Bond Financings: Recent Developments in Securities and Tax Law Enforcement

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Overview

- Public finance continues to become more complex, particularly with respect to the role of securities and tax regulation.
- This presentation is intended to highlight certain recent regulatory updates, with a particular focus on enforcement and related areas.
- Our goals include:
  - Providing certain take-aways about regulatory and enforcement matters in public finance; and
  - Providing issuers with greater awareness of potential issues so that they can work effectively with their solicitors and other advisors in connection with debt financings or regulatory or compliance matters related to debt.

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General Comments

- Most of this presentation assumes the involvement of an operating authority (such as for water, sewer or another enterprise).
- However, much of the discussion would also be relevant for a financing involving a general purpose authority or health/education authority that serves as a conduit issuer.
- In the latter case, however, the conduit borrower (*e.g.*, a university or hospital) would bear most of the responsibility for the financing.
- In the last few years, as a general matter, there have been more significant regulatory developments in public finance related to securities law and disclosure than there have been related to tax law).

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Tax-exempt financing; through two principal means — capital markets or bank financing

- Issuance of debt the interest on which is excludible from the investor's gross income for federal income tax purposes.
- The benefit of tax-exemption for investors enables issuers to access financing at interest rates below taxable rates.
- Mostly accessed through the capital markets while some is obtained through bank financing.
- Bank financing tends to involve a single bank purchaser of the bonds and therefore eliminates the need for an official statement.
- However, for an issuer with already outstanding public bond debt, who undertakes a privately-placed bank financing, the bank financing raises issues about how and when it will be disclosed for the benefit of the holders of the outstanding publicly held bonds.

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Federal Tax Compliance

- Use of Bond Proceeds
- Use of Bond Financed Facilities
- Arbitrage – Investment Yield Restrictions and Rebate Requirements
- Remedial Actions

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Tax Compliance – Use of Bond Financed Facilities

- Limitations on "private use"
  - Generally, no more than 10% of proceeds of a governmental issue
  - No more than 5% for private activity bonds and qualified 501(c)(3) bonds
- Examples
  - Leases to certain persons
  - Sale of bond-financed assets
  - Management contracts and other contracts

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Tax Compliance – Investment Yield Restrictions and Rebate Requirements

Investment Yield Restrictions v. Rebate Requirements

- These are two ways the IRS tries to stop "arbitrage."
- Applicability and interpretation of the rules can be complex.
- These issues will become more important as investment yields rise.

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Post-Issuance Tax Compliance Policies (continued)

- Post-issuance federal tax requirements generally fall into two categories: (1) qualified use of proceeds and financed property; and (2) arbitrage yield restriction and rebate.
- Qualified use requirements require monitoring of the various direct and indirect uses of bond-financed property over the life of the bonds and calculations of the percentage of nonqualified uses.
- Arbitrage requirements also require monitoring over the life of the bonds to determine whether the yield on investments acquired with bond proceeds are properly restricted and whether the issuer must pay a yield reduction payment and/or rebate payment.

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Post-Issuance Tax Compliance Policies (continued)

- IRS has said that issuers (conduit borrowers) should adopt written procedures, applicable to all bond issues, which go beyond reliance on tax certificates included in bond documents provided at closing. Sole reliance on the closing bond documents may result in procedures insufficiently detailed or not incorporated into an issuer's operations.
- The goal of establishing and following written procedures is to identify and resolve noncompliance, on a timely basis, to preserve the preferential status of tax-advantaged bonds.
- Form 8038—check the box?

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Post-Issuance Tax Compliance Policies (continued)

- Written procedures should contain certain key characteristics, including making provision for:
  - due diligence review at regular intervals;
  - identifying the official or employee responsible for review;
  - training of the responsible official/employee;
  - retention of adequate records to substantiate compliance (*e.g.*, records relating to expenditure of proceeds);
  - procedures reasonably expected to timely identify noncompliance; and
  - procedures ensuring that the issuer will take steps to timely correct noncompliance.

