

Satisfying Municipal Market Continuing Disclosure Standards Set by SEC Enforcement Actions

STEVE T. PARK AND TESIA N. STANLEY, BALLARD SPAHR LLP,
WITH PRACTICAL LAW PUBLIC SECTOR

Search the [Resource ID numbers in blue](#) on Westlaw for more.

An Article discussing Securities and Exchange Commission (SEC) enforcement actions against municipal bond issuers. This Article also provides practical advice to bond issuers on creating defensible disclosure policies and procedures.

The local government attorney's role in issuing municipal bonds is often limited to advising on the government entity's authority, public notice and meeting requirements, and other legal issues of local concern. The oversight and obligations that must be complied with, however, are often not familiar functions of bond issuance. Failure to meet these obligations is increasingly resulting in the SEC filing fraud charges against the local government and its officers.

This Article introduces the regulatory environment to municipal issuers by providing a brief introduction to the regulatory regime and posture of enforcement agencies and tips on creating compliance procedures and policies.

For more information on issuing and regulating municipal bonds, see Practice Notes:

- Government Bonds: An Introduction for Issuing State and Local Government Attorneys ([W-008-1426](#)).
- Legal Issues in Municipal Finance ([W-001-5064](#)).
- Municipal Securities Regulation: Overview ([W-006-4694](#)).
- Municipal Advisor Registration ([W-004-7807](#)).

REGULATORY ENVIRONMENT FOR MUNICIPAL BONDS

Federal regulators are barred from regulating municipal issuers by a 1975 amendment to the Securities Exchange Act of 1934, known as the Tower Amendment. While federal regulators cannot require municipal issuers to publicly file any disclosure document, the Securities and Exchange Commission (SEC) has authority to bring an enforcement action against a municipal issuer, if the issuer engages in fraud under federal securities law.

This municipal market regulatory framework has created much discussion among market participants regarding the appropriate level and uniformity of municipal market disclosure, including in the area of continuing disclosure. Municipal issuers, in general, do not disagree that investors should be provided with continuing disclosure information about an issuer, such as annual financial statements, to help them make investment decisions.

THE REGULATOR'S PERSPECTIVE

From a federal regulator's perspective, the most fair and efficient municipal market is one in which investors have access to timely and uniform continuing disclosure information in a central repository, which the SEC has designated as Municipal Securities Rulemaking Board's (MSRB's) Electronic Municipal Market Access (EMMA) website.

The SEC has for decades sought to accomplish heightened continuing disclosure standards by regulating municipal securities underwriters because it lacks direct regulatory authority over municipal issuers. Under SEC Rule 15c2-12, underwriters may not underwrite a municipal securities transaction unless an issuer has agreed to provide continuing disclosure to investors on EMMA. This disclosure included not only annual financial information, but also material event notices, such as rating change notices. Instances of material non-compliance with a continuing disclosure agreement in the past five years by an issuer must be disclosed in offering documents under SEC Rule 15c2-12.

THE REALITY OF THE MUNICIPAL MARKET

While municipal issuers may generally agree with the SEC and market participants about an appropriate level of information for the market, the broad and uniform disclosure regime supported by the SEC may be a one-size-fits-all approach that does not reflect the reality of the municipal market. The size and structure of municipal issuers varies as widely as their financing needs. A state may issue billions of dollars in municipal bonds to finance complex infrastructure projects, while a town may issue just enough bonds to pay for a fire truck. Some municipal issuers, especially smaller or infrequent issuers, may not have the financial ability to comply with complex disclosure requirements.

A long list of required disclosure by the SEC may also be of limited use to investors because municipal issuers are public entities that already provide information to the public on a regular basis, even if it is not posted in a central location, such as the EMMA website.

THE SEC'S INCREASED ANTIFRAUD ENFORCEMENT

Until recently, the SEC has continued to put the pressure solely on underwriters to ensure adequate continuing disclosure rather than use its antifraud authority over municipal issuers. In July 2013, the SEC for the first time charged a municipal issuer, West Clark Community Schools, with fraud for falsely stating in 2007 municipal bond offering documents that it was compliant with its continuing disclosure obligations when it had not made any of its required disclosure filings. The SEC brought a related action against the school district's underwriter for failing to discover the school district's lack of compliance, which should have been disclosed in offering documents. (See SEC Charges School District and Muni Bond Underwriter in Indiana With Defrauding Investors, 2013 WL 3872963.)

The SEC's action against West Clark Community Schools was the prelude to a market initiative to change continuing disclosure practices on a wide scale. The SEC's Municipalities Continuing Disclosure Cooperation (MCDC) Initiative was introduced on March 10, 2014, to encourage self-reporting by municipal securities issuers and underwriters of possible securities law violations related to misrepresentations in offering documents concerning an issuer's prior compliance with its continuing disclosure obligations. In total, the SEC took action against 72 issuers and 72 underwriters that self-reported under its MCDC Initiative. The SEC is now taking action against issuers and underwriters it believes should have self-reported under the MCDC Initiative, but did not self-report.

