



Muni Minute – An Update on Recent SEC and IRS Activity and other Debt Hot Topics

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Overview of Session

- Securities Law Update
 - Brief Background
 - Municipal Bond Market, Disclosure and Antifraud Requirements
 - Continued focus on the Municipal Bond Market
 - Recent SEC Enforcement Actions
 - Lessons Learned
 - What's next?
- Recent IRS Activity
 - Regulatory Update
 - Management Contract guidelines and Issue Price regulations
 - Treasury Update
 - Reorganization of Tax-Exempt Bond Branch
 - Updated Audit Process
 - What's next?

SEC Activity: Why are we talking about this?

- Governments and their securities generally are exempt from registration and reporting requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934
- The SEC cannot regulate governments, however ...
 - Rule 10b-5 or 17(a) violations = fraud
 - Rule 15c2-12 = regulates municipal offering documents indirectly by regulating the actions of the underwriters

Municipal Bonds; Antifraud Laws

Rule 10b-5

It shall be unlawful for any person...to make

- any untrue statement of a material fact or
- to 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,
- in connection with the purchase or sale of any security.

Recklessness is sufficient to establish scienter (a mental state embracing *intent* to deceive, manipulate or defraud) under Rule 10b-5

- Recklessness is highly unreasonable conduct that is an extreme departure from the standards of ordinary care
 - Danger need not be known; must at least be so obvious that any reasonable person would have known of it

Municipal Bonds; Antifraud Laws

Section 17(a) of the Securities Act

- It shall be unlawful for any person in the offer or sale of any securities ... directly or indirectly:
 - (1) to employ any device, scheme, or artifice to defraud, or
 - (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
 - (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.
- Based on SEC settlements: negligence is sufficient to establish a violation of Section 17(a)
 - no finding of scienter (intent) is required
 - “knew or should have known” standard for establishing negligence
 - Failure by an actor to conform conduct to the standard of a reasonable person under like circumstances
 - *SEC staff: did you adhere to industry standards?*

Materially Accurate and Complete

- ▶ Case law defines materiality:
 - there is a substantial likelihood
 - that a reasonable bond investor
 - would consider it important in making an investment decision
- ▶ There must be a substantial likelihood that a fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

“Speaking to the Market”

- ▶ Consider timing of remarks
- ▶ Initial Disclosure
 - Preliminary Official Statement
 - Final Official Statement
 - ▶ Often drafted by underwriter or other party – remains the issuer’s responsibility
 - Various sources provide information, including issuer staff
- ▶ Ongoing Disclosure
 - Rule 15c2-12
 - Annual information and notice of the occurrence of certain listed events
 - Contractually obligated to provide continuing disclosure
- ▶ Voluntary Disclosure

“In fact, whenever a municipal issuer releases information to the public that is reasonably expected to reach investors and the trading markets, such disclosure is subject to the antifraud provisions.” 2012 Report

SEC Continues to Focus on Municipal Market

- ▶ 2012 Report on the Municipal Securities Market
 - <https://www.sec.gov/news/studies/2012/munireport073112.pdf>
- ▶ SEC will initiate an enforcement investigation when it has reason to suspect that the federal securities laws have been violated
 - Looking for disclosure-based violations
 - Investigation typically involves scrutiny of all persons involved in the conduct in question
 - issuer, its officers and key employees (whether or not still employed), the underwriters, the municipal advisor, legal counsel
- ▶ SEC Enforcement Division's Public Finance Abuse Unit:
 - First-of-their-kind enforcement actions
 - "I think it's fair to say this is a place we're here to stay."
 - "From my perspective, the most effective deterrent is individual liability" - Andrew Ceresney, SEC Dir. Enforcement, November 2014

SEC Enforcement = a Number of “Firsts” in the Municipal Securities Industry

- Stopping bond issues from proceeding
 - *Harvey, Illinois – SEC obtained an emergency court order to stop bond issue from proceeding where it asserted the city and its staff had been involved in a scheme to divert bond proceeds to improper uses.*
- Barring individuals and issuers from participating in future bond issuances
 - *UNO Charter Schools – former president of UNO Charter School Network paid a fine and prohibited from participating in any future bond issuing for failing to disclose conflicts of interest among the parties and other risks to bond owners.*
- Jury trials
 - *City of Miami – First jury trial to decide federal securities case against municipality or its officers. Unanimous jury verdict found city and former budget director had violated anti-fraud laws.*
- Criminal fraud charges
 - *Ramapo, New York – First criminal securities fraud case brought against city officials for accounting fraud in connection with the sale of municipal bonds.*

