

# COMMONWEALTH DISCLOSURE 101

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# Federal Securities Regulation

- Commonwealth bonds are securities.
- Most securities must be registered with the federal Securities and Exchange Commission (SEC) and a registration statement must be filed, including a prospectus, containing prescribed categories of information regarding the issuer of the securities.
- Securities issued by states are exempt from the registration requirements.

# Applicability of Federal Securities Laws

The Commonwealth's bonds are, however, subject to the anti-fraud provisions of the federal securities laws.

In 1975, the federal securities laws were amended to:

- regulate broker-dealers that sell municipal securities, through the creation of the Municipal Securities Rulemaking Board (MSRB) and
- make the anti-fraud provisions expressly applicable to issuers of municipal securities.

## Tower Amendment

However, the 1975 amendments also contained the “Tower Amendment,” which expressly

- precludes the SEC or the MSRB from requiring issuers of municipal securities to make filings with the SEC or the MSRB prior to the sale of municipal securities and
- precludes the MSRB from requiring municipal issuers to deliver information to the MSRB or bond purchasers.

## SEC 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.

## Disclosure Documents

- What is called a “prospectus” in the world of registered securities is called an “Official Statement” in the world of municipal securities.
- A “Preliminary Official Statement” is usually circulated prior to the pricing of a bond issue, with a final Official Statement following after the bonds have been sold and the interest rates have been determined.
- For Commonwealth bonds, the front part of the Official Statement typically describes the terms of the bonds and the security for the bonds, with information about the Commonwealth itself contained in a separate “Information Statement” which is attached as an appendix.
- Anti-fraud rules also apply to materials supplied to rating agencies and any disclosures made in a manner that is reasonably likely to reach investors (e.g. press releases, public statements, and information on an investor relations website).

# SEC Report on the Municipal Securities Market

- Released August 13, 2012 after two years of study and field hearings.
- Asks Congress to consider authorizing SEC:
  - to require disclosure (including time frames for the frequency of dissemination and minimum disclosure requirements)
  - to establish the form and content of financial statements and
  - to require issuers to have their financial statements audited.

## Rule 15c2-12

- Requires underwriters of municipal securities to review a “deemed final” preliminary official statement prior to offering securities to potential investors and to receive a final official statement after underwriting the securities.
- Prohibits the purchase or sale of municipal securities by an underwriter unless the issuer undertakes to provide continuing disclosure.



# Continuing Disclosure Obligations

- In its continuing disclosure undertakings, the Commonwealth agrees:
  - to file its financial statements (the SBFR and CAFR)
  - to file annual financial information relating to a particular fiscal year no later than 270 days after the end of that fiscal year, and
  - to file “material event notices” when certain types of material events occur, such as debt service payment delinquencies, early redemptions of bonds, defeasances of bonds and rating changes.

# Commonwealth Disclosure Enhancements

**Goal: Best disclosure in the municipal securities market**

- Formal disclosure policy
- Investor web site
- Regularly scheduled bimonthly Information Statement updates
- Voluntary disclosure filings
- Required disclosure training
- Bimonthly investor calls
- Formal underwriter due diligence meetings
- Formal annual review of disclosure process by TRE, ANF and OSC.

## EMMA

- The Commonwealth's disclosure materials are posted to the Electronic Municipal Market Access ("EMMA") system.
- EMMA is operated by the MSRB and is similar to the EDGAR filing system for corporate securities.
- Documents will also be posted on the Commonwealth's investor web site.

## Information Statement Updates

- The full Information Statement is updated bimonthly (generally by the 5<sup>th</sup> business day of the month).
- Full Information Statement updates are published in early January, March, May, July, September and November, with updates due to disclosure counsel one week prior to publication.
- A complete, updated Information Statement is attached to each POS and final OS.
- Information generally as of the previous month-end.

## Voluntary Continuing Disclosure

The Commonwealth files the following disclosure documents voluntarily on a regularly scheduled basis:

- bimonthly Information Statement updates
- quarterly economic data
- investor presentations
- preliminary official statements
- rating agency presentations

## Materiality Standard

“The adequacy of the disclosure provided in municipal security offering materials is tested against an objective standard: an omitted fact is material if there is a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable [investor]. Put another way, **there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.**”

SEC Interpretive Release published in 1994, quoting  
*TSC Industries, Inc. v. Northway, Inc.*, 426 U. S. 438, 449 (1976)

## Materiality Guidelines

- What is “material” in the context of a state issuing general obligation bonds?
- Various industry groups have promulgated disclosure guidelines, including the Government Finance Officers Association (GFOA) and the National Federation of Municipal Analysts (NFMA).
- Governmental Accounting Standards Board (GASB) guidelines are also helpful, though not conclusive.
- The Information Statement contains a lot of information that is not, strictly speaking, material.
- What is material to a particular agency or department may not be material to the Commonwealth as a whole.
- Err on the side of caution.