DISCLOSURE POLICIES AND PROCEDURES CRITICAL TO COMPLIANCE

One of the primary takeaways from the SEC's MCDC Initiative is that disclosure policies and procedures can be critical to a municipal issuer's compliance with its continuing disclosure obligations. As noted by the SEC in its MCDC Initiative cease-and-desist orders, negligence is sufficient to establish an anti-fraud violation of Section 17(a)(2) of the Securities Act of 1933 (see *Aaron v. SEC*, 446 U.S. 680, 696-97 (1980)). Disclosure policies and procedures can help avoid inadvertent anti-fraud violations. There are at least six areas that should be covered by these policies and procedures:

- Primary Market Disclosure (see Primary Market Disclosure).
- Secondary Market Disclosure (see Secondary Market Disclosure).
- Public Statements (see Public Statements).
- Avoidance of Selective Disclosure (see Avoiding Selective Disclosure).
- Record Retention (see Record Retention).
- Training (see Training).

PRIMARY MARKET DISCLOSURE

Regarding primary market disclosure, policies and procedures should identify the party responsible for reviewing offering documents and ensuring they are accurate and not misleading.

A member of the legal team and a member of the finance team, such as the treasurer, typically take primary responsibility for ensuring the accuracy of an issuer's disclosure documents. The governing body of the issuer should review all offering documents. A municipal issuer should consider whether formal approvals or certifications by key staff members regarding accuracy and completeness of disclosure documents should be included in its disclosure policies and procedures.

SECONDARY MARKET DISCLOSURE

The secondary market disclosure section of a municipal issuer's policies and procedures should cover the timing, manner, and content of all continuing disclosure information posted on EMMA.

Municipal issuers should carefully review the continuing disclosure information they are committing to provide under a continuing disclosure agreement. Issuers should have adequate policies and procedures in place to provide all required information under a continuing disclosure agreement.

To the extent the issuer is committing to provide information beyond what is required under SEC Rule 15c2-12, a municipal issuer should verify they are capable of providing this information on an ongoing basis. During the MCDC process, many issuers realized too late that they had committed to provide continuing disclosure information, such as annually updating a table included in an official statement, that is not readily available.

The SEC has issued guidance on amending continuing disclosure agreements that allows for amendments in only limited circumstances, such as a change in the law, which do not include amending an agreement to eliminate a requirement to provide information that is not feasible for the issuer to provide on an ongoing basis.

For this reason, issuers should also be consistent in their deadlines for providing continuing disclosure information under continuing disclosure agreements. Municipal issuers may agree to inconsistent due dates, for example one continuing disclosure agreement may require annual financial information to be posted on EMMA 180 days after the end of the issuer's fiscal year and another may require the same information to be posted on EMMA 210 days after the end of the year. These inconsistent deadlines can lead to inadvertent failures to timely post annual financial information on EMMA.

Dissemination Agents

Municipal issuers that have engaged dissemination agents should ensure that their policies and procedures require continuing disclosure information to be sent to dissemination agents far enough in advance of a filing deadline to allow a dissemination agent enough time to post the information on EMMA. A municipal issuer's disclosure policies and procedures should also call for sufficient oversight of a dissemination agent as the ultimate responsibility for providing continuing disclosure information to investors rests with the issuer.

Voluntary Disclosures

A municipal issuer's disclosure policies and procedures should also cover voluntary disclosures. For example, many municipal issuers post bank loan information on EMMA, which is not currently required to be provided under SEC Rule 15c2-12. Although municipal issuers

are under no obligation to provide this information, if they choose to publicly disclose it, the information must be complete, accurate, and not misleading.

EMMA Website Enhancements

The MSRB has enhanced its EMMA website to help issuers meet their continuing disclosure obligations. Municipal issuers can sign up on EMMA to receive email reminders of disclosure deadlines. Staff members of a municipal issuer can also sign up to receive EMMA alerts anytime a filing is made against one of its securities.

PUBLIC STATEMENTS

Public statements, including political speech, can serve as the basis for an SEC antifraud action. As political speech often casts a municipality in a positive light, a municipal issuer's policies and procedures should seek to ensure public statements are in compliance with federal securities law. If an issuer's disclosure policies and procedures are otherwise followed, it is also much more likely accurate information is to be made publicly available and considered by the SEC in a materiality analysis if a misleading statement is made by a public official.

The First SEC Enforcement Action Based on Political Speech

In 2013, the SEC leveled charges against the Harrisburg, Pennsylvania, for misleading investors about its financial health in the annual state of the city address, as well as in its financial and budget reports. That action was groundbreaking in that it was the first SEC action against a state or local government based on public statements made separately from required municipal bond disclosure documents. (See Commission Charges City of Harrisburg for Fraudulent Public Statements, 2013 WL 1884752.)

The enforcement action against Harrisburg was also the first SEC action to cite a municipal issuer's failure to post continuing disclosure information on EMMA as a contributing factor to the SEC's finding of fraud.

