficulties
- 5) Substitution of credit or liquidity providers, or their failure to perform
- 6) Adverse determinations with respect to the tax status of the bonds
- 7) Modifications to rights of holders, if material
- 8) Bonds Calls, if material, and tender offers
- 9) Defeasances
- 10) Release, substitutions, or sale of property securing repayment of the securities, if material
- 11) Rating changes (S&P - 10/15)
- 12) Bankruptcy, insolvency, receivership or similar event of the obligated person
- 13) Merger, consolidation, or acquisition involving an obligated person, if material
- 14) Appointment of a successor or additional trustee or the change of name of a trustee, if material
- 15) ****Financial obligation** of the issuer or obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the issuer or obligated person, any of which affect security holders, if material; and
- 16) ****Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of the financial obligation of the issuer or obligated person, any of which reflect financial difficulties.**

Federal Securities Laws – Amendments added

- 15c2-12 (b)(5)(C)(**15**) and (**16**)
 - ...[F]inancial Obligations, if material, could substantially increase or change an issuer's overall **indebtedness** and impact it's **liquidity** and overall **creditworthiness** and thereby affect the value of municipal securities
 - ...[C]ovenants of a financial obligation that may negatively affect security holder's **contractual rights** (i.e., debt payment **priority structure** of the issuer's or obligated person's outstanding securities), **pledge assets** previously available to secure the bonds to the lender causing **dilution, liquidity risk, credit risk, or refinancing risk.**
 - SEC wants more 1)timely and 2) informative disclosure

Material Listed Events – “15”

- **Driver behind Amendment: “15”**

- The 2012 Municipal Report states, among other things, that the Commission could consider further amendments to Rule 15c2-12 to mandate more specific types of secondary market event disclosures, including disclosure relating to new indebtedness (whether or not such debt is subject to Rule 15c2-12 and whether or not arising as a result of a municipal securities issuance). The Commission further stated that market participants raised concerns that issuers and obligated persons may not properly disclose the existence or the terms of bank loans, particularly when the terms of the bank loans may affect the payment priority from revenues in a way that adversely affects bondholders.
- In recent years issuers and obligated persons have increasingly used direct purchases of municipal securities and direct loans (collectively, “direct placements”) as alternatives to public offerings of municipal securities. Despite continued efforts by market participants to encourage disclosure of certain financial obligations, the MSRB has stated that the number of actual disclosures made is limited. The Commission believes that investors and other municipal market participants should have access to continuing disclosure information regarding financial obligations to improve their ability to analyze their investments and, ultimately, make more informed investment decisions.

Material Listed Events – “15”

- Key Terms and Phrases re: “15”
 - “Financial Obligation” - Defined in Amendment
 - ✦ Focuses on debt, debt-like and debt-related obligations of issuers/obligated persons
 - ✦ “Lease” – Removed from definition of Financial Obligation *but*
 - “... ‘debt obligation’ should be considered to include lease arrangements ... that operate as vehicles to borrow money.” 17 CFR Part 240.
 - ✦ Capital Lease
 - The Commission believes that a lease entered into as a vehicle to borrow money is more appropriately defined as a variety of “debt obligation” rather than a separate type of “financial obligation” as was proposed. The Commission believes that leases entered into as a vehicle to borrow money are commonly used by municipal securities issuers and obligated persons and, when used, commonly understood to be a tool for facilitating an issuer’s or obligated person’s ability to borrow money. Therefore, under the Rule, a lease that operates as a vehicle to borrow money generally should be treated like an obligation incurred under the terms of an indenture, loan agreement, or similar contract.
 - ✦ Operating Lease
 - With respect to leases that do not operate as vehicles to borrow money, the Commission agrees with commenters that the burden of assessing their materiality and disclosing such leases within ten business days would not justify the benefit of such disclosures. While the Commission continues to believe that lease arrangements that are not vehicles to borrow money might be relevant to the general financial condition of an issuer or obligated person, the Commission also believes that such lease arrangements do not warrant inclusion in the Commission’s definition of “financial obligation” because they generally do not represent competing debt of the issuer or obligated person.