## 10b-5 Certificates

- The term “10b-5 certificate” comes from Rule 10b-5, as does the language of the certificate.
- The Commonwealth delivers a “10b-5 certificate” to the underwriters of each bond issue, signed by the State Treasurer and the Secretary of Administration and Finance.
- Various state officials deliver “10b-5 letters” to the State Treasurer and the Secretary of Administration and Finance to undergird their signatures on the Information Statement and the Commonwealth’s blanket certificate.
- 10b-5 letters are to be signed by the head of the applicable agency or department.
- 10b-5 letters are expected to be collected whenever updated Information Statements are filed with EMMA.



## Timing - Sale and Closing

- Three or four bond issues per year, plus monthly offerings as part of the Commonwealth's new rolling offering program.
- Bonds are "priced" or "sold" a week or two before they are actually delivered to investors and money received ("closing").
- The Preliminary Official Statement must be accurate as of its date and as of the pricing date ("deemed final").
- The final Official Statement must be accurate as of the date of sale of the Bonds and as of the closing date.

## SEC Enforcement Actions

- This is the typical venue for legal actions involving allegations of faulty disclosure in the context of municipal securities.
- Elements for Rule 10b-5 violation: (i) materially misleading misstatement or omission, (ii) fraudulent intent or recklessness, (iii) in connection with the purchase or sale of a security. (Private plaintiffs also need to prove reliance and damages.)
- Negligence standard for violations of Section 17(a)(2) or Section 17(a)(3) of the '33 Act (any fraud or misrepresentation made in connection with the offering or sale of securities).
- In the context of general obligation bonds, the principal materiality issues usually center around the financial condition of the issuer.
- In other contexts, key issues may be conflicting interests of the various parties, how the bond proceeds were used or invested, how the valuation of bond-financed property was determined, etc.

## **Examples from SEC Enforcement Actions**

- Misrepresentations and omissions regarding the underfunding of state pension obligations (State of New Jersey, State of Illinois)
- Bad financial statements – showed surplus of \$400k instead of actual deficit of \$9.4m – said summary financial information was audited when some of it was derived from financial statements upon which auditors had issued qualified opinions (City of Syracuse, NY)
- Accurate but stale financial statements; doesn't matter that the issuer could still pay its debts (Maricopa County, AZ)
- Cash flow crisis/proceeds used for operating costs/ratings downgrade; misstatements in CAFR and transmittal letter (City of Miami, FL)
- Risky investment strategy/dependence on investment pools (Orange County, CA)
- Playing games with pension funding (City of San Diego, CA)

## **SEC Enforcement Actions in 2013**

- March – State of Illinois – Misrepresentations and omissions regarding structural underfunding of state pension obligations
- April – Victorville, CA – inflated property valuations for airport authority – charges filed against individual city official
- May – Harrisburg, PA – misleading statements made in budget reports, annual and mid-year financial statements, mayor’s state-of-the-city address posted on website
- May – South Miami, FL – misstatements and omissions in tax certifications and in loan agreement
- July – Miami, FL – interfund transfers masked deficit, violation of previous cease-and-desist order, charges brought against former Budget Director individually
- July – West Clark Community Schools, IN – issuer falsely stated that had complied with continuing disclosure obligations
- November – Greater Wenatchee Regional Events Center Public Facilities District, WA – fine assessed against issuer

# **In the Matter of the Massachusetts Turnpike Authority and James J. Kerasiotes**

- SEC investigation relating to alleged faulty disclosure by the Turnpike Authority relative to costs of the Big Dig project.
- Three bond issues were examined - Turnpike Authority bonds in March, 1999, Commonwealth bonds in September, 1999 and MBTA bonds in December, 1999.
- Turnpike Authority was liable for the information it provided to the Commonwealth and the MBTA for use in their disclosure documents, even though it was not the issuer of the bonds.
- The Turnpike Authority and Kerasiotes argued that:
  - project cost increases had not been fully quantified or confirmed and were therefore speculative,
  - it would have been premature to disclose cost increases until a funding plan could be announced simultaneously, and
  - their primary obligation was to control costs, and premature or piece-meal disclosure of cost overruns would have led to still higher costs.

## Turnpike Authority and Kerasiotes (cont'd)

SEC's answer:

“[T]heir failure to disclose such cost increases did not take into account their obligations under the federal securities laws. By their negligent conduct, the Turnpike Authority and Kerasiotes committed or caused violations of Sections 17(a)(2) and (3) of the Securities Act.”

## Lessons Learned

- It can happen here. In fact, it did.
- Individual officials and non-Commonwealth entities can be liable.
- Cannot sit on material information even if disclosure will be harmful.

## Liability of Issuer Officials

From the SEC's report on Orange County, CA:

- “In authorizing the issuance of securities and related disclosure documents, a public official may not authorize disclosure that the official knows to be false; nor may a public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading. When, for example, a public official has knowledge of facts bringing into question the issuer's ability to repay the securities, it is reckless for that official to approve disclosure to investors without taking steps appropriate under the circumstances to prevent the dissemination of materially false or misleading information regarding those facts. In this matter, such steps could have included becoming familiar with the disclosure documents and questioning the issuer's officials, employees or other agents about the disclosure of those facts.”
- Public officials may rely on lawyers, financial advisors, underwriters, and other government employees in carrying out their disclosure obligations, but any such reliance must be reasonable.



## Questions?

Feel free to contact disclosure counsel:

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– Disclosure counsel will notify state officials of new developments in the regulatory environment.