STEP 8: SECURITIES LAW DISCLOSURE FOR MUNICIPAL SECURITIES

WHAT IS DISCLOSURE?

Disclosure is the act of providing investors with all known material information (whether favorable or negative) which the investor might need to make informed investment decisions. Disclosure begins with the Preliminary Official Statement (POS) and continues over the life of the bonds (continuing disclosure).

NEW ISSUE DISCLOSURE

The Securities Act of 1933 generally requires that securities must be registered with the U.S. Securities Exchange Commission (SEC) before they can be offered to investors. The Securities Exchange Act of 1934 imposes reporting requirements on issuance of securities. However, there is an exception for municipal securities. Generally, a security issued or guaranteed by any state, political subdivision of a state/territory, or any public instrumentality of a state/territory is not subject to the registration and reporting requirements.

Although municipal securities are exempt from registration and reporting requirements, they are subject to the antifraud provisions of the federal securities law.

SEC Rule 15c2-12 requires an Underwriter of municipal securities to:

1. Obtain and review an Issuer[1]'s Official Statement that, except for certain information, is deemed final by an Issuer, prior to making a purchase, offer, or sale of municipal securities;
2. Provide the Issuer's most recent Preliminary Official Statement (if one exists) to potential customers (for Negotiated sales);
3. Deliver to customers, upon request, copies of the final Official Statement for a specified period of time; and
4. Contract to receive, within a specified time, sufficient copies of the Issuer's final Official Statement to comply with the rule's delivery requirement, and the requirements of the rules of the Municipal Securities Rulemaking Board (MSRB).

The Issuer of the securities has the primary legal responsibility for the accuracy and completeness of information in the disclosure document and may be held primarily liable under the federal securities laws for misleading disclosure. Under SEC Rule 10b-5, it is unlawful to make an untrue statement of a material fact or to omit to state a material fact resulting in fraud

[1] The term "Issuer" is a general reference to issuing districts, municipalities, and local governments.

or deceit. Accordingly, the Official Statement must disclose material information about the securities to allow investors to make informed decisions.

WHAT MUST BE DISCLOSED?

The Issuer must disclose all material information with no material misstatements or omissions. An omitted fact is material if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the total mix of information made available.

Materiality is a facts and circumstances test. The SEC has determined to be material:

- Intended use of bond proceeds,
- Accurate disclosure of financial condition,
- Any financial interest in transaction, and
- Potential taxability of bonds.

The SEC has suggested that the governing body of the Issuer review the disclosure documents at least two weeks prior to its distribution.

The SEC requires Underwriters to perform due diligence under supervised formal written policies and procedures prior to purchasing a transaction. Municipal Advisors have a similar responsibility under the Duty of Care provision in MSRB Rule G-42. Due diligence refers to the process of forming a reasonable basis for a belief in the truthfulness, accuracy and completeness of the key representations made in the OS. Due diligence goes beyond mere credit analysis to evaluation of the accuracy and completeness of the Issuer's disclosure. The financing team, including the Issuer, Bond Counsel, Municipal Advisor, and the Underwriter (in a Negotiated sale), and Underwriter's Counsel, (if any), will typically convene a due diligence call prior to finalizing the POS. On the call, the financing team will review a broad questionnaire designed to determine the accuracy and completeness of the disclosure in the POS and to discover any material misstatements or omissions in the disclosure necessary to make the official statement accurate and complete.

SECONDARY MARKET DISCLOSURE (SEC RULE 15C2-12)

Under SEC Rule 15c2-12 (the Rule), Underwriters are prohibited from purchasing or selling municipal securities unless the Obligor on the securities has contracted to provide continuing disclosure as described in the Rule, unless the offering is exempt.

Since 1995, however, the rules have changed. Disclosure does not stop upon completion of the primary offering. Rather, the SEC has declared that future investors trading in the secondary

market are entitled to receive virtually the same level of information that was furnished in the primary offering stage.

Continuing disclosure generally refers to a process of providing "annual historic financial information" (which includes current financial information and operating data) on a regular basis for as long as securities are outstanding.

Amendments to SEC Rule 15c2-12 took effect February 27, 2019. Issuers of new municipal bonds are required to agree to disclose to investors significant information about the incurrence of bank loans and similar borrowings, as well as events reflecting financial difficulties related to its existing financial obligations. The new disclosure requirements apply if a municipality issues a bond on or after February 27, 2019, for which it enters into a new continuing disclosure agreement.

WHO MUST PROVIDE CONTINUING DISCLOSURE?