SEC Enforcement = a Number of “Firsts” in the Municipal Securities Industry

➤ Seeking financial penalties

- *Against issuers, officials (personal liability), underwriters, developers and others*
 - *City of Miami*
 - *City fined \$1,000,000*
 - *Budget Director fined \$15,000 (reduced from \$450,000)*
 - *Westlands Water District*
 - *District fined \$125,000*
 - *General Manager and former Assistant General Manager paid \$50,000 and \$20,000, respectively*

➤ Finding individuals liable

- *Allen Park, Michigan - The first time the SEC has charged a municipal official under a federal statute that provides for “control person” liability. Mayor was an active champion of the project; in a position to control the actions of the City and the City Administrator with respect to the fraudulent bond issuances. Mayor held liable as a “control person” for the City’s and City Administrator’s violations of the anti-fraud laws – joint and severally liable with and to the same extent as the City and the City Administrator.*

Port of New York and New Jersey

- ▶ January 10, 2017 SEC Settlement
- ▶ Section 17(a) of the Securities Act
- ▶ \$400,000 penalty paid by Port Authority
- ▶ No individuals named
- ▶ Port admitted violation of Section 17(a)
 - ▶ Negligent in not disclosing to bondowners the legal uncertainty of the Port's authority to finance certain roadway projects

Port of New York and New Jersey – Legal Analysis

- Port Authority lawyers initially:
 - No authority to spend funds on approach roads to the Holland Tunnel
 - “there is no clear path to legislative authority to undertake such projects”
- Push to approve; Board of Commissioner meeting scheduled for next week
 - Multiple emails exchanged concerning statutory authority
 - Port attorneys revised memo to characterize the projects as roadways which approach and feed into the Lincoln Tunnel (not the closer Holland Tunnel).
 - The Lincoln Tunnel legislative authority was broader and allowed roadway approaches.
 - Port engineering department directed to complete a supporting traffic study and to conclude that the roadway projects were consistent with the Lincoln Tunnel legislation
- Memo noted risks that analysis:
 - is not without doubt
 - may raise questions in the minds of some
 - veers away from the traditional model used by the Port Authority
 - the looser the statutory construction means the greater the risk of a successful challenge by the bondholders and investors

Port of New York and New Jersey

- ▶ Board approved projects
 - on consent calendar
 - without discussion
 - without disclosure of:
 - the legal risks of the analysis or
 - that the analysis was premised on treating the roadways as an approach to the Lincoln Tunnel
- ▶ Series of bond issues
 - No mention of legal uncertainty regarding projects in disclosure

Port of New York and New Jersey – Remedial Actions

- Port remedial actions:
 - Eliminating consent agenda approach for these decisions
 - Hiring outside bond counsel
 - the Port general counsel had previously delivered the bond opinions
 - Hiring new general counsel
- Port undertakings:
 - Hire independent consultant and implement recommendations
 - Adopt written policies and procedures and periodic trainings relating to bond offering disclosures
 - Adopt a policy requiring that the Port Authority's Law Department:
 - certify in writing to the Port Authority's Board of Commissioners that any proposed expenditure presented to the Board for approval is legally authorized and
 - provide the Board with a legal opinion that any \$50m+ expenditure is legally authorized

Post MCDC Enforcement

- ▶ Municipalities Continuing Disclosure Cooperation (“MCDC”) Initiative
 - Industry wide initiative asking issuers and underwriters to self report inaccurate statements in final official statements about prior compliance with continuing disclosure obligations
 - Over from the SEC’s perspective
 - SEC does not expect to recommend any further settlements under the initiative
 - As part of the settlement, each respondent neither admitted nor denied the findings and agreed to cease and desist from future violations and to adopt or enhance written disclosure-related policies and procedures
 - Financial penalties were imposed on underwriters only
 - 72 underwriter settlements (96% of the market); 71 issuer settlements
 - The SEC has now turned its focus to issuers and underwriters who did not self-report, in which case any settlements may include greater penalties than the standardized terms offered under the MCDC initiative