In an SEC enforcement action, it looks at whether a particular misstatement was material in light of the total mix of information available to investors. The SEC alleged that the misleading public statements by Harrisburg were especially problematic because investors did not have access to accurate information on EMMA.

In other words, the political speech by the Harrisburg's mayor in the annual state of the city address carried more weight in the SEC's analysis because accurate information about Harrisburg's financial health was not otherwise publicly available at the time the inaccurate statements were made. The SEC's order against Harrisburg cited 1994 interpretive guidance by the SEC that provided:

"[s]ince 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 be reasonably expect to reach the securities markets."

Given the "total mix" of information that had been made available by Harrisburg, the SEC found Harrisburg's public statement to be materially misleading under federal securities law.

AVOIDING SELECTIVE DISCLOSURE

Another area that should be covered by disclosure policies and procedures is selective disclosure. In September 2017, the MSRB issued a market advisory on selective disclosure. In the advisory, the MSRB warned issuers to be aware of providing disclosure information to only some bondholders rather than the market as a whole, such as during investor conference calls and invitation-only meetings with analysts. The MSRB stated that municipal issuers may be, often inadvertently, providing an advantage to a select group of investors.

MSRB Examples of Selective Disclosures

The MSRB provided three examples of selective disclosure in its market advisory, published as Regulatory Notice 2017-18:

- **Example 1:** Issuer A is a state housing development authority that has issued one series of single-family mortgage revenue bonds. The official statement describes the relationship between the bond maturities and the scheduled mortgage loan repayments. It also describes provisions in the trust indenture that require a mandatory call at par from mortgage loan prepayments that exceed their expected rate. An employee of Issuer A, in a one-on-one conversation with an institutional investor, shares that the level of prepayment of mortgage loans related to the bonds is higher than expected based on initial prepayment models, which allows that investor to gauge the likelihood of its bonds being redeemed.
- **Example 2:** Issuer B is a city that has recently settled a lawsuit, but the details of the settlement have not been made public. The city is aware that the amount owed by the city is to be substantially less than originally expected. In an effort to provide transparency to investors, Issuer B holds a conference call with all current bondholders to provide additional information related to the lawsuit. However, this information is not provided to potential future investors or the market more broadly.
- **Example 3:** A municipal advisor is hosting a general informational meeting for an invited group of buy-side analysts on behalf of Issuer C. During the question-and-answer portion of the meeting, an employee of Issuer C mentions that a large infrastructure project is significantly behind schedule. This information has not been disclosed to the marketplace broadly.

A municipal issuer's disclosure policies and procedures should be written to avoid the type of disclosure gaps identified in the MSRB's examples.

RECORD RETENTION

Regarding record retention, municipal issuers should have a process in place for putting a hold on the destruction of any records that may be relevant to pending or threatened litigation arising from an issuer's market disclosure. Issuers should be aware that charges beyond securities law violations, such as for obstruction of justice, are possible if relevant evidence is not properly handled in the course of an investigation.

TRAINING

A municipal issuer's policies and procedures should detail the training of officials, board members, and staff responsible for the issuer's disclosure. Disclosure policies and procedures are of little value if they are not followed. These trainings may involve a

combination of annual presentations, periodic webinars, and on-demand recordings. This training should be aimed at any individual that bears some responsibility for a municipal issuer's disclosure under federal securities law.

In addition to adopting policies and procedures, municipal issuers should consider the accessibility of their information to investors. Municipal issuers can consider setting up an investor relations page on their own websites. Municipal issuers can also customize their EMMA homepage to provide disclosure contact information and links to the issuer's website, including an investor relations page.

RESPONDING TO POTENTIAL NON-COMPLIANCE

In the wake of the MCDC Initiative, municipal issuers should be careful to comply with their continuing disclosure obligations and to accurately disclose any instances of material non-compliance with a continuing disclosure agreement in the past five years in all offering documents.

If a municipal issuer does not have a solid understanding of its compliance for disclosure purposes, there are third-party data companies that can review an issuer's compliance and provide a detailed report of any compliance failures. These reports can be a launch point to enhanced disclosure policies and procedures and accurate disclosure in offering documents about a municipal issuer's past compliance with its continuing disclosure agreements.

If contacted by the SEC, municipal issuers should engage their counsel to communicate with SEC staff. The SEC has the authority to subpoena documents, and an investigation can begin formally or informally. If the issuers and individuals, such as staff members, are both being investigated by the SEC, they should retain separate counsel for conflict of interest purposes. While the SEC can levy fines against municipal issuers, it has, at least historically, been reluctant to do so, as these fines are often paid by taxpayers.

ABOUT PRACTICAL LAW

Practical Law provides legal know-how that gives lawyers a better starting point. Our expert team of attorney editors creates and maintains thousands of up-to-date, practical resources across all major practice areas. We go beyond primary law and traditional legal research to give you the resources needed to practice more efficiently, improve client service and add more value.

If you are not currently a subscriber, we invite you to take a trial of our online services at legalsolutions.com/practical-law. For more information or to schedule training, call **1-800-733-2889** or e-mail referenceattorneys@tr.com.