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Tax Compliance — Remedial Actions

- Issuer may take remedial actions discussed in Treasury Regulations to cure deliberate action
  - Redemption/defeasance
  - Alternative use of disposition of proceeds
- Voluntary Closing Agreement Program — to be discussed
- Continuing Education

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Securities Enforcement: If the SEC Calls…

- The United States Securities and Exchange Commission (SEC) has increasingly scrutinized municipal securities, especially given the Municipalities Continuing Disclosure Cooperation (MCDC) Initiative, which we will discuss later in this program.
- Your response to an SEC inquiry can have significant financial and reputational consequences for your institution, and potentially, for individual officials.
- The MCDC was a 2014 program designed to have issuers (such as operating authorities), borrowers and underwriters self-report failures to disclose in official statements continuing disclosure reporting obligation failures.
- The SEC has announced settlements with various underwriters and is in the process of pursuing settlements with issuers and borrowers, or may be seeking additional information from them.

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What to Remember if Contacted by the SEC

- Assume that you are under investigation — despite any informality or the lack of an adversarial tone on the SEC's part.
- The SEC will not tell you whether you are a "target" or a "witness."
- Assume that the SEC takes notes and that any conversation is part of the record.
- Your statements are "admissions" that could be used against your entity, and you personally, in civil or criminal proceedings.
- Your communications with counsel generally are subject to the attorney-client privilege.

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What to Remember if Contacted by the SEC (continued)

- If your institution filed an MCDC submission in consultation with counsel, tell the SEC that outside counsel was consulted and have outside counsel contact the SEC to respond.
- In other cases, consider speaking with counsel *before* engaging in any substantive discussions with the SEC.
- The SEC should not draw negative inferences from the fact that you first seek guidance from counsel.
- Counsel can help issuers communicate with the SEC (while avoiding admissions traps or the waiver of the issuer's attorney-client privilege) and negotiate settlements.

Hopefully, your entity will never face an SEC inquiry. If it does, however, proceeding cautiously will provide time to work with counsel to fashion an appropriate response strategy.

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Disclosure — Direct Loans

- **Usually no credit ratings**
  - However, rating agencies are requiring to be informed of plans and provided loan documents.
- **No public disclosure required**
  - Regardless, borrowers should consider publishing loan documentation through the Municipal Securities Rulemaking Board's Electronic Municipal Market Access (EMMA) system.
  - This would be a voluntary secondary market disclosure and not a required continuing disclosure material event filing.
  - For context, interestingly, reporting companies that incur additional debt may be required to publicly disclose it through an 8-K filing.

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Specific Points for Bank Loan Disclosure

- The MSRB set out the following points in its guidance to market participants for consideration for bank loan disclosure (See MSRB Regulatory Notice 2015-03, January 29, 2015 Publication Date):
  - Details of the purposes and use of proceeds of the bank loan;
  - Amount of the debt and impact on debt position (*e.g.*, how it might affect debt service coverage ratios or debt capacity);
  - Source of repayment (this can be explained in relation to existing debt);
  - Payment dates;
  - Interest rate information (particular rate if fixed rate; method of computation/related index, etc., if variable);
  - Maturity and amortization of the bank loan;
  - Covenants;
  - Terms of the additional debt (particularly that may impact liquidity or require future market access in order to refinance) such as optional, mandatory and extraordinary prepayment (or tender or purchase provisions such as where the bank lender could put the debt back to the issuer);
  - Evidence of compliance with additional debt tests, if applicable;
  - Events of defaults and remedies (particularly the number of days related to ability to cure defaults before remedies can be exercised);
  - Acceleration events (*e.g.*, a ratings downgrade), with a focus on impact on liquidity;
  - Disclosure of "most favored nation" or similar clauses that extend covenants to bank lenders; and
  - Redistribution and put rights, if applicable.

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Bank Loan Disclosure

Two major points should be considered with bank loans:

- Depending on how they are structured, they may be treated as municipal securities.
- In any case, the incurrence of a bank loan for an issuer with outstanding publicly held bonds (or who may issue future publicly held bonds) may raise concerns for rating agencies and investors related to how the bank loan may impact liquidity and credit quality for the publicly held securities.