Post MCDC Enforcement

- ▶ April 5, 2017 SEC settlements
- ▶ Multiple bond issues to finance healthcare-related projects for the benefit of developer Christopher Brogdon
- ▶ Official statements incorrectly stated that the Brogdon-related borrowers were in compliance with prior ongoing disclosure undertakings (filings were in fact missing or late)
- ▶ First post-MCDC orders focusing on misstatements regarding compliance with ongoing disclosure undertaking
- ▶ SEC found that the Underwriter (Lawson Financial Corporation), its CEO and its purported underwriter's counsel failed to conduct reasonable due diligence to confirm the borrowers' compliance with prior ongoing disclosure undertakings
 - “Underwriters are critical gatekeepers relied upon by investors to ensure that accurate information is being provided in municipal bond offering documents. Lawson Financial failed to confirm that continuing disclosure obligations were being met by the Brogdon-controlled borrowers, allowing Brogdon’s nursing home investment scheme to continue.” - Andrew Calamari, Director of the SEC’s New York Regional Office.

Sanctions

- ▶ Lawson Financial
 - Cease and desist from future violations of anti-fraud rules and 15c2-12
 - Censured
 - Jointly and severally liable with CEO to pay \$200,000 (disgorgement and interest)
 - Civil penalty of \$200,000
- ▶ Lawson Financial CEO
 - Cease and desist from future violations of anti-fraud rules and 15c2-12
 - Barred from industry for 3 years
 - Jointly and severally liable with Lawson Financial to pay \$200,000 (disgorgement and interest)
 - Civil penalty of \$80,000
- ▶ Investment Banker at Lawson Financial and “Underwriter’s Counsel”
 - Cease and desist from future violations of anti-fraud rules
 - Found to have intentionally committed fraud in violation of 10b-5 by recklessly stating in the official statements that he was underwriter’s counsel when he presumably would have known that he was not licensed to practice law
 - Permanently suspended from appearing/practicing before the SEC as an attorney
 - May be barred from representing clients on SEC matters (more to come...)
 - Fines and penalties of almost \$45,000

SEC Enforcement Actions

- ▶ Common themes
 - SEC focus on content of disclosure from the perspective of reasonable investor
 - Did the issuer/other parties intend to commit fraud or were they negligent?
 - Did they follow industry standards and/or adopted policies?
- ▶ Not necessary to have a bond default or other financial harm
- ▶ Almost all enforcement actions resulted from omitted information
 - Post-issuance, rear view mirror review
 - Hindsight is always 20/20
- ▶ Enforcement as a regulatory tool to change behavior of market participants

Lessons Learned

- ▶ Best practices
 - Adopt written disclosure policies and procedures that require periodic trainings
 - To ensure accurate, complete, timely initial and ongoing disclosure
 - Identify responsible individuals, outline process
 - Raise awareness level among decision makers about:
 - Level of disclosure (and therefore the level of certainty) required in a financing
- ▶ The role of professional advisor
 - To manage securities legal risk, demonstrate reasonable care, manage control person risk
- ▶ Read the documents
- ▶ Be careful with consent agenda; transparency with board can be a factor
- ▶ Hire outside professionals
- ▶ Resolve questions of authority before issuing bonds

What's Next?

- ▶ New administration's impact on the focus of enforcement?
- ▶ Proposed Amendments to Rule 15c2-12
 - Released by the SEC on March 15, 2017
 - Comments due May 15, 2017
 - Add two new listed events:
 15. Incurrence of a “financial obligation” of the obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material.
 16. Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, any of which reflect financial difficulties.
 - Concern – “financial obligation” is defined broadly – debt obligations, leases (drafted to include operating leases), guarantees, etc.