The Rule applies to Obligated Persons, which is defined in Rule 15c2-12 as:

> *"…any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account ... committed by contract or other arrangement to support payment of all, or part of the obligations on municipal securities..."*

In most cases, the governmental unit that is issuing bonds will be an Obligated Person subject to the continuing disclosure requirements. However, this does not always hold true. The key to identifying the Obligated Person(s) is to carefully read the contract or other document describing repayment of the bonds. The Rule does not require a disclosure commitment from *each* Issuer or Obligated Person. Instead, only those parties for whom financial information and operating data are presented in the Official Statement are covered. Thus, a purely conduit Issuer of non-recourse Revenue Bonds may not be subject to continuing disclosure so long as the conduit Borrower contracts to provide continuing disclosure. For pooled financings with multiple participants, objective criteria (e.g. percentage of overall payment support) and the continuing disclosure agreement executed at the time of issuance will determine who the appropriate disclosure parties are and what is required to be disclosed. For example, for certain pooled bond offerings (such as the OSBA pension bond pools), individual Borrowers are required to provide their audited financial statements and certain operating data but the Trustee is required to provide notice of material events (such as rating changes).

The Rule excludes providers of most forms of credit enhancement (e.g., bond insurance, letters of credit or other liquidity facilities) from the definition of Obligated Person.

HOW ARE DISCLOSURE OBLIGATIONS DETERMINED?

A general representation or undertaking to provide continuing disclosure is typically included in the principal documents under which the securities are issued (e.g. the trust indenture, ordinance, or resolution). Typically, the specific requirements of the obligation to provide annual financial information is set out in a separate agreement or certificate entered into for the benefit of bondholders.

An Underwriter must receive reasonable assurance regarding the continuing disclosure commitment before agreeing to act as Underwriter. In Negotiated offerings, this assurance will be obtained at the time of signing the bond purchase contract. In Competitive offerings, such assurance will be contained in the Issuer's notice of sale. A form of the undertaking to provide continuing disclosure is usually included as an appendix to the POS.

The Rule allows for delegation of information dissemination responsibilities to designated agents or to indenture Trustees. The Rule does not enumerate the consequences if an Issuer breaches its disclosure undertaking. Remedies for breach will vary under state law and, the SEC concludes, are a subject for negotiation between the parties. The Rule does require, however, that Issuers disclose in their final Official Statements all instances in the previous five years in which they have failed to comply with any continuing disclosure obligations.

WHAT CONSTITUTES CONTINUING DISCLOSURE?

Two things must be disclosed under the Rule: annual financial and operating information and certain material events "…as they occur". Annual financial information is defined as:

> *"…financial information or operating data, provided at least annually, of the type included in the final official statement with respect to an obligated person."*

The Rule does not dictate strict form and content requirements for what constitutes the "annual financial information." The written undertaking by the Issuer or Obligated Person, as well as the Final Official Statement (FOS), must specify in reasonable detail those categories of information that will be included. The undertaking must also specify the date by which the annual financial information will be provided (e.g., X days following the end of the fiscal year or a date certain, such as by March 1 of each year).

The undertaking must describe the accounting principles used in preparation of the annual financial information, including whether or not audited financial statements will be prepared. An undertaking that references generally accepted accounting principles, as modified by the Government Accounting Standards Board (GASB), or mandated state statutory principles (as in effect from time to time) would satisfy this provision of the Rule.

Operating data is a subset of annual financial information and refers to historic quantitative information in the Official Statement that provides investors material financial information in connection with the offering of securities. For example, in a health care financing, operating data would typically include a description of hospital administration and management, service area and economic base, capital plan and operating statistics (such as bed use), admissions criteria, payor use, etc. For ease of compliance, Issuers may choose to include the operating data required to be provided as part of its continuing disclosure as part of the management discussion and analysis in its annual financial statements or as a supplementary section so there is only one document to be filed on an annual basis.

In addition to disclosure of "annual financial information," the Rule requires (as of August 2018) disclosure of sixteen listed events within 10 business days after the occurrence of the event:

1. Principal and interest payment delinquencies.
2. Non-payment related defaults, if material.
3. Unscheduled draws on debt service reserves reflecting financial difficulties.
4. Unscheduled draws on credit enhancement reflecting financial difficulties.
5. Substitution of credit or liquidity providers or their failure to perform.
6. Adverse tax opinions or events affecting the tax-exempt status of the securities.
7. Modifications to rights of security holders, if material.
8. Bond calls, if material, and tender offers.
9. Defeasances.
10. Release, substitution or sale of property securing repayment of the security, if material.
11. Rating changes.
12. Bankruptcy, insolvency, receivership or similar event of the obligated person.