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Tax Issue Resolution: VCAP

- One way that certain types of tax problems associated with tax-exempt bonds, tax credit bonds and direct pay bonds (collectively, “tax-advantaged bonds”) can be resolved is through a process initiated by an issuer with the IRS through the voluntary closing agreement program (“TEB VCAP”).
- Through TEB VCAP, issuers of tax-advantaged bonds may voluntarily approach the office of Tax Exempt Bonds ("TEB") to resolve most violations of the Internal Revenue Code (the "Code" or "IRC") and applicable Income Tax Regulations (the "Regulations”) on behalf of their bondholders or themselves through closing agreements with the IRS.
- TEB VCAP was updated effective September 30, 2015 as set forth in the IRS’ IRM (Part 7 “Rulings and Agreements”).

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VCAP — Objectives

- The primary objectives of TEB VCAP are to encourage issuers to:
  - exercise due diligence and to ensure that others using the proceeds of tax-advantaged bonds exercise due diligence in complying with the IRC and applicable Regulations, and
  - voluntarily bring forward to the IRS discovered violations, and to provide a vehicle to correct these violations as expeditiously as possible.
- Generally, based on the issuer's voluntary request for VCAP together with its statements of good faith and its adopted procedures to promote future compliance, the issuer can expect more favorable resolution terms than if the violation had been discovered on examination.
- TEB VCAP reflects TEB's continuing policy of resolving violations of federal tax law applicable to tax-advantaged bonds at the transaction level instead of the bondholder level.

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VCAP: Scope (tax-exempt bonds)

- TEB VCAP requests will be accepted when an issuer's submissions indicate that there is a sufficient basis for TEB to conclude that there has been a federal tax law violation.
- TEB VCAP is available only if the issuer works with CPM in good faith to proceed toward resolution of the matter with due diligence throughout the process.
- TEB VCAP is appropriate when there is an advantage to having the violation permanently and conclusively resolved and TEB determines that
  - it is in the best interests of the United States to enter into the agreement; and
  - the United States will sustain no disadvantage through consummation of such an agreement, as specified in Notice 2008-31.
- TEB VCAP generally may be used for violations applicable to tax-exempt bonds under IRC 103 or related provisions of the IRC or applicable Regulations.
- TEB VCAP is not available, however, if the violation can be remediated under other remedial action provisions (*e.g.*, provisions for addressing change in use of bond financed facilities).

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VCAP — Scope (direct-pay bonds)

- TEB VCAP generally may be used for violations applicable to direct-pay bonds under the IRC or applicable Regulations.
- Build America Bonds, as taxable bonds, are not included in the exception from the significant modification rule for defeasance of tax-exempt bonds under applicable Treasury Regulations. **Therefore, defeasance of a Build America Bond may cause a reissuance, and a bond reissued after December 31, 2010 is not a Build America Bond pursuant to the Internal Revenue Code (and therefore, the subsidy reimbursement would become unavailable).**
- Until specific remedial action provisions are provided in the Regulations or other published guidance, an issuer may remediate deliberate actions impacting Build America Bonds by taking remedial actions, **other than defeasance of nonqualified bonds**.
- Line 21 of Form 8038-CP, *Return for Credit Payments to Issuers of Qualified Bonds,* allows issuers of direct-pay bonds to adjust by a net increase or net decrease previous credit payments to correct prior clerical or computational errors.
  - This form is not intended to and does not remediate violations of the IRC or Regulations applicable to direct-pay bonds.

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VCAP — Other issues for scope and eligibility

- TEB VCAP is not available unless the issuer has taken steps, including adopting and implementing procedures, to prevent future violations of the same type as in the TEB VCAP request for its tax-advantaged bonds.
- TEB VCAP is not an appropriate forum to conclusively resolve matters of law relating to future events or actions that may impact the tax-advantaged status of bonds. Issuers seeking guidance on the tax implications of future events or actions may request a private letter ruling in appropriate circumstances.
- TEB VCAP is not available if the bond issue is under examination.
- TEB VCAP is not available when the tax-advantaged status of the tax-advantaged bonds is an issue in any court proceeding or is being considered by the IRS Office of Appeals.
- TEB VCAP is not available if the violation was due to willful neglect.
- TEB VCAP is not available if the transaction giving rise to the violation occurred, but the issuer has not yet filed a Form 8038 Series information return in connection with the bond issue for which TEB VCAP is sought.

