ENFORCEMENT TRENDS IN THE MUNICIPAL MARKETPLACE: "WRITING ON THE WALL"

by Daniel T. Manning

Imagine you are a city official, standing before a group of citizens, about to deliver a speech announcing that the city will be selling municipal bonds to fund essential road and sewer repairs in your town. By now the news has gotten out, and the citizens of your fiscally conservative, debt-averse town are skeptical. Why does the city need to issue bonds to pay for the repairs? Is there another way to fund them? If not, why bother making the repairs? Are they really necessary?

Your goal with this speech is to inspire enthusiasm for the project and put any concerns your citizens might have about the city going into debt to pay for the repairs to rest. You might highlight the importance of the repairs to maintain a high quality of life for the city, and to protect the safety of drivers on the road. You might explain that a bond issuance is the best way to pay for the improvements while ensuring the city has enough cash on hand to pay for the city's many other needs. Finally, you might reassure your citizens that the city is financially healthy and will be able to repay the bonds. However, based on recent Securities and Exchange Commission (SEC) action, you just made a disclosure regulated by securities laws that might lead to a SEC enforcement action against you and your city.

Federal Securities laws prohibit issuers of municipal bonds from making any misstatement of material fact, or making a statement that is misleading because of the omission of a material fact "in connection with the purchase or sale of securities." A fact is considered "material" if it is reasonably expected for the statement to reach investors, and if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. Certain statements and required disclosures are plainly connected to the sale of securities, and are plainly material. For instance, issuers in public markets must always prepare and file an official statement for the purpose of selling the Securities in the primary offering, and the underwriter will usually require the city to file annual financial statements. However, SEC has indicated that it interprets a "material statement connected with the sale of Securities" much more broadly than mere filings and statements directed towards the marketplace. Over the last decade, SEC has steadily and incrementally heightened its expectation for disclosures affecting the municipal Securities market. The dawning of this "new day" in SEC's focus has resulted in an unprecedented number of enforcement actions and penalties against cities.

"Writing On The Wall"

Municipal Securities are an essential tool for local governments to finance public infrastructure projects. As such, the municipal Securities market has grown exponentially over the last 30 years. According to a 2012 Report on the Municipal Securities Market issued by SEC, at the end of 2011 there were more than one million different outstanding municipal bonds with a total aggregate principal of more than $3.7 trillion. The growth and current size of the municipal bond marketplace is indicative of the success local governments have had financing projects through bond issuances and of the attractiveness of municipal bonds to investors; municipal bonds typically enjoy advantageous tax treatment and historically have a lower rate of default than corporate bonds. However, the growth of this public market also has brought increased scrutiny by regulators, particularly regarding issuer disclosures.

Enforcement in the municipal Securities market has evolved on two fronts: 1) in the type of information SEC considers "material," and 2) in what is expected of issuers in the disclosure process. As early as 1994, SEC took the position in a statement published in the Code of Federal Regulations that any statement "concerning the entity's fiscal affairs" reasonably expected to reach investors and the trading markets was considered a material fact in connection with the purchase or sale of Securities. Public statements and press releases made by municipal officials not necessarily intended for investors were expressly mentioned. The statement concluded by saying:

"Since access by market participants to current and reliable information is uneven and inefficient, municipal issuers presently face a risk of misleading investors through public statements that may not be intended to be the basis of investment decisions, but nevertheless may reasonably be expected to reach the Securities markets . . In order to minimize the risk of misleading investors, municipal issuers

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should establish practices and procedures to identify and timely disclose, in a manner designed to inform the trading market, material information reflecting on the creditworthiness of the issuer and obligor and the terms of the Security."

Two years later, in a "Report of Investigation" regarding the conduct of the Board of Supervisors of Orange County, California in a bond offering, SEC again signaled its expectations of municipal issuers' disclosures. In that case, the supervisors merely relied on the representations of the County's agents with respect to the information in the official statement before approving it. In SEC's view, this was not enough. The county supervisors "had a duty to take steps appropriate under the circumstances to assure accurate disclosure was made to investors."

SEC has continued to set standards for issuers in more recent enforcement orders and public statements. In a 2007 white paper to Congress, SEC recommended several revisions to issuer disclosure requirements, including "ensuring that issuers establish policies and procedures for disclosure appropriate for the particular issuer" and "clarifying the legal responsibilities of issuer officials for the disclosure documents that they authorize." Later that year, Linda Chatman Thomsen, then director of the division of enforcement at SEC, delivered a speech calling the municipal Securities market "a top priority for SEC" and stating her belief that "SEC's attention to this market segment will increase." In that same speech, Thomsen laid out five "critical lessons" that she believed municipalities should learn from the recent enforcement actions. These included:

- A review to ensure that the municipality had written policies and procedures in place that produce complete and accurate disclosures;
- Training to municipal officials and employees "regarding the applicable disclosure requirements of federal Securities laws" and Government Accounting Standards Board financial reporting provisions;
- The importance of always keeping the overarching goal in mind, which is full and fair disclosure to investors;
- The importance to disclose known bad news; and
- The need to hire auditors with the skills to do the job.

