
Debt Disclosure Policies, Practices, and (Potential) Pitfalls

February 23, 2018

PANELISTS

- **Sarah Hollenbeck, Managing Director, PFM**
- **Tom Innis, Managing Director, Piper Jaffray**
- **Danielle Kenealey, Chief Deputy City Attorney, City of San José**
- **James A. Wawrzyniak, Jr., Shareholder, Jones Hall**

DISCLAIMERS

- **This presentation has been prepared for general information purposes only. The information presented is not legal advice, is not to be acted on as such, may not be current and is subject to change without notice.**
- **Piper Jaffray is providing the information contained herein for discussion purposes only in anticipation of being engaged to serve as underwriter or placement agent on a future transaction and not as a financial advisor or municipal advisor. In providing the information contained herein, Piper Jaffray is not recommending an action to you and the information provided herein is not intended to be and should not be construed as a “recommendation” or “advice” within the meaning of Section 15B of the Securities Exchange Act of 1934. Piper Jaffray is not acting as an advisor to you and does not owe a fiduciary duty pursuant to Section 15B of the Exchange Act or under any state law to you with respect to the information and material contained in this communication. As an underwriter or placement agent, Piper Jaffray’s primary role is to purchase or arrange for the placement of securities with a view to distribution in an arm’s-length commercial transaction, is acting for its own interests and has financial and other interests that differ from your interests. You should discuss any information and material contained in this communication with any and all internal or external advisors and experts that you deem appropriate before acting on this information or material.**

OVERVIEW

- **Background on municipal bonds and financing participants**
- **Federal securities laws overview and best practices**
- **Other post-issuance compliance requirements**
- **Much more focus on disclosure and importance of meeting requirements to sell bonds in marketplace today**

FINANCING PARTICIPANTS AND THEIR ROLES

- **Issuer staff**
 - ❖ City manager/general manager
 - ❖ Chief financial officer/finance director
 - ❖ General counsel/city attorney
 - ❖ Other specialists, depending on the type of credit
- **Outside consultants**
 - ❖ Disclosure counsel
 - ❖ Bond counsel
 - ❖ Municipal advisor
 - ❖ Underwriter

ISSUER STAFF

- **Coordinator – responsible for assembling team, both internal staff and outside consultants**
- **Other City staff – contributors to disclosure**
 - ❖ **City manager for global view of affairs of the City**
 - ❖ **City attorney for litigation risks**
 - ❖ **Public works for flood, seismic and natural gas pipeline risk factors**
 - ❖ **Fire department for wildlands fire risk factor**
 - ❖ **Director of applicable department for revenue credits, such as sewer, water, airport**

DISCLOSURE COUNSEL

- Assist issuer with preparing the Preliminary Official Statement (POS) and Official Statement (OS), in conformance with Rule 10b-5 and Rule 15c2-12
 - ❖ Due diligence function, eliciting material information
 - ❖ Provide knowledge of federal securities laws and SEC enforcement background when crafting disclosure
 - ❖ Coordinate input and comments from rest of financing team
- Deliver 10b-5 letter at conclusion of transaction

BOND COUNSEL

- **Primary role is providing legal opinion on the validity of the Bonds and tax status**
 - ❖ **Reviews applicable sections of the POS/OS**
 - ❖ **Prepares form of bond opinion and summary of legal documents included in the POS/OS**
 - ❖ **Helps craft disclosure related to validity/tax risks**

UNDERWRITER

- Purchases the bonds from the issuer for resale to investors – has no fiduciary responsibility to the issuer, but has due diligence obligation under federal securities law
 - ❖ Critical to evaluating materiality to investors
 - ❖ Must comply with Rule 15c2-12, including hiring of outside company to review continuing disclosure compliance
 - ❖ Typically employ underwriter's counsel that issues 10b-5 letter
- Role has evolved from primary drafter to reviewer of the disclosure prepared by issuer and disclosure counsel