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VCAP — Effect of Closing Agreement

- Under IRC 7121 and corresponding Regulations, closing agreements executed under TEB VCAP are final and conclusive.
- In the absence of fraud, malfeasance, or misrepresentation of material fact, closing agreements may not be reopened as to matters agreed upon or be modified by an officer, employee or agent of the United States.

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Relationship between VCAP and Audits

- Absent extraordinary circumstances, a bond issue will not be selected for examination while it is under review in TEB VCAP.
- Generally, a bond issue will be treated as under review in TEB VCAP on the date a TEB VCAP request satisfying all the requirements has been submitted and received by CPM.
- For example, a TEB VCAP request made by an issuer on an anonymous basis does not satisfy all of the requirements because the names of the issuer and the bond issue, together with other required information, have not been disclosed.
- Any bond issue previously reviewed in TEB VCAP will be subject to general or project classification and may be selected for examination.
- However, the resolution of any specific violation through a closing agreement under TEB VCAP will be final and conclusive.
- Source documents may be reviewed and tested to confirm the accuracy of factual representations in the TEB VCAP request and relating to the closing agreement.

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VCAP: Anonymous Requests and Limitations

- When the IRS's resolution standards do not provide guidance on how a particular violation may be resolved, an issuer may request information on the appropriate resolution methods for a particular violation anonymously.
- The anonymous request option is intended to assist an issuer in evaluating appropriate resolution methods in instances in which its violation is novel or unique or when there is otherwise significant uncertainty regarding the appropriate settlement terms.
- The anonymous request option is not intended to encourage issuers to delay the submission of fully disclosed TEB VCAP requests relating to relatively simple or straightforward violations when the appropriate resolution methods are reasonably clear.
- When deciding whether to respond to an anonymous request, regulators will consider whether the request represents a less than good faith effort on the part of the issuer to resolve the violation as expeditiously as possible.
- The anonymous request shall only pertain to a general matter, question or factual scenario. The IRS will provide a general response in writing and will not participate in further discussion on the matter other than to clarify any vague or ambiguous language in its written response.
- The IRS may decline to respond to any anonymous request that is based upon a detailed factual scenario or when declining the request is in the interest of sound tax administration.
- Because an anonymous request does not satisfy all the requirements for a VCAP submission, the issuer will receive no protection under the TEB VCAP procedures from the IRS beginning an examination of the bond issue. An issue relating to an anonymous request which has been opened for examination prior to identification to the IRS will no longer be eligible for TEB VCAP.

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VCAP: Anonymous Requests (continued)

- TEB's response to an anonymous request is intended only to describe the most likely resolution standard under the general description of facts the issuer submits.
- It does not represent TEB's settlement offer.
- Moreover, if the facts submitted with the disclosed TEB VCAP request reveal more serious or additional violations than those described in the anonymous request, TEB's response to the anonymous request is given no weight in arriving at the final resolution.
- In reviewing the proposed resolution terms, the IRS will consider whether they are consistent with other TEB closing agreements regarding similar violations.
- If the IRS's internal review committee does not have enough information to determine if the proposed resolution will be consistent with other TEB closing agreements, it may recommend that TEB not provide a response to the anonymous request or may seek further development of the issues.

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VCAP: Information Required in Submission Request

- An issuer is required to submit a completed Form 14429, *Tax Exempt Bonds Voluntary Closing Agreement Program Request.*
- An issuer, including any other person or entity joining the issuer, requesting a closing agreement under TEB VCAP must submit a statement under penalties of perjury that includes, among other things, the following information:
  - A description of the violation(s) for which the issuer is requesting resolution under TEB VCAP
  - The issuer's proposed resolution terms for resolving the violation, including with respect to any proposed payment of a closing agreement amount
  - Certain issuer representations including:
    - that policies and/or procedures have been or will be implemented to prevent this type of violation from recurring with this or any other of the issuer's bond issues and a description of those policies and procedures, including as applicable, the title of the person responsible for monitoring compliance, the frequency of compliance check activities, the nature of the compliance check activities undertaken, and the date such procedures were originally adopted and subsequently updated (if applicable)
    - whether the bonds are under review in any court (other than a federal court), administrative agency, commission, or other proceeding (identify the proceeding)
    - the date(s) of the violation, the date and circumstances surrounding the discovery of the violation, and the date and nature of any actions taken in response to the discovery of violation (*e.g.*, redemption, defeasance)

