To Tell the Truth: How to Prepare Top-Shelf Bond Disclosure

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Introduction: The basics of federal antifraud laws

- Federal antifraud laws (primarily the Securities Exchange Act of 1934) and interpretative rules (particularly Rule 10b-5) prohibit making material misstatements or omissions of material facts if necessary to avoid a misleading statement

- What is material?
  - Any fact a reasonable investor would consider to be important in making an investment decision

  - What the SEC has said:

    "Public entities that issue securities are primarily liable for the content of their disclosure documents and are subject to proscriptions under the federal securities laws against false and misleading information in their disclosure documents." (Orange County 21(a) Report)

  - Since January 2004 (when the City of San Diego filed its voluntary disclosure), we have learned that the municipal securities market has its own problems!!!

What is the SEC going after?

- What are the "problem areas" of the municipal securities market?
  - **The "Silo" Effect**
    - San Diego, New Jersey, Illinois and Kansas
  - **Internally rather than externally focused**
    - New Jersey
  - **Lack of training**
    - New Jersey, South Miami
  - **Political influence**
    - Harrisburg, Allen Park, Miami, Port Authority
  - **Staff turnover**
    - West Clark Community Schools
- When these problems are present, the SEC has learned that it can become tough for good information to get to investors to make informed investment decisions

Case study: City of San Diego

- What happened?
  - City's obligations to pension plan were increasing rapidly (from $51 million in 2002 to $248 million in 2009);
  - City completed five offerings and prepared and filed continuing disclosure information
  - City did not disclose in those materials:
    - Growth of unfunded liability of pension plans
    - Pension obligations and annual contributions were going to increase substantially
    - Huge liability for retiree health benefits
  - At the same time, there was a blue-ribbon committee report and city manager's response that detailed with remarkable precision the rapidly increasing pension contributions the city would have to make

Case study: City of San Diego

- What did the SEC say?
  - The City violated Section 17 of the 1934 Act and Rule 10b-5 because it acted with scienter (knowledge of wrongdoing)
  - City officials were “reckless”
  - SEC required remedial efforts:
    - Independent consultant
    - City formed a Disclosure Group, conducted disclosure training, reformed financial management.
- Why does it matter?
  - Really started the current focus by SEC on municipal securities market
  - Many themes that the SEC is focused on today with municipal issuers were present
  - The City of San Diego became embroiled in many years of investigations, responses, and recrimination
  - All of this cost a lot of money, created huge distractions and ended careers

So what do issuers need to do?

- Make sure they are telling the credit story
- Adopt good disclosure policies and procedures ***and practice them***
- Make sure that any “elephant in the room” is disclosed
- Stay on top of secondary market disclosure (disclosure after – sometimes years after – the bond issuance)

Telling the credit story

- Understand the big-picture condition of an issuer's credit
- Ensuring all information is obtained
- Think about all of the information to make sure that the issuer has a coherent understanding of the credit ***from an investor's perspective***
- Get the right people in a room asking the right questions to make sure that the issuer puts the most complete and accurate picture together
- Make sure key players ***read the document***

Disclosure policies and procedures

- Make sure it is clear who is responsible for what
  - Disclosure coordinator
  - Disclosure committee
- Horizontal expert review
  - Are all the right people within the issuer involved with the disclosure process and reviewing what they should?
- Vertical review
  - Are people with the right positions of authority appropriately involved?
- Disclosure practices committee
  - Are the right people and departments within the issuer getting together to talk about disclosure in the right kinds of ways?
- Documentation
- Training

Disclosing the "elephant in the room"

- Perhaps the most important thing for issuers to keep in mind is: Disclose the Elephant in the Room and disclose it well. . .
- Not doing this has been the best and most efficient way for an issuer to be the subject of an enforcement action by the SEC:
  - *Orange County*: the elephant in the room was the investment strategy of the County's investment pools
  - *San Diego*: the elephant in the room was rapidly increasing obligations to their pension plan
  - *Harrisburg*: the elephant in the room was the city's guaranties of a solid waste facility's debt and that the city simply did not have enough money to pay all of its obligations
  - *Wenatchee*: the elephant in the room is that experts had called into question whether revenue projections for an events center were reasonable

Why don't issuers disclose the elephant in the room?

- Individuals working on the disclosure really do not understand the issues or why investors would want to know that information
- Individuals at the issuer are trying to bury the information from the Public (or their elected officials)
- Individuals are trying to bury their heads in the sand
- Individuals are concerned that the information will "harm" the rating or bond sale, increasing the cost of funds
- Often information is still preliminary, and the issuer wants to wait until it is more certain
- Rather than disclosing problems, an issuer might prefer to fix the problem first, and then disclose

Underwriters are responsible for due diligence

- The SEC says an underwriter is making an implied recommendation to investors
- What does this mean an underwriter is supposed to do?
  - Responsibility to perform a reasonable investigation
  - Responsibility to review the offering document in a professional manner
- In short, in addition to regulating what underwriters say in offerings, the Federal antifraud laws impose an affirmative responsibility on underwriters to perform due diligence
- But issuers should take only minor comfort in the underwriter's due diligence process
  - Due diligence protects the underwriter, not the issuer
  - The issuer has superior knowledge of the facts
  - The official statement and other disclosure is the *issuer's* document and responsibility

The major process failures of municipal issuers?

- Failure to connect the silos
- Not thinking about the credit story from the investor's perspective
- Failure to talk about the elephant in the room and other politically motivated disclosure failures
- Failure to be systematic about the disclosure process

How these failures manifest themselves

Five ways that issuers have failed to satisfy or have misunderstood their obligations under the Federal antifraud laws:

- They think that if they do not "lie," they haven't violated the securities laws
- They focus almost exclusively on what they say and do not place equal emphasis on what they do not say
- They confuse the kind of financial or operating information that political stakeholders (such as taxpayers) care about for the kind of financial or operating information that investors care about
- They confuse what is acceptable dialogue in the political realm for what is acceptable dialogue in their securities disclosures
- They allow policy or political considerations to trump good securities disclosure

So what do we do now?

- Education
  - Congratulations for being here. You passed.
  - CDIAC, GFOA and NABL provide good resource materials
    - E.g., https://www.nfma.org/assets/documents/other.orgs/crafting_disclosure_policies.pdf
- Preparing a policy
  - Putting something in writing may be the next step, but it is only the beginning
    - Policies help only when they support practice
    - Walking the walk is harder than talking the talk
- Create your tribe: the working group
  - No single individual has the complete picture
  - Debt manager should serve as the quarterback
  - Identify the appropriate reviewers and subject experts
- Real diligence
  - Working group meetings early in the process is where the action should be
  - Open, freewheeling, exploratory conversations is where new thoughts might emerge, where dots might become connected that previously were not

Disclosure practice “to do” list

- Ask hard questions
  - Risk: what are your potential stresses and vulnerabilities
  - Ask yourself, “what keeps me up at night about my organization?”
- Make sure your official statement and your CAFR tell the same story
- Be prepared for when bad things happen to good governments
  - What will you wish you had said if stuff were to hit the fan
- Disclosure should not be seen as marketing, but rather as Exhibit 1 in your and your agency's defense
  - Bad things happen to good bureaucrats too
- But good disclosure is balanced and accurate
  - Overstating the negative is dishonest
  - The document should not read like the side effects of a prescription drug
- It takes only one bond issue to make you a habitual repeat discloser thanks to continuing disclosure

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