Material Listed Events – “15”

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- Key Terms and Phrases re: “15”
 - “Materiality”
 - ✦ “... the Commission continues to believe that materiality determinations should be based on whether the information would be important to the total mix of information made available to the reasonable investor.” 17 CFR Part 240, 23-24 (citing Exchange Act Release No. 34-33741 (March 9, 1994)).
 - ✦ “... an issuer or obligated person will need to consider whether a financial obligation or the terms of a financial obligation, if they affect security holders, would be important to a reasonable investor when making an investment decision.” *Id.* citing *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).
 - ✦ Facts and Circumstances: Some issuers and obligated persons may have differing opinions with respect to whether a piece of information would be considered important to a reasonable investor when making an investment decision. *Id.*
 - Materiality of a financial obligation determined upon the incurrence of each distinct financial obligation
 - Material Terms of a Financial Obligation should be disclosed.
- “I know it when I see it”
 - in 1964 by United States Supreme Court Justice Potter Stewart to describe his threshold test for obscenity in *Jacobellis v. Ohio* wrote:
 - ✦ “I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description [“hard-core pornography”], and perhaps I could never succeed in intelligibly doing so. But ***I know it when I see it***, and the motion picture involved in this case is not that.”

Material Listed Events – “16”

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- Key Terms and Phrases re: “16”
 - “Reflect Financial Difficulties” – “Market participants should be familiar with the concept as it relates to the operation of Rule 15c2-12.” *Id.* at 63. Existing disclosure events:
 - ✦ Unscheduled draws on debt service reserves *reflecting financial difficulties*
 - ✦ Unscheduled draws on credit enhancements *reflecting financial difficulties*

- Effective Date: February 27, 2019
 - The amendments will only affect those CDAs entered into on or after the compliance date. Issuers and obligated persons with a CDA entered into on or after the compliance date must disclose:
 - ✦ Material financial obligations incurred on or after the date on which such a CDA was entered into.
 - ✦ Default, Event of Acceleration, Termination Event, Modification of Terms or Similar Events under the terms of a financial obligation, any of which reflect financial difficulties that occurs on or after the compliance date must be disclosed regardless of whether such obligation was incurred before or after the compliance date. *Id.* at 65.

Federal Securities Laws

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- To assist the Underwriter in satisfying Rule 15c2-12 (establishing a reasonable basis), the Issuer makes certification that:
 - The Official Statement does not contain any untrue statement of a material fact or omit to state any material fact required to be stated therein or necessary to make the statements therein, in light of the circumstances under which they were made, not misleading.
 - **MAKE SURE THIS IS TRUE!!!**

Disclosure Requirements

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Responsibility for disclosure documents

- ISSUERS HAVE PRIMARY RESPONSIBILITY FOR THE CONTENT OF THEIR DISCLOSURE DOCUMENTS and may be held liable under federal securities laws for misleading disclosure.
- An Issuer does not discharge its disclosure obligations by hiring professionals to prepare the official statement.

Federal Securities Laws -Disclosure Requirements

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Examples of non-compliance with CDA

- Failure to file annual information by the date specified in the CDA (annual financial/operating, 16 events)
- Failure to make late filing notice of annual information.
- Failure to provide agreed upon voluntary information.

Remedy for material non-compliance of CDA

For the next five years, the issuer must provide a description of the non-compliance in every offering statement.