MUNICIPAL ADVISOR

- Primary role is to advise the issuer on the structure, marketing and sale of bonds, has fiduciary responsibility to issuer, but no due diligence obligation under federal securities laws
 - ❖ Assist issuer with hiring other members of financing team, determining need for dissemination agent or disclosure consultant
 - ❖ Assist issuer with projected financial information and impact of planned future financings
 - ❖ Review other financial information in the POS/OS

FEDERAL SECURITIES LAWS OVERVIEW AND BEST PRACTICES

- Overview of applicable federal securities laws
- Selective disclosure concerns
- Securities and Exchange Commission (SEC) enforcement
- Disclosure policies and procedures

OVERVIEW OF APPLICABLE FEDERAL SECURITIES LAWS

- Securities Act of 1933
 - ❖ In general, the Securities Act requires registration of securities with the SEC – BUT nearly all municipal bonds are exempt
 - ❖ Section 17(a) prohibits fraud in the offer or sale of securities – includes municipal bonds, similar to Section 10 of 1934 Act
- Securities Act of 1934
 - ❖ Section 10 prohibits fraud in the purchase or sale of securities
 - ❖ Section 15 provides rules to regulate broker-dealers (underwriters)

OVERVIEW OF APPLICABLE FEDERAL SECURITIES LAWS

- Pursuant to rulemaking authority, SEC has promulgated:
 - ❖ SEC Rule 10b-5 – prohibiting fraud
 - ❖ SEC Rule 15c2-12 – requiring certain disclosures
- Rule 10b-5 directly governs municipal bond issuers
- Rule 15c-12 indirectly governs municipal bond issuers

RULE 10b-5

- Unlawful for any person engaged with the purchase or sale of a security to:
 - ❖ Make any untrue statement of a material fact, or
 - ❖ 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

DEFINITION OF MATERIALITY

- **"Materiality": A fact is material if there is a substantial likelihood that, under all the circumstances, the fact would have actual significance in the deliberations of the reasonable investor when deciding whether to buy or sell the securities**
 - ❖ **US Supreme Court case (Levinson vs. Basic Inc.)**
 - ❖ **SEC does not provide any further definition, but instead relies on enforcement actions and court decisions**

RULE 15c2-12

- Rule 15c2-12 requires underwriters of publicly offered municipal securities to provide certain initial disclosures and ongoing continuing disclosures
 - ❖ Underwriters must comply with this provision, but indirectly governs issuers given requirement for an issuer undertaking
 - ❖ Ability to influence disclosure in connection with the sale of municipal bonds allows SEC to side-step the limitations under the 1933 Act
- Only applies to “publicly offered” securities, so issues sold on a private placement basis are exempt
- Certain small issuers (less than \$1 million) are also exempt

RULE 15c2-12 – INITIAL DISCLOSURES

- **Governs initial disclosures in Preliminary Official Statement (POS)**
 - ❖ POS must contain information concerning the terms of the securities and financial information or operating data material to evaluating bonds
 - ❖ POS must be reviewed by underwriter before it bids for, offers, purchases, or sells bonds
 - ❖ POS must be "deemed final" by the issuer
- **Also governs Official Statement (OS), which adds final pricing**
 - ❖ OS must be delivered to underwriter within 7 business days after pricing and in time to accompany buyer confirms

RULE 15c2-12 – CONTINUING DISCLOSURE

- Underwriter must ensure issuer agrees, in a written undertaking, to provide:
 - ❖ Annual reports
 - ❖ Listed event notices.
- Annual reports and listed event notices are posted to the Electronic Municipal Market Access (EMMA) website

RULE 15c2-12 – CONTINUING DISCLOSURE (Cont'd)

- **Annual Reports**
 - ❖ **Filed annually, with certain information**
 - ❖ **Audited financial statements (when and if available)**
 - ❖ **Financial information or operating data of the type included in the OS (as specified in the undertaking – usually a list of specific tables)**
 - ❖ **Check your undertaking for your specific obligations**

RULE 15c2-12 – CONTINUING DISCLOSURE (Cont'd)