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VCAP: Model Agreement

- TEB has created a VCAP model closing agreement (the "VCAP Model Agreement").
- The VCAP request must include a draft of the VCAP Model Agreement, filled in as appropriate for the TEB VCAP request.
- Generally, TEB will not deviate from the terms specified in the VCAP Model Agreement that are applicable to the TEB VCAP request.
- However, if the issuer believes a deviation is necessary, it should notate the proposed change on the VCAP Model Agreement it submits and state the reason it believes that the deviation is necessary.
- In some instances, the TEB VCAP request may be for a violation for which the IRS has provided a specialized closing agreement.

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VCAP: Case Resolution

- The IRS will review the proposed resolution terms to determine whether they are consistent with other TEB closing agreements for the same type of violation.
- If the closing agreement language has been substantively modified from the standard language, the IRS will review to determine whether the closing agreement is enforceable.
- In reviewing the resolution terms, the IRS will consider whether the comparable agreements came in through the TEB VCAP program, versus through an examination, and other relevant factors that might support different resolution standards.

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VCAP: TEB VCAP Resolution Standards

- The IRS has set out resolution standards under TEB VCAP for specific violations. TEB anticipates continuing to expand the list of resolution standards for specified violations over time.
- If the violation is not described in the IRS's specified standards, or if the issuer requests the IRS to consider unusual factors to arrive at a different resolution, the violation will be resolved through the TEB VCAP general procedures on such terms as are determined appropriate under the facts and circumstances.
- The primary administrative objective of the TEB VCAP resolution standards is to streamline the closing agreement process with respect to the specific violations, resulting in more efficient processing of cases.
- The specified resolution standards are not available when, for example:
  - the TEB VCAP request covers multiple violations,
  - the specific violation identified in the TEB VCAP request is not a violation specifically described in the specified standards,
  - the issuer submits a TEB VCAP request after the latest date specified for resolution under the applicable resolution standard, or
  - an issuer's failure to submit a TEB VCAP request by the latest date specified for the applicable resolution standard does not prevent the violation from being resolved otherwise through the TEB VCAP general procedures on such terms as are determined appropriate under the facts and circumstances.

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VCAP: Unresolved Cases

- In certain situations, it is appropriate to close a TEB VCAP case without a final resolution. For example:
  - an issuer might withdraw the request,
  - an issuer and the government might fail to reach an agreement in a reasonable period of time after the government offers to enter into a closing agreement,
  - an issuer might not timely submit information requested, or
  - an issuer might fail to negotiate in good faith.
- In these or other situations, the IRS specialist may recommend initiating an unresolved closure of the case.
- **When a TEB VCAP case closes without a final resolution, the IRS will consider whether a referral for examination is appropriate based on the facts disclosed by the issuer during the VCAP process.**

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Political Subdivision

- In February 2016, the IRS released proposed rules regarding the definition of “political subdivision” for tax-exempt bond purposes.
- Under existing law, the key determinant of political subdivision status is whether an entity has power to tax, eminent domain powers, or police powers. Beyond possessing a substantial amount of at least one of these “sovereign” powers, there have been no specific rules related to whether an entity must be performing a governmental function or under public control in order to qualify as a political subdivision.

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Political Subdivision (continued)

- The Proposed Regulations contain a three-pronged test to determine whether an entity is a political subdivision.
- First, as under the current rules, a political subdivision must have the ability to exercise a substantial amount of at least one sovereign power.
- Second, the entity must have been formed for and actually serve a governmental purpose, including whether the entity operates in a manner that provides significant public benefit with no more than an incidental benefit to private persons.

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Political Subdivision (continued)

- Finally, the entity must be "governmentally controlled," by which the IRS contemplates ongoing rights or powers to: (1) approve **and** remove a majority of the governing board of the entity, (2) elect a majority of the governing body of the entity, or (3) approve or direct significant uses of funds or assets of the entity.
- Governmental control requires the control to be by either **a general purpose governmental unit or an established electorate**, but not an electorate controlled by a small number of individuals, corporations, or other private entities.