Director Thomsen's prediction proved correct, and SEC's attention to the municipal Securities market did increase. By 2010, SEC had expanded its investigatory scope to include enforcement actions for negligent conduct, rather than intentional misstatements or misleading omissions. Now, SEC may bring an enforcement action if it determines that a material misstatement or misleading omission occurred merely as a result of the issuer's failure to exercise reasonable care. Intentional misconduct is not necessary. The breadth of authority now exercised by SEC developed gradually over several years of regulations, enforcement orders, and speeches exposes municipal issuers to an unprecedented level of liability.

Could Your Municipality Be Next?

There are several enforcement actions that illustrate how expansive SEC interprets its regulation of municipal issuers. In Harrisburg, Pennsylvania, both the City and the mayor were sanctioned for, among other things, making a materially misleading disclosure during the mayor's state of the city address when the mayor referred to the City's problems servicing the debt on a bond offering as "an additional challenge" and an "issue [that] can be resolved." In South Miami, Florida, the City was sanctioned after it failed to report that a public-private development financed by tax-exempt municipal bonds had changed to a fully-private development that affected the tax treatment of the bonds. In the enforcement order, SEC noted that significant turnover in the City's finance department left no one

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knowledgeable of the City's disclosure obligations, and the lack of a formal training program for new employees constituted a lack of reasonable care by the City. Of particular import in these and other enforcement actions, SEC noted incomplete or non-existent disclosure policies and procedures as a cause in the municipality's violation.

All signs indicate that the scrutiny directed at the municipal Securities market is the new normal, and cities should take note of the trend. In 2014, the SEC Division of Enforcement announced the "Municipalities Continuing Disclosure Cooperation Initiative" in which it offered "favorable settlement terms" to issuers and other market players who self-report continuing disclosure violations to the Division of Enforcement. However, the Division made clear that it offered "no assurances that it will recommend the above terms in any subsequent enforcement recommendation." The not-so-subtle message to municipalities and other parties in the municipal Securities marketplace was essentially, self-report now, or feel the wrath later.

Time For A Proactive Approach?

In August 2015, the National Association of Bond Lawyers (NABL) issued a white paper to its membership discussing best practices in crafting disclosure policies, particularly emphasizing statements not necessarily directed at investors. The report noted the increased enforcement activity against municipal bond issuers as an influencing factor for the report, and pointed out SEC's consistency in requiring disclosure policies in recent enforcement orders against municipal issuers. While the report stopped short of imploring municipal issuers to adopt a disclosure policy pre-issuance, it made a point to note the advantages of doing so, particularly the preventative benefits, such a policy would afford. Furthermore, there was no need for NABL to make such an exhortation; SEC has done so time and again over the last decade. That NABL found the topic important enough to warrant its own white paper on the heels of such a hostile environment should be warning enough: now is the time to be proactive.

The NABL paper points out, as SEC has in past, that it is important to keep the purpose of disclosure in mind when developing a policy and then carrying it out – disclose material information to the market place so that investors can judge the financial health of a city and make a determination as to whether to purchase the bonds. This requires an active process of considering what role different information plays in painting a clear and accurate picture of a city's finances. Ultimately, it is essential to start with an evaluation of existing procedures, determine the gaps, and craft an enhanced policy that fills those gaps. According to NABL, a comprehensive policy that will help prevent disclosure problems down the road will have the following features:

- Include a description of every type of statement regarding a city's financial health that might reach the marketplace;
- State specific procedures for due diligence, review, consultation with professionals if needed, and final approval;
- Include a documentation process; and,
- Describe a training process for key personnel associated with the disclosure process.

Training is one of the areas that SEC has touched on time and again in its enforcement orders, as exemplified in the South Miami case. Training helps ensure current personnel are up to date on the most current law and guidance from regulatory authorities, informs new employees of disclosure requirements and their responsibilities, and forces everyone involved to consider the strengths and weaknesses of their specific municipality's policies and procedures. Finally, NABL stresses the importance of following the policy once adopted. It cannot serve its preventative function if it is stuffed in a drawer and ignored. Indeed, ignoring an existing policy could, itself, be evidence of negligence by an issuer should a disclosure problem arise once a policy is adopted.

No Time Like The Present

The regulatory tenor presently surrounding the municipal Securities market is demonstrably different from ten years ago. SEC has been increasingly active in sanctioning municipal issuers who, in their view, are providing an incomplete picture of their financial situation to the marketplace. Even unintentionally negligent conduct can land a city in hot water and lead to serious sanctions, including excluding municipal officials personally from participating in future financings. In such a hostile environment, it is imperative for local governments that have issued or plan to issue municipal bonds to take preventative measures to protect themselves. Implementing a comprehensive policy that takes into account recent developments in municipal Securities enforcement can save municipal issuers the hassle, embarrassment, and repercussions of a SEC enforcement action.❑

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