IRS Regulatory Update: Updated Management Contract Safe Harbors

- ▶ **Private Business Use**
 - Tax-exempt bonds issued for governmental entities and 501(c)(3) organizations have limitations on private business use of bond-financed property
 - Contracts for management of the property have the potential to result in private business use
- ▶ **Revenue Procedure 97-13 provided safe harbors for management contracts**
 - Formulaic approach based on the term of the contract and the type of compensation received by the manager
- ▶ **Replaced by Rev. Proc. 2017-13 (which superceded Rev. Proc. 2016-44)**
 - More flexible, less formulaic approach
 - Compensation must be reasonable and not give provider a share of net profits (or net losses)
 - Additional limitations on deferral of compensation, term of contract, risk of loss, control over rates
- ▶ **New Safe Harbors became effective on January 17, 2017**

IRS Regulatory Update: Issue Price Regulations

- ▶ What is “Issue Price”?
 - Generally, the price at which a substantial amount (10%) of the bonds or a maturity of bonds are sold
 - Relevant for the calculation of bond yield, which is needed to assure compliance with arbitrage and rebate requirements
- ▶ Three Rules for determining the Issue Price of Bonds sold to the Public
 - General Rule: Issue price is the first price at which 10% of the bonds are sold to the public
 - Initial Offering Price: Issue price is the price at which the underwriters offered the bonds to the public, but underwriters must agree to “hold the price” for five business days or until 10% of the bonds are sold
 - Competitive Sale: Issue price is the reasonably expected initial offering price to the public (i.e. the price in the winning bid) if certain requirements are met
 - Notice of Sale reasonably designed to reach potential underwriters
 - All bidders have equal opportunity to bid
 - At least three underwriters with industry reputations bid
 - Winning bid is the firm offer with the highest price or lowest true interest cost

IRS Regulatory Update: Issue Price Regulations con't

- ▶ New Issue Price Regulations apply to bonds sold on and after June 7, 2017
- ▶ NABL and SIFMA have prepared form documentation
 - Bond Purchase Agreement and Agreement Among Underwriters
 - Notice of Sale
 - Underwriter's Certificate
- ▶ Potential areas of concern
 - Negotiated sale where 10% of the bonds are not sold by the issue date – will the underwriter be willing to “hold the price”?
 - Competitive sale: form Notice of Sale includes the expectations of the issuer regarding the issue price requirements.
 - Expect that Requirement may not be satisfied: Bidders need to price their bids with the expectations that the hold the offering price rule will apply.
 - Expect that requirement will be satisfied:
 - Bids cancelled unless bidder confirms that it is willing to hold the price
 - Sale cancelled if requirements are not satisfied

IRS Treasury Update

- ▶ **Treasury Tax Exempt and Government Entities (TE/GE) Reorganization**
 - Tax-Exempt Bonds Branch and Indian Tribal Government Branch will be combined
 - Christie Jacobs, director of ITGB, will head the combined departments
 - Internal reorganization includes cutting the Compliance and Program Management division (education, outreach and VCAP) within the Tax-Exempt Bonds Branch and moving some of those individuals into a TE/GE Compliance, Planning and Classification group
 - What does this mean for tax-exempt bonds?
- ▶ **New Audit Process**
 - As of April 1, 2017, there is a new audit examination and Information Document Request (IDR) process for tax-exempt bonds
 - IDR is generally the first step in an examination process; new procedures mean that IRS may contact the issuer prior to sending the IDR. This early discussion may shape the content of the final IDR request and the time given to the issuer to respond.
 - IRS memoranda regarding the new audit process say it is intended to increase efficiency, but some practitioners are concerned that the new process is less favorable to issuers and borrower and may result in more contentious examination proceedings

IRS: What's next?

▶ Tax Reform

- Obviously, if sweeping tax reform legislation passes, that could have wide-ranging implications for the tax-exempt bond market
- Is the muni tax-exemption at risk? We don't know. It has not been cited as a specific item to be cut; however, Trump's summary plan includes closing loopholes and eliminating deductions – which could include the tax-exemption
- Lower individual or corporate tax rates could make the exemption less beneficial to taxpayers, which could mean higher rates for issuers

▶ Regulatory Actions

- One of Trump's early actions was to declare a freeze on new regulations and add a requirement that for every regulation enacted two existing regulations need to be cut
- Uncertainty as to what that means for potential tax-exempt bond regulations
- May only apply to “significant regulatory actions” – generally those that have an annual effect on the economy of \$100 million or more – that are subject to review by the Office of Mgmt and Budget
- Treasury is not delaying implementation of the issue price regulations and hopes to release proposed TEFRA (public hearing and approval) regulations this year

Wrap Up

- ▶ Questions?
- ▶ Comments?
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