- **Listed Event Notices**
 - ❖ **Filed within a specified period – current rule specifies within 10 business days, previously said “promptly”**
 - ❖ **Current rule and the undertaking specify 14 events (e.g., rating changes, draw on reserve fund)**
 - ❖ **Certain events require finding by issuer of materiality, others do not**
 - ❖ **Check your undertaking for your specific obligations**

SEC ENFORCEMENT

- Recent increase in SEC enforcement related to continuing disclosure, including the Municipalities Continuing Disclosure Cooperation Initiative ("MCDC")
 - ❖ Settlements with self-reporting underwriters (2015)
 - ❖ Settlements with self-reporting issuers (2016)
 - ❖ Actions against issuers that did not self-report (2017)
- History of SEC anti-fraud cases under Rule 10b-5 against issuers and public officials

SEC ENFORCEMENT EXAMPLES – ORANGE COUNTY

- Board of Supervisors failed to take “steps appropriate under the circumstances” to adequately disclose County's financial situation to potential investors
- “Public official who approves issuance of securities and related disclosure documents may not authorize disclosure that the public official knows to be materially false or misleading”
- “Public official may not authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading”
- Takeaway: Public officials have disclosure obligations

SEC ENFORCEMENT EXAMPLES – SAN DIEGO

- SEC alleged City officials had engaged in securities fraud in 2002 and 2003 for failing to disclose material information
 - ❖ City had large unfunded liabilities for pensions and retiree health care, but did not adequately disclose in official statement, rating agency docs, etc.
 - ❖ Officials falsely certified there were no material misstatements
 - ❖ Did not hire auditors with the skills and resources necessary to adequately audit City's financials in connection with its securities offerings
- Settlement required implementation of disclosure policies and procedures, training of City staff and Council members
- Takeaway: Focus on big picture issues, disclose potential problems that are material, hire qualified consultants

SEC ENFORCEMENT EXAMPLES – WESTLANDS WD

- SEC charged District, General Manager and Assistant General Manager with fraud
 - ❖ To meet required 1.25 debt coverage ratio, District reclassified funds from reserve accounts to record additional revenue – not disclosed
 - ❖ Without the accounting change (General Manager referred to as “Enron Accounting”) ratio would have been 0.11 – not disclosed
- Settlement required the District and both officers to pay fines
- Takeaway: Need to disclose material changes in accounting treatment or re-classifications to investors

SEC ENFORCEMENT EXAMPLES – BEAUMONT

- Beaumont Financing Authority and its Executive Director committed fraud – failures to disclose non-compliance with continuing disclosure agreements (CDAs)
 - ❖ Between 2004 and 2013, the Authority failed to comply with CDAs
 - ❖ In 2012 and 2013 offerings, Authority stated it had only failed to comply in one instance – this was a material misstatement
- Authority required to adopt written policies and procedures for continuing disclosure, and hire independent consultant
- Takeaway: Need to audit continuing disclosure compliance to ensure disclosure accuracy

SEC ENFORCEMENT EXAMPLES – PERSONAL LIABILITY

- Orange County
 - ❖ Elected Treasurer: SEC cease and desist; 1 year jail; \$100,000 fine
 - ❖ Assistant Treasurer: SEC cease and desist; \$10,000 fine
- San Diego
 - ❖ City Manager, Deputy City Manager, Auditor & Comptroller, City Treasurer: fines ranged from \$5,000 to \$25,000

SEC ENFORCEMENT EXAMPLES – PERSONAL LIABILITY

- Westlands Water District
 - ❖ General Manager: SEC cease and desist; \$50,000 fine
 - ❖ Assistant General Manager: SEC cease and desist; \$20,000 fine
- Beaumont Financing Authority
 - ❖ Executive Director/City Manager: \$37,500 fine and barred from participating in any future municipal bond offerings

SELECTIVE DISCLOSURE CONCERNS

- MSRB Market Advisory dated September 23, 2017, warns that issuers must be careful when disclosing material information that reaches only some investors but not all
 - ❖ Initial disclosures: ensure all information used in “roadshows” also appears in the Official Statement
 - ❖ Continuing disclosure: ensure all information provided to existing investors is posted to an investor page on issuer’s website or to EMMA
- Similar guidance has been issued in the past, and there are extensive rules (Regulation FD) governing corporate issuers
- Guidance but no enforcement actions have been brought