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Issues with the Proposed "Political Subdivision" Regulation

- The Municipality Authorities Act specifies that board member approval lies with the governmental unit, but removal is a process that requires the Court of Common Pleas.
- The controlling entity must have control rights on **an ongoing basis**. The ability of a government to create an entity and to approve the entity's organizational documents and plan of operation is not enough.
- Control must be left to the "discretion" of the controlling entity. That is, the ability to appoint board members or directors, but to remove them only "with cause," might not be enough.

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Issues with the Proposed "Political Subdivision" Regulation (continued)

- Entities that have governing boards appointed by multiple state or local governments also do not appear to meet the control test unless a single general purpose governmental entity has the power to appoint/remove a majority of the governing board.
- The regulations are merely proposed at this point.
- If Treasury promulgates final regulations, they will apply to bonds issued more than 90 days after the effective date of the final regulations. The final regulations will not apply to any current or advance refunding bonds issued after the effective date that are issued to refund bonds issued before the effective date, as long as the refunding bonds do not extend the remaining weighted average maturity of the refunded bonds.

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Municipal Securities

- Not generally regulated directly by the SEC
- Offered to investors by means of an official statement or other offering document
- Official statement generally includes at least three key topics:
  - Description of bonds and source of repayment
  - Description of key factors influencing source of repayment
  - Audited financial statements of the entity providing the source of repayment

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SEC — Increased Activity

- State of Illinois – cease and desist order involving pension disclosure
- City of Harrisburg, Pennsylvania – public statements made outside of the formal disclosure process
- City of South Miami, Florida – allegations of fraud relating to eligibility of bonds for tax-exemption
- West Clark Community Schools, Indiana – failure to disclose non-compliance with continuing disclosure obligations
- City of Miami, Florida and its budget director – alleged misrepresentations relating to the nature of internal fund transfers that were fraudulent
- Largest hospital in Miami-Dade County, Florida – alleging negligent failure to disclose the extent of its deteriorating financial condition; recognizing the hospital's poor financial position, no financial penalties were imposed
- The Greater Wenatchee Regional Events Center Public Facilities District, Washington, and a senior staff member – alleging disclosure failures relating to review of financial projections; the District agreed to develop written disclosure policies and to pay a $20,000 fine (the first financial penalty assessed by the SEC against a municipal issuer in an order)

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SEC Actions — Expanded Enforcement Tools

- Municipal Continuing Disclosure Cooperation Initiative ("MCDC") – offered issuers and underwriters the opportunity to "self-report" what the SEC viewed as certain violations of the Federal antifraud laws; SEC puts the municipal market on notice that its intent is to change disclosure practices
- City of Harvey, Illinois – SEC proactively and successfully petitions a court to halt an offering
- State of Kansas – SEC enters an order against an issuer for pension disclosure
- City of Allen Park, Michigan and 2 of its officials – SEC enters an order for false and misleading statements about the scope and viability of a movie studio project as well as the City's overall financial condition and its ability to service the bond debt. This is the first order in which the SEC pursued not just the issuer but its officials, resulting in a fine for the individuals.
- Procedural Matters – Throughout these actions, in addition to focusing on the content of the substantive disclosure, the SEC has emphasized whether the issuer follows a set of formal disclosure practices and procedures and whether those involved in disclosure activities have been properly trained.

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SEC Enforcement: Harvey, Illinois

- In 2014, the City of Harvey, Illinois entered into a settlement with the SEC.
- The SEC had brought a civil action against the City and other parties earlier that year.
- The case was significant in that, prior to the eventual settlement, the SEC obtained an injunction in court to prevent a municipal bond offering from going forward.
- The background of the case involved allegations that the City had made misrepresentations in several bond issues about using bond proceeds to develop a hotel, but that at least $1.7 million of bond proceeds had been diverted into the City's general operations account to pay the City's operating costs, including payroll.

