

***Elected Officials' Role
in Municipal Bond Disclosure***

San José City Council

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Item 3.6

Overview

- Introduction
- Overview of Municipal Bonds and Participants in a Bond Sale
- Overview of Federal Securities Laws
- Disclosure Policies and Procedures
- Conclusion

Presentation Participants

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- Jones Hall, A Professional Law Corporation
 - Steve Melikian – Bond and Disclosure Counsel
 - Juan Galvan – Bond and Disclosure Counsel

Overview of Municipal Bonds

- What are bonds?
 - Debt security, similar to a loan
 - Investors in the municipal market lend money to government agency (issuer)
 - Issuer promises to repay face value (principal) plus interest when the bond matures or becomes due

Overview of Municipal Bonds

- What is a municipal bond?
 - Debt obligation issued by states, cities, counties and other governmental entities
 - Money is used for capital projects, such as libraries, police stations, fire stations, parks, airports, public infrastructure and wastewater systems
 - Generally, interest paid to bond owners on municipal bonds is tax-exempt if issued in compliance with IRS rules and regulations

Key Participants in Municipal Transactions

- **Bond Owners**
- **Issuer staff**
 - City Manager
 - Finance Director
 - City Attorney
 - Other specialists, depending on the type of credit
- **Outside consultants**
 - Bond counsel
 - Disclosure counsel
 - Municipal advisor
 - Underwriter

Bond Owners

- **Bond owner** – owner of the bond
 - Individuals (aka “mom and pops” or retail investors, including very wealthy individuals)
 - Institutions such as banks, insurance companies, mutual funds and corporations
 - Generally entitled to receive regular interest payments and return of principal when bond matures

Issuer Staff

- **City Staff** – contributors to disclosure
 - City Manager for global view of affairs of the City
 - City Attorney for litigation risks
 - Director of Finance
 - Budget Director
 - Most City departments review and contribute to disclosure

Bond Counsel

- **Primary role is providing legal opinion on the validity of the Bonds and tax status**
 - Prepares legal documents
 - Provides legal opinions:
 - Bonds are valid and binding obligations of issuer
 - In case of tax-exempt bonds, bonds are exempt from federal and state income taxes
 - Helps craft disclosure related to validity/tax risks

Disclosure Counsel

- **Advises on Federal securities laws**
- **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

Underwriter or Purchaser

- **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 laws**
 - “Due Diligence Obligation”: a reasonable investigation and care by underwriter that the Official Statement for such securities does not contain any material misstatements or omissions
 - Must comply with Rule 15c2-12, including review of continuing disclosure compliance

Municipal Advisor

- **Primary role is to advise the issuer on the structure, marketing and sale of bonds**
 - Has fiduciary responsibility to the issuer
 - Assists issuer with hiring other members of financing team, determining need for dissemination agent or consultant
 - Assists issuer with projected financial information and impact of planned future financings
 - Reviews POS/OS, but does not have affirmative due diligence obligation under federal securities laws



***What Issuers of Municipal
Securities Should Know about
Federal Securities Laws***

Overview of Applicable Federal Securities Laws

- **Securities Act of 1933**
 - In general, requires registration of securities with Securities and Exchange Commission (SEC)
 - BUT, exempts most municipal securities from registration
 - Section 17(a) prohibits fraud in offering or sale of securities – includes municipal bonds, similar to Section 10 of the 1934 Act
- **Securities Exchange Act of 1934**
 - Section 10(b) prohibits fraud in purchase or sale of securities
 - Section 15 provides rules to regulate 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 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 of the circumstances, the fact would have actual significance in the deliberations of the reasonable investor when deciding whether to buy or sell the securities

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 to provide continuing disclosure
 - Initial disclosure only applies to certain “publicly offered” securities
 - Exemptions, include:
 - Limited offerings (e.g. 35 or fewer purchasers) to accredited investors
 - Certain offerings of municipal securities with a stated maturity of 18 months or less

Rule 15c-12 – Initial Disclosure

- **Preliminary Official Statement (POS)**

- Information concerning the terms of the securities and financial information or operating data material to an evaluation of the securities
- Issuer’s responsibility to assure accuracy and completeness
- Must be “deemed final” by the issuer
 - Does not contain any material misstatement or omission

- **Official Statement (OS)**

- Adds pricing-related information to POS
- Delivered to underwriter within 7 business days after sale

Rule 15c-12 – Continuing Disclosure

- **Underwriter must ensure issuer agrees, in written undertaking, to provide:**
 - Annual reports
 - CAFR
 - Financial information or operating data of the type included in the OS
 - Listed event notices.
 - Failure to file annual report
 - 16 events (see last slide of presentation)
 - Method of Filing
 - Annual reports and listed event notices are posted Electronic Municipal Market Access (EMMA) website