SELECTIVE DISCLOSURE EXAMPLE

- Example: Issuer B is a city that has recently settled a lawsuit, but the details of the settlement have not been made public. It is aware that the amount owed by the city will 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, information is not provided to potential future investors or the market more broadly.
- Takeaway: Need to post material information to a location accessible to both current and future investors, such as EMMA

DISCLOSURE POLICIES AND PRACTICES

- In general, establish processes and controls to promote compliance with federal securities laws
 - ❖ Initial disclosures (Rule 10b-5 and Rule 15c2-12)
 - ❖ Continuing disclosure (Rule 15c2-12)
- Adopted by governing body of the local agency or staff
 - ❖ If adopted by governing body, delegate authority to staff to supplement
 - ❖ Need to provide flexibility for future changes in best practices
- Establish a “disclosure coordinator” to have responsibility for compliance and oversee other staff

DISCLOSURE PITFALLS

- Stale information – starting from prior OS, but changing circumstances (e.g., real estate market downturn and rebound)
- Confidential Information – may not be able to issue if cannot disclose (e.g., pending litigation)
- Technical information – can you explain terms to investors?
- Conflicting information – issuer has conflicting documents in public (e.g., financial statements do not align with OS)
- Omitted information – critical review necessary to identify what is missing (e.g., newly emerging risk to an enterprise)

DISCLOSURE POLICIES AND PRACTICES – BEST PRACTICES

- Establish written policies and procedures, in order for staff to:
 - ❖ Ensure a internal controls and systems are in place
 - ❖ Identify “disclosure documents” – information reasonably expected to reach potential investors of new bonds and/or existing marketplace
 - ❖ Identify primary staff contributors and reviews/checks and balances
- Require “big picture” brainstorming sessions
 - ❖ Financial problems and other issues
 - ❖ Scrutinize disclosure documents: could average investor read the disclosure documents and understand the issue?

DISCLOSURE POLICIES AND PRACTICES – BEST PRACTICES

- **Ensure legislative body knows and meets its obligations:**
 - ❖ **Transmit the POS to legislative body with a cover memo highlighting security for bonds, repayment risks**
 - ❖ **Transmittal should be early enough to provide legislative body sufficient time to review and ask questions**
- **Provide practical ongoing training to staff and legislative body**
 - ❖ **Changing laws and results of new enforcement actions**
 - ❖ **Staff and legislative body turnover**

DISCLOSURE POLICIES AND PRACTICES – BEST PRACTICES

- Historically, issuers served as own dissemination agent or employed trustee/fiscal agent
 - ❖ MCDC identified “foot faults” from dissemination agents not fulfilling role or being proactive
 - ❖ Newly evolving role of disclosure consultant – expanded expectations with respect to annual report and listed event notices preparation, and tracking of listed events (e.g., rating changes)
- Given SEC focus on continuing disclosure compliance, consider hiring disclosure consultant to help with continuing disclosure
- Ultimately, continuing disclosure is issuer responsibility!

DRAFT SAN JOSE POLICIES AND PROCEDURES

- Implementation of Council-adopted debt management policy
- Systematize the disclosure process by addressing:
 - ❖ Why have Policies – Promote compliance with securities laws, while maintaining flexibility
 - ❖ Who is Responsible – Identify Disclosure Coordinator, Core Working Group and Disclosure Working Group
 - ❖ What is Covered – Identify Disclosure Documents (e.g. Official Statements, CAFR, Rating Agency Surveillance)
 - ❖ What are the Responsibilities – Disclosure Coordinator, Core/Disclosure Working Groups & Contributors

DRAFT SAN JOSE POLICIES AND PROCEDURES (Cont'd)