    Note – For the purposes of the event identified in this paragraph 12, the event is considered to occur when any of the following occur: The appointment of a receiver, fiscal agent or similar officer for an obligated person in a proceeding under the United States Bankruptcy Code or in any other proceeding under state or federal law in which a court or governmental authority has assumed jurisdiction over substantially all of the assets or business of the obligated person, or if such jurisdiction has been assumed by leaving the existing governing body and officials or officers in possession but subject to the supervision and orders of a court or governmental authority, or the entry of an order confirming a plan of reorganization, arrangement or liquidation by a court or governmental authority having supervision or jurisdiction over substantially all of the assets or business of the obligated person.
13. Consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material.
14. Appointment of a successor or additional Trustee or the change of name of a Trustee, if material.

15. Incurrence of a financial obligation of the issuer or obligated person, if material, or agreement to covenants, events of defaults, remedies, priority rights, or other similar terms of financial obligation of the issuer or obligated person, any of which affect security holders, if material.
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.

Failure to provide annual financial information by the date specified in the written undertaking also requires a notice of the failure to file.

The determination of whether events other than the 16 specified “material events” should be the subject of event filings is left to the Issuer. Issuers should beware of any undertakings to provide notice of events beyond those specifically listed in the Rule. Undertakings that expand the list of sixteen with open-ended disclosure commitments like "...and any other material events" should be avoided.

The timing of the material event filing depends on when the affected bonds were issued. Currently, continuing disclosure agreements for new bonds must state that the notice of material events must be provided to EMMA within ten business days. Older bonds may have less onerous reporting requirements such as requiring such events to be reported in “timely manner”. Issuers should be aware of the content of all their continuing disclosure agreements and have practices and procedures in place to ensure that materials events, should they occur, are reported as required in the continuing disclosure agreement.

WHERE TO DISCLOSE?

Currently (September 2018), obligated persons under the Rule are required to file on Municipal Securities Rulemaking Board (MSRB) through its electronic web-based system known as EMMA, which stands for Electronic Municipal Market Access. Document filing via EMMA is free.

MODIFICATION OR TERMINATION OF DISCLOSURE OBLIGATIONS

Generally, the undertaking to provide continuing disclosure may not be modified after the fact. However, an undertaking that includes an amendment provision may comply with the Rule if certain conditions are met. Samples of Continuing Disclosure Certificates can often be found in the Appendix of an Official Statement (which can be found on EMMA).

An Issuer or Obligated Person may terminate their continuing disclosure obligations when they cease to have any liability for payment on the bonds. The SEC has stated that this occurs upon full redemption of the securities, or the legal defeasance and release of any lien securing the bonds.

Although it is not expressly permitted by the Rule, many Issuers include a provision authorizing them to terminate their disclosure undertaking if they obtain an opinion of Bond Counsel.

EXEMPTIONS FROM THE RULE

All municipal securities issued prior to July 3, 1995 and bond issues of less than $1 million in aggregate principal amount are exempt from the Rule altogether. Bond issues in large minimum denominations (i.e., $100,000 or more face value) are exempt from the Rule if:

- They are Privately Placed with no more than 35 sophisticated investors; or
- They have a maturity of 9 months or less; or
- They may be optionally tendered at par at least every 9 months.

Effectively, this means that most Private Placements and variable rate issues are exempt from the Rule. Short-term notes and other municipal securities whose stated maturity is 18 months or less are exempt from the financial information disclosure requirements of the Rule. However, Issuers must still undertake to provide timely notice of material events.

LINKS / RECOMMENDED READING

Rule 15c2-12 applies to different bond structures and programs in different ways, particularly with respect to the Obligated Person analysis. Issuers must consider the kinds of debt they issue (e.g. general obligation, revenue, special assessment, etc.) and their own unique circumstances. This would include establishing a protocol for who will speak on an Issuer's behalf and when, what they will say, and how they will say it. Issuers with multiple bonding programs should also try to maintain consistency in their contractual undertakings. Standardizing the form of undertaking and the schedule for reporting should ease some of the administrative burden of providing continuing disclosure on numerous programs. Finally, when in doubt about disclosure obligations, Issuers should consult with their Bond Counsel. The following are some helpful links in regards to disclosure:

- GFOA Best Practices
- GFOA Blue Book
- Securities Industry and Financial Markets Association (SIFMA)
- Municipal Securities Rulemaking Board (MSRB)
- Securities Exchange Commission (SEC)