Federal Securities Laws -Disclosure Requirements

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Disclosure Documents (forms in which Issuers “speak to the market”)

- **Primary Offering Documents**
 - (Preliminary) Official Statements, Remarketing Memoranda
- **Secondary (Continuing Disclosure) Documents**
 - Audited financials
 - Tables, schedules or other financial information
 - Material Listed Events, Late Filing Notice
- **Public Statements Reasonably Expected to Reach Investors**
 - Issuer Websites
 - Public Statements by Officials
 - Investor Presentations
 - Due Diligence Calls

SEC Enforcement



SEC Enforcement - MCDC

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- MCDC Non-Compliance Examples
 - Failure to cross-reference to annual filing elsewhere on EMMA MSRB (ensure outstanding CUSIPS linked)
 - Annual filing made at least 33 days late
 - Failure to file event notice regarding defeasance
 - Silence of compliance in official statement deemed to be statement of compliance
 - Notice of failure must accompany late/missing filings (financial and operating information)
 - Misstatement can't be cured by later filing an amendment to OS (4 months later).

SEC Enforcement - MCDC

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Post MCDC Take-Aways

- SEC's focus is on content of disclosure from the perspective of the reasonable investor. It is not necessary to have a bond default or other financial harm.
- SEC enforcement is a post-issuance tool, with a rear view perspective. Most SEC enforcement actions stem from *omitted* information.
- Managing securities legal risks; demonstrating reasonable care:
 1. Importance of initial and ongoing disclosure policies and procedures.
 2. SEC settlements consistently require the adoption of policies and procedures.
 3. Document analysis and due diligence.

SEC Enforcement Actions

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- *Beaumont Financing Authority* (August 2017) – Post MCDC – fines, suspensions, and bar from participation.
- *In the Matter of Westlands Water District* – Failure to disclose accounting adjustments. Fines of District, general manager and assistant manager.
- *Town of Ramapo* – Failure to disclose deteriorating financial condition - individual liability, fines, criminal charges and bar from participation.

Best Practices



Practices for Issuers

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- Understand Filing Obligations and Timing
 - ✦ Suggest Specific Annual Filing Date Deadlines
- Analyze Disclosure History on EMMA – Independent 3rd Party
 - ✦ Careful diligence (15c2-12 Analysis) of *content* of secondary market Operating and Financial data filings
- Update Past Delinquent Filings
- Consider Ongoing 15c2-12 Analysis/Refresh/Alerts
 - ✦ Reminders for Current Filing Obligations
 - ✦ Independent Review to Confirm Filings Done Properly (vs. having the filing agent reviewing – “Fox watching the hen house”)
- Let Underwriters Know of Issuer’s Policies and Procedures
- Engagement of Borrower and Disclosure Counsel

Continuing Disclosure Practices

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Goal: Adopt or enhance policies and procedures that will create an environment focused on providing accurate, timely, and complete disclosures

1. Identify the Issuer's administrative staff and agents (Disclosure Working Group)
2. Outline policies and procedures
3. Develop checks and balances

Continuing Disclosure Practices

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Rule 15c2-12 (15) & (16) Considerations

Integrate Amendments into current policy and procedures, including guidelines for making the following determinations. Establish personnel and consultants to make the following determinations:

1. Determine if new contract or agreement is a financial obligation.
2. Is financial obligation, material (to investor)?
3. Decide on disclosure form (i) entire document and/or (ii) material terms.

The Underwriter's Perspective

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- Approach to 15c2-12 Compliance – A New Reality
 - Review Obligations and Assess Corrective Actions for Issuers with Failures in Past Filings
 - Assessment of Issuer's Disclosure/Statements in POS/OS
 - Reach a Conclusion of an Issuer's Ability to Comply Prospectively
- What is “Reasonable Diligence?” No Single Standard
 - 5 Year Lookback – All Deals Outstanding at Any Time
 - Consistency and Timeliness in CAFR and CDA

Conclusion

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Responsibilities don't end at closing.

**ISSUERS HAVE PRIMARY RESPONSIBILITY FOR
THE CONTENT OF THEIR DISCLOSURE
DOCUMENTS**

Follow adopted policies and procedures to ensure
against negligence/liability claims.

Investors need accurate and complete information.