MUNICIPAL BOND DISCLOSURE
The Story You Are Required To Tell

Introduction

It is with great pride that municipalities promote their communities. However, when it comes to offering bonds or other municipal securities you are required to disclose all material facts whether the facts are favorable or negative. Stated differently, issuers must provide all information that enables investors to make informed investment decisions.

Historical Overview of Municipal Disclosure Practices

Following congressional hearings into allegations of corporate fraud in the early 1930s, Congress passed the Securities Act of 1933 with the objective of providing investors full disclosure of material facts about securities offered and sold. In 1934, Congress passed the Securities Exchange Act of 1934 that created the Securities and Exchange Commission (SEC) and empowered the SEC with broad authority over most aspects of the securities industry.

Both the Securities Act of 1933 and the Securities and Exchange Act of 1934 (the “Securities Acts”) were enacted with broad exemptions for municipal securities. Municipal securities received special exemptions based on considerations of federal-state comity (a principle to minimize federal interference and disruption of states’ jurisdiction in order to avoid friction). In addition, at the time of enactment, there was a lack of perceived abuses in the municipal securities market as compared with the corporate market. Furthermore, the typical purchasers of municipal securities were institutional investors with financial expertise.

Although municipal securities are exempt from the registration and reporting requirements of the Securities Acts, issuers are subject to liability under the anti-fraud provisions of the Securities Acts (principally Rule 10b-5 of the Securities Exchange Act of 1934). Rule 10b-5 requires the disclosure of all material facts and prohibits the omission of facts necessary to make statements not misleading. The Securities Acts do not detail the extent of liability nor the information an issuer must disclose. Courts, however, have consistently held that an omitted fact is "material" if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision.

In spite of Rule 10b-5, full disclosure was not frequently practiced by municipal issuers. Prior to the 1960s, the majority of tax-exempt issues were general obligation bonds. Due to the full faith and credit pledge, predominance of institutional investors, and consistent terms, municipal bonds were sold without difficulty even when disclosure was limited to a notice of sale.

After the 1960s, dramatic changes began occurring in the municipal bond market. Revenue bonds became more prevalent, new types of bonds were introduced, such as advance refunding, industrial revenue, and housing bonds, and innovative structures such as zero coupon, variable rate and credit enhanced issues were created. Diversity of security types necessitated greater disclosure. A major thrust to change disclosure requirements and practices occurred during the 1970s as a result of bond defaults. Prior to the default by the City of New York in 1975, tax-exempt securities were thought to be "risk free." To address the growing need for disclosure, in 1976, the Municipal Finance Officers Association (now the Government

Finance Officers Association) completed disclosure guidelines.[1] The guidelines were not intended to be legally binding, but rather to encourage improved disclosure and greater standardization of disclosure practices. The guidelines set forth information that the Association believed municipal issuers should disclose to potential investors.

Changes in investor composition after the 1970s also triggered a demand for increased disclosure. While the historical buyers of bonds (i.e. banks, insurance companies and individuals) remained the same, the demand for municipal securities among various buyers changed dramatically. Brought about principally by revisions in the tax code, banks were no longer the primary buyers of tax-exempt bonds. Since the mid-1980s, the public sector, comprised of individuals and trusts, has accounted for more than 50% of the purchases of new issues. In contrast to institutional investors, which are staffed with professional analysts and have resources and access to a variety of informational sources, individual investors are likely to depend upon an official statement as the primary source of information.

Public sentiment for increased disclosure reached new heights in 1983 when the Washington Public Power Supply System defaulted on $2.45 billion of tax-exempt revenue bonds. Congress requested that the SEC investigate whether Federal Securities Laws had been violated. On September 22, 1988, the SEC released to Congress the results of its extensive investigation. At the same time, the SEC published a Release requesting comment on several initiatives that were designed to improve the quality, timing, and dissemination of disclosure in the municipal securities markets. The Release proposed adoption of Rule 15c2-12 under the Securities Act of 1934. While the Rule was adopted in the wake of the Washington Public Power Supply System default, it also was in response to a widely held belief that there were problems in the timeliness of and access to official statements.

On January 1, 1990, Rule 15c2-12 went into effect. Although the SEC is prohibited from imposing disclosure rules on municipal governmental entities, it did so indirectly through the requirements that Rule 15c2-12 placed on broker-dealers.

Summary of Rule 15c2-12 for Primary Offerings

Rule 15c2-12 obligates underwriters participating in primary (new) offerings of municipal securities of $1,000,000 or more to obtain, review, and distribute to investors copies of the issuer's official statement. The official statement preparation and dissemination requirements of the Rule are as follows:

> (1) Prior to bidding on or purchasing an issue, the underwriter is required to "obtain and review" an official statement that is deemed final by the issuer as of its date, except for the omission of certain information that is not known until the time of the sale. The information which may be omitted includes the offering price, interest rates, selling compensation, aggregate principal amount, principal amount per maturity, delivery dates, ratings, other provisions required to be specified in a competitive bid, other terms of the securities depending on such matters, and the name of the underwriter.
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> (2) In a negotiated underwriting, the underwriter must distribute preliminary official statements, if one has been prepared by the issuer, not later than the next business day, to potential customers upon request.