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SEC Enforcement: Municipal Advisors

- In March 2016, the SEC brought the initial case under the Dodd-Frank provision which creates a fiduciary duty for municipal advisors.
- The SEC found that the municipal advisor firm (Central States Capital Markets), its chief executive officer and two employees breached a duty to a city by not disclosing a conflict of interest (*i.e.*, that they had a financial interest in the underwriting of the bond issues as well as being the financial advisor).
- The SEC asserted that the municipal advisor firm and its employees had deprived the City of the opportunity to seek unbiased financial advice.

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SEC Enforcement: Civil Penalties and Actions Against Issuer Officials

- There have been increased enforcement actions and sanctions sought and imposed against issuers and issuer officials.
- In November of 2013, the SEC assessed a civil monetary penalty for the first time (The Greater Wenatchee Regional Events Center Public Facilities District).
- In April of 2014, the SEC alleged that town officials in Ramapo, New York resorted to fraud to hide strain in the town's finances related to the $60 million cost to build a baseball stadium and declining sales and property tax revenues.
- The Ramapo action is significant in at least three respects:
  - four town officials were charged with aiding and abetting violations by the town and a related local development corporation ("LDC"),
  - two town officials were charged with liability under Section 20(a) of the Securities Exchange Act of 1934 as "controlling persons" for the alleged violations by the town and the LDC, and
  - the U.S. Attorney's Office (SD NY) announced criminal charges against two officials in a parallel action.

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SEC Enforcement: Water Authority Case

- In March of 2016, the SEC brought cease and desist proceedings against the Westlands Water District (an agricultural water district in California) and its General Manager and Assistant General Manager.
- The SEC brought the actions on a negligence (not intent) basis using a "knew or should have known" standard.
- The SEC alleged that a 2012 official statement for the District was misleading in its treatment of a debt service coverage ratio.
- The SEC specifically alleged that the District's fiscal year 2010 revenues and coverage ratio were misleading because:
  - the District failed to disclose that it had engaged in extraordinary accounting transactions in 2010 solely to recognize additional revenues for purposes of calculating the debt service coverage ratio without raising customer rates; and
  - the District failed to disclose the impact of a 2012 prior period adjustment to account for expenses that would have decreased revenues in 2010.

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SEC Enforcement: Water Authority Case (continued)

- Sanctions included:
  - Civil monetary penalties (including $50,000 and $20,000 assessed against the respective officials)
  - Cease and desist order
- The SEC indicated that in accepting the settlement, it considered the respondent's cooperation and prompt remedial action, including the development of written financial disclosure policies and staff training related to the District's debt offerings.

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SEC Enforcement: MCDC Update — Background

- For public bond offerings, the issuer agrees to provide certain annual information and notices of certain specified events.
- Annual enforcement information and notices are submitted electronically through the Municipal Securities Rulemaking Board's Electronic Municipal Market Access system (referred to as "EMMA").
- Annual information consists of audited financial statements and financial and operating data regarding the issuer included in the official statement.
- SEC Rule 15c-2-12 specifies events for which notice is to be provided.
- A bond offering document is to specify any failures by the issuer in the last five years to comply with any previous continuing disclosure undertaking.
- Banks or investors (in certain bond financings) may require quarterly financial and operating information.
- Continuing disclosure is subject to anti-fraud provisions (SEC Harrisburg action).

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SEC Enforcement: MCDC Update

- In 2014 the SEC initiated, on a limited-time basis, a voluntary self-reporting regime for issuers and underwriters to self-report misstatements and omission in official statements about an issuer's continuing disclosure history.
- One of the articulated purposes of the municipalities continuing disclosure cooperation initiative (MCDC) is to provide favorable settlement terms for those who self-report.
- The SEC received various reports by underwriters and issuers through the applicable 2014 deadlines and has entered into settlement agreements with various underwriters.
- We understand that the SEC is now working on settlement agreements with various municipal bond issuers.
- As stated in the MCDC framework set out by the SEC, we understand that issuer settlements will not entail civil monetary penalties but will largely consist of issuers undertaking certain disclosures about their participation in MCDC as well as instituting compliance policies and procedures and undertaking training of their officers and employees.