SEC's Perspective on Municipal Market

- Historical Enforcement Priorities
 - Quality of financial disclosure
 - Timeliness of financial disclosure
 - Undisclosed potential tax violations

SEC Enforcement Actions – Orange County

- Board of Supervisors failed to take “steps appropriate under the circumstances” to adequately disclose County's financial situation to potential investors
- Supervisors failed to take “*steps appropriate under the circumstances*” to assure that the County's financial situation was being adequately disclosed 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 Actions – San Diego

- San Diego issued \$260 million in 5 issues in 2002 and 2003
- SEC alleged City officials had engaged in securities fraud for failing to disclose material information
 - City had large unfunded liabilities for pensions and retiree health care, but did not adequately disclose in OS, rating agency documents, 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

Lessons from San Diego

- *“What should the municipal securities markets take away from these actions? I can tell you that the Enforcement Division believes there are five critical lessons that municipalities should learn from our recent actions”*
 - adopt written disclosure policies and procedures
 - provide appropriate training to city officials and employees
 - focus on the big picture issues facing the city
 - disclose the bad with the good
 - hire competent professionals

- Linda Chatman Thomsen, Director, SEC Division of Enforcement (2007)

SEC Enforcement Actions – Personal Liability

Officials of Issuer May Face Penalties

- Orange County
 - **Treasurer:**
 - SEC cease and desist order
 - 6 years in jail
 - \$100,000 fine
 - **Assistant Treasurer:**
 - SEC cease and desist order
 - 3 years in jail
 - \$10,000 fine

SEC Enforcement Actions – Personal Liability

Officials of Issuer May Face Penalties

- San Diego
 - **City Manager, Deputy City Manager, Auditor & Comptroller and City Treasurer**
 - Each consented to entry of judgment and paid civil penalties ranging from \$5,000 to \$25,000

SEC Enforcement Actions – Personal Liability

Since 2010, SEC has stepped up enforcement against municipal issuers and officials

- Civil Fines Imposed on Issuers from \$20,000 to \$1 Million (Miami)
- Civil Fines Against Officials from \$10,000 to \$50,000
- Barring Officials to work on future bonds

Reasons for SEC Enforcement Actions

- Misleading or Overly Optimistic Statements in Official Statements
- False Statements About Issuer's Finances
- Miami Budget Director - Illegal transfer of funds to general fund to bolster the general fund balance
- Stale/Outdated Disclosure

Municipalities Continuing Disclosure Cooperation Initiative

- Announced on March 10, 2014 with goal of encouraging self reporting of disclosure violations by issuers, obligated persons and underwriters
- Participants in MCDC Initiative were offered standardized settlement terms
 - SEC settled with 71 issuers and 72 underwriting firms
- Settlement terms for issuers and obligated persons included:
 - Cease and desist proceeding with no admission or denial of findings
 - Establishing continuing disclosure compliance policies and training
 - No payment of a civil penalty
- Initiative did not cover individuals and they remain exposed to potential SEC enforcement



***Disclosure Best Practices
and
City of San Jose's
Application of Best Practices***

Disclosure Policies & Procedures

- Establish Internal Controls and Systems
- Identify “disclosure documents” - information reasonably expected to reach investors/trading markets
- Require staff brainstorming sessions to discuss “big picture”

Disclosure Policies & Procedures

- Transmit the POS to legislative body early enough to provide legislative body sufficient time to review and ask questions
- Disclose bad news along with good news
- Provide training to City Council and staff

Conclusion

- San José team takes seriously the responsibility of working with City Council to ensure compliance with applicable laws and City's policies and procedures
- Seasoned and experienced finance management team and consultants



Additional Information

Rule 15c2-12 – Listed Events

Always Require Notification	Require Notification If Material
Principal and interest payment delinquencies	Unless described in the left-hand column, adverse tax opinions or other material notices or determinations by the Internal Revenue Service with respect to the tax status of the securities or other material events affecting the tax status of the securities
Unscheduled draws on debt service reserves and credit enhancements reflecting financial difficulties	Modifications to rights of holders of the securities
Substitution of credit or liquidity providers, or their failure to perform	Optional, unscheduled or contingent Bond calls
Issuance by the Internal Revenue Service of proposed or final determination of taxability or of a Notice of Proposed Issue (IRS Form 5701 TEB)	Release, substitution or sale of property securing repayment of the securities
Tender offers	Non-payment related defaults
Defeasances	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
Rating Changes	Appointment of a successor or additional trustee or the change of name of a trustee
Bankruptcy, insolvency, receivership or similar event of the obligated person	Incurrence of a financial obligation or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the District, any of which affect bond holders
Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the issuer, any of which reflect financial difficulties	