(3) The underwriter must contract with the issuer or its agents to receive a sufficient number of copies of a final official statement to enable compliance with the delivery requirements of the Rule and the rules of the Municipal Securities Rulemaking Board (see MSRB Rule G-32). The issuer must provide copies of the final official statement not later than seven business days after entering into a contract for the sale of securities.

(4) The underwriter must provide a copy of the final official statement, upon request, to any potential customer for designated time periods following an underwriting of a new issue.

The rule does not apply to certain private placements or short-term issues if the securities are in denominations of $100,000 or more and if such securities:

(1) Are sold to no more than thirty-five persons which the underwriter believes: (a) have knowledge and experience in financial and business matters and are capable of evaluating the merits and risks of the prospective investment; and (b) is not purchasing for more than one account or with the view to distribute the securities; or

(2) Have a maturity of nine months or less.

Secondary Market Disclosure

While the quality of disclosure for primary offerings significantly improved with the passage of Rule 15c2-12, there was a continuing concern with the adequacy of disclosure in the secondary market. Contributing to the concerns were highly publicized defaults, growing ownership of municipal securities by individual investors, and the increasing volume and complexity of new issues. In 1993, the SEC's Division of Market Regulation conducted a comprehensive review of many aspects of the municipal securities market, including secondary market disclosure. The findings were set forth in the September, 1993 Staff Report on the Municipal Securities Market. The Staff Report indicated that the growing participation of individual investors, who may not be sophisticated in financial matters, as well as the proliferation of complex derivative municipal securities, underscored the need for improved disclosure practices in both the primary and secondary municipal securities markets.[2]

On November 10, 1994, the Securities and Exchange Commission amended Rule 15c2-12. Under the amended Rule, broker-dealers are barred from buying municipal securities sold on and after July 3, 1995 (January 1, 1996 for bonds of small issuers) unless the issuer has agreed, in writing, to provide ongoing disclosure. Although the SEC cannot regulate municipalities, it once again effectively did so indirectly by the rules imposed on broker-dealers. With certain exceptions, described below, the rule required bond issuers to prepare and disseminate to Nationally Recognized Municipal Securities Information Repositories “Annual Financial Information" and notices of material events. In 2008, the MSRB established an Electronic Municipal Market Access (“EMMA”) system and through amendments to Rule 15c2-12 made EMMA the sole repository for continuing disclosure filings.

Under Rule15c2-12 the issuer's written agreement to provide ongoing disclosure may take the form of a covenant in the trust indenture, bond ordinance or bond resolution or there may be a separate written agreement. Although the agreement may be executed at the time of the bond closing, the underwriter may not enter into a contract for the purchase of the security unless the underwriter has made a reasonable determination that there will be continuing disclosure at the

time the bond purchase agreement is executed. A reasonable determination may be made by including an obligating provision in the bond purchase agreement or, in the case of a competitively bid offering, such assurances could be contained in a notice of sale.

The term Annual Financial Information means financial information or operating data, provided at least annually. In its Release No. 34-34961 the SEC indicated that Annual Financial Information is to "mirror" the type of quantitative financial information and operating data contained in the final official statement. For issuers with less than an aggregate of $10 million in outstanding securities the Annual Financial Information must include, at minimum, financial information and operating data which is customarily prepared by the issuer and is publicly available.

Annual financial information may be presented through any disclosure document or set of disclosure documents. In its Release No. 34-34961,SEC warned that the fact that the amended Rule relies on the official statement to set the standard for ongoing disclosure it should not serve as an incentive for issuers to reduce existing disclosure practices in the preparation of official statements. The SEC stated that it encourages market participants to continue to refer to voluntary guidelines (such as the guidelines prepared by the Government Finance Officers Association) and the SEC's Interpretive Release in preparing official statements. If audited financial statements are prepared, then such audited financial statements must also be submitted to EMMA.

At the time bonds are offered, the issuer must outline the type of Annual Financial Information it will provide annually and the terms of its continuing disclosure agreement. The contract must include and the official statement must describe (i) the type of information to be provided as part of the Annual Financial Information, (ii) the accounting principles used to prepare the financial statements and the timing of such statements, (iii) the date in each year by which the Annual Financial Information will be provided and to whom, and (iv) who will be providing the information - the issuer, an "obligated person" (as defined by the Rule), an indenture trustee or a designated agent. The official statement must also indicate any instances in the previous five years in which there has been a failure to provide the continuing disclosure for which the issuer is contractually bound.