- Identify specific requirements related to continuing disclosure
 - ❖ Annual report due dates and content
 - ❖ Listed event notices and timing
- Provide for Periodic Disclosure Training
 - ❖ Outside disclosure counsel presentations
 - ❖ Internal list-serve or email distributions of recent developments

OTHER POST-ISSUANCE COMPLIANCE REQUIREMENTS

- Federal tax law obligations
- CDIAC reporting
 - ❖ Annual Debt Transparency Report (SB 1029)
 - ❖ Mello-Roos and Marks-Roos reporting – See Appendix
- Special tax and bond accountability reporting – See Appendix

FEDERAL TAX LAW OBLIGATIONS

- Record-keeping – Retain records related to Bonds for at least 3 years following maturity or earlier redemption
- Arbitrage rebate – Compute and rebate any arbitrage (yield earned in excess of Bond yield) to federal government once every 5 years
- Change in use – Monitor use of tax-exempt financed facilities by private users and federal agencies to avoid tax violations

ANNUAL DEBT TRANSPARENCY REPORT (SB 1029)

- SB 1029: became effective Jan. 1, 2017; annual reporting requirements commence January 31, 2018 (for reporting period July 1, 2017 – June 30, 2017)
- Gov. Code 8855(k): requires report to CDIAC ("Annual Debt Transparency Report"), including debt authorized and issued (and unissued), debt outstanding, and use of proceeds of debt

CONTACT INFORMATION

Sarah Hollenbeck
PFM Financial Advisors LLC
Email: hollenbecks@pfm.com
Tel: 415-982-5544

Tom Innis
Piper Jaffray & Co.
Email: thomas.p.innis@pjc.com
Tel: 415-616-1635

Danielle Kenealey
City of San José
Email: danielle.kenealey@sanjoseca.gov
Tel: 408-535-1916

James A. Wawrzyniak, Jr.
Jones Hall, A Professional Law Corp.
Email: jwawrzyniak@joneshall.com
Tel: 415-391-5780

APPENDIX

Useful Websites for Municipal Bond Disclosure Guidance

- CDIAC: <http://www.treasurer.ca.gov/cdiac/index.asp>
- GFOA: <http://www.gfoa.org/topic-areas/disclosure>
- MSRB: <http://www.msrb.org/EducationCenter.aspxcd>
- NMFA: <http://www.nfma.org/disclosure-guidelines>
- SEC: <https://www.sec.gov/municipal/municipal-securities-disclosure.html>

- Rule 10b-5: <https://www.law.cornell.edu/cfr/text/17/240.10b-5>
- Rule 15c2-12: <https://www.law.cornell.edu/cfr/text/17/240.15c2-12>

APPENDIX

Rule 15c2-12(b)(5)(C) – 14 Listed Events

- (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 enhancements reflecting financial difficulties;
- (5) Substitution of credit or liquidity providers, or their failure to perform;
- (6) Adverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the security, or other material events affecting the tax status of the security;
- (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 securities, if material;
- (11) Rating changes;
- (12) Bankruptcy, insolvency, receivership or similar event of the obligated person;
- (13) The 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.

APPENDIX

Mello-Roos and Marks-Roos Reporting

- Gov. Code 53359.5: for each CFD bond, by Oct. 30th each year must disclose certain information to CDIAC, including principal amount of CFD bonds, reserve fund balance, assessed values in the CFD
- Gov. Code 6599.1(b): for each JPA bond used to acquire a local obligation by Oct. 30th each year must disclose certain information to CDIAC, including principal amount of bonds, reserve fund balance, administrative expenses, etc.

APPENDIX

Special Tax and Bond Measure Accountability

- Gov. Code 50075.3: for each special tax, chief financial officer must file with governing body annual report stating:
 - ❖ Funds collected and expended
 - ❖ Status of the project to be funded by the special taxes
- Gov. Code 53410: for each voter-approved bond measure, must include accountability provisions, including:
 - ❖ Statement of specific purpose of the bond, and requirement that proceeds will only be used for such purpose
 - ❖ Creation of an account into which bond proceeds are placed
 - ❖ Annual report with same requirement as under 50075.3