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SEC Enforcement: MCDC Update (continued)

- As of mid-August 2016, we are not aware of publicized issuer settlements.
- Various underwriter settlements and SEC statements have fallen short of delineating any bright lines about what is material regarding misstatements about continuing disclosure history.
- However, a number of SEC settlements pointed out failures to provide notices with the continuing disclosure repositories (*i.e.*, currently EMMA) of notice failures required by continuing disclosure undertakings as material.
- The SEC underwriter settlements did not focus on missed rating notices (due to changes in credit enhancements, such as the widespread bond insurer downgrades in connection with the financial crisis of 2008).
- We expect based on statements to the industry that the SEC will not necessarily seek a settlement with every issuer that self-reported (presumably because the reported failures were not material or because settlement was not justified for other policy reasons).
- We also expect that the SEC fully expects any issuer that self-reported to go through with a standardized settlement, with the implication that not cooperating could lead to a less favorable settlement or outcome in other proceedings.
- We also expect that the SEC would eventually provide some notice to issuers when it decides not to seek a settlement based on a self-report, but it might not do so immediately upon making the decision.
- Also, the SEC may be examining whether it should seek enforcement action against issuers who did not self-report (presumably an issuer who did not self-report but was noted in an underwriter's self-report may be more likely to be scrutinized).

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Securities Law and Disclosure: Disclosure Policies and Procedures

- There has been increasing pressure from regulators and trade groups for issuers to develop policies and procedures related to preparing bond disclosure, both for primary market purposes (*i.e.*, official statements) and secondary market purposes (*i.e.*, continuing disclosure).
- This is not required *per se*, although the SEC has essentially required it in connection with various settlements, including the MCDC program.
- A good paper on the topic has been released by the National Association of Bond Lawyers (NABL).
- Major theme: One size does not fit all.
- The purposes of disclosure policies include the following:
  - Overcome information "silos" within an issuer.
  - Encourage consideration of disclosure preparation from a perspective broader than simply mechanically updating prior information.
  - Develop procedures for institutional continuity to deal with changes in personnel due to transfers, retirements, etc.
  - Develop means to have some review by higher level officials (*e.g.*, at a board level, who may have information or a perspective to which others may not have access).

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Securities Law and Disclosure: Disclosure Policies and Procedures (continued)

- Although somewhat beyond the scope of today's program, it should be noted that disclosure policies can be particularly helpful for issuers that are trying to run investor relations programs to address how to handle investor presentations/calls between bond transactions and address issues about selective disclosure.

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Summary: 10 Specific Take-Aways

1) The proposed income tax regulations regarding the definition of "political subdivision" have raised broad criticism within trade groups. A likely outcome might be revisions or other changes to more narrowly address concerns about private control of development districts.

2) The IRS in 2015 updated the VCAP Program (*i.e.*, the voluntary closing agreement program). This might be useful in many, but not all, circumstances. It remains to be seen how the general move to greater uniformity in settlements will impact their timeliness.

3) The SEC's MCDC program has not provided many bright lines with respect to materiality.

4) Generally, there has not been as much focus on event disclosures and little concern about failures to report third-party credit enhancer rating changes.

5) MCDC settlements have suggested a focus on whether issuers provide failure to file notices when annual information filings per continuing disclosure undertakings are late.

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Summary: 10 Specific Take-Aways (continued)

6) In recent years, the SEC has ventured into new enforcement territory, seeking civil monetary penalties and injunctions against issuers.

7) The SEC is pursuing issuer officials in certain instances, including under control person theories. Limited immunity theories are likely unavailable.

8) There is increased emphasis on disclosure (including voluntary secondary market disclosure) regarding an issuer's bank loans.

9) There is an ever-increasing focus on post-issuance compliance policies (from both a tax and securities perspective). These policies are not strictly required by some who think that they might help to reduce audit risk and put issuers in a better position in enforcement proceedings — particularly where procedures help an issuer identify and initiate remediating instances of non-compliance.

10) There is repeated emphasis that although professional advisors are important, a disclosure document belongs to the issuer, rather than to the underwriter or others.

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Concluding Comments

- The public finance area will remain subject to various changes due to both market and regulatory forces.
- Please feel free to contact us for a copy of these slides or should you have any questions.
- Thank you for attending today.

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