Issuers are also required to file event notices with EMMA in not more than 10 business days after the occurrence of the event.[3] As of December 1, 2010, the events that must be reported are as follows:

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, IRS notices or 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 (which is considered to occur when any of the following occur: appointment of a receiver, fiscal agent or similar officer for an obligated person in a proceeding under the U.S. Bankruptcy Code or in any other proceeding under state or federal law in which a court or governmental authority has assumed jurisdiction over substantially all of the assets or business of the obligated person, or if such jurisdiction has been assumed by leaving the existing governing body and officials or officers in possession but subject to the supervision and orders of a court or governmental authority, or the entry of an order confirming a plan of reorganization, arrangement or liquidation by a court or governmental authority having supervision or jurisdiction over substantially all of the assets or business of the obligated person)

13. Merger, consolidation, or acquisition of the obligated person, if material

14. Appointment of a successor or additional trustee, or the change of name of a trustee, if material

In 1995, SEC attorneys noted that issuers' disclosure obligations under the securities fraud laws go beyond the SEC's list and covers anything that could materially affect their bonds.[4] Issuers will have to determine if a notice of other material events must be filed.

Primary issues that are exempt from rule 15c2-12 are also exempt for purposes of secondary market disclosure. In addition, issues which are outstanding 18 months or shorter are exempt from secondary market disclosure.

2019 Amendments

Over the past few years there has been a growing trend for municipal entities to obtain bank loans for issues that were previously financed with publicly sold obligations. Since 2012, the Municipal Securities Rule Making Board (MSRB) has been advocating for disclosure of loans on EMMA. Ultimately the MSRB convinced the SEC that additional disclosures are needed. The SEC voted to change rule 15c2-12 by imposing additional secondary market disclosures on Underwriters (which effectively requires additional disclosures by issuers).

Two new event notices will be required to be added to any Continuing Disclosure Agreement executed on or after February 27, 2019. These events notices are as follows:

> Issuers must disclose the incurrence of a financial obligation of the issuer or obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the issuer or obligated person, any of which affect security holders, if material.
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> and
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> Issuers must disclose any default, event of acceleration, termination event, modification of terms, or other similar events under the terms of the financial obligation of the issuer or obligated person, any of which reflect financial difficulties.

Failure to Comply With Secondary Market Disclosure

A failure to comply with the undertaking would be a breach of contract. The rule however, does not specify the consequences of an issuer's breach of its undertakings to provide secondary market disclosure.

In the SEC Release No. 34-34961 the SEC stated that:

"The amendments do not prohibit Participating Underwriters from underwriting an Offering of municipal securities if an issuer or obligated person has failed to comply with previous undertakings to provide secondary market disclosure. However, if a failure to comply with such previous undertakings has not been remedied as of the start of the Offering, or if the party has a history of persistent and material breaches, it is doubtful whether a Participating Underwriter could form a reasonable basis for relying on the accuracy of the issuer's or obligated person's ongoing disclosure representations.

The Spirit of the Law

Several organizations including the Government Finance Officers Association and the National Association of Municipal Analysts (See http://www.nfma.org) have long urged municipalities to provide secondary market disclosure and have suggested going beyond the requirements of Rule 15c2-12. Continuing disclosure improves relations with investors and analysts. At the 2001 National Association of State Auditors, Comptrollers and Treasurers annual conference, Stephen J. Wenstein from the Office of Municipal Securities of the Securities and Exchange Commission stated "*The provisions of Rule 15c2-12 set a floor, not a ceiling. Common-sense approaches to disclosure also serve ethical considerations and the issuers' self-interests, in keeping their investors and constituent's alike current and fully informed.*

Secondary Market Disclosure Services

To assist government entities in fulfilling their secondary market disclosure requirements, WM Financial Strategies, offers continuing disclosure services. WM Financial Strategies collects and compiles data and prepares an Annual Financial Information Report that meets the requirements as well as the spirit of Rule15c2-12. When the document is completed, WM Financial Strategies serves as the Dissemination Agent in filing with EMMA, and any other parties named in the continuing disclosure undertaking, the Annual Financial Information Report together with audited financial statements. WM Financial Strategies prepares all documents in word searchable PDF format as now required by the MSRB.

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(1) To reflect changes in the tax exempt market, the Government Finance Officers Association periodically drafted new disclosure guidelines; however, revised disclosure guidelines were last published in 1991.

(2) Exchange Act Release No. 34961. November 10, 1994.

(3) All issues closed prior to December 1, 2010 otherwise subject to continuing disclosure, are exempt from the event notice rules that became effective on December 1, 2010. For issues that closed prior to December 1, 2010, notice is required for the following eleven events, in a timely manner and if material: (i) Principal and interest payment delinquencies; (ii) Non-payment related defaults; (iii) Unscheduled draws on debt service reserves; (iv) Unscheduled draws on credit enhancement; (v) Substitution of credit or liquidity providers, or their failure to perform; (vi) Adverse tax opinions or events affecting the tax-exempt status of the security; (vii) Modifications to rights of security holders; (viii) Bond calls; (ix) Defeasances; (x) Release, substitution, or sale of property securing repayment of the securities; and (xi) Rating changes.

(4) The Bond Buyer, January 31, 1995. Reporting on comments made at the practicing Law Institute's 13th Annual Institute on Municipal Finance by SEC attorneys Paul Maco and Amy M. Starr.

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