



## Presentation to South Pasadena Unified School District

### Disclosure Responsibilities under the Federal Securities Laws

Robert J. Whalen  
Stradling Yocca Carlson & Rauth  
(949) 725-4166  
rwhalen@sycr.com

# Why Is Disclosure Necessary?

- South Pasadena Unified School District issues securities in the public capital markets
- Investors in municipal securities have rights under federal securities laws
- All “material” information must be disclosed

# The Securities Act Of 1933

- 1933 Act has two substantive rules:
  - Registration requirement
  - Antifraud rule
- Municipal securities are exempt from the registration requirement, but are subject to antifraud rule
- Section 17(a)(2) prohibits any person from, directly or indirectly, obtaining money or property by means of any untrue statement of a material fact or by a misleading omission.
- Negligent conduct can trigger liability under Section 17(a)(2)

# Securities Exchange Act Of 1934

## Rule 10b-5

- Also contains antifraud provisions
- 1975 amendments to 1934 Act made it clear that antifraud provisions apply to government issuers

# Rule 10b5

“It shall be unlawful for any person . . .

- a) To employ any device, scheme or artifice to defraud,
- b) 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 . . . .”

# The “Materiality” Standard

- “[w]hether or not there is a substantial likelihood that a reasonable investor or prospective investor would consider the information important in deciding whether or not to invest.”
- Materiality is determined in context of all the facts and circumstances, but usually on a retroactive basis
- Guidance comes primarily from court decisions and SEC enforcement cases
- SEC has declined to provide advance guidance on materiality

# Levels Of Culpability

- Negligence – Failed to meet Prudent Person Test
- Recklessness – Ignored “red flags”
- Intent to defraud – Scienter

# What Should Be Disclosed?

- Unlike corporate securities, there is no “line item” set of rules for what goes into an O.S.
- Starting in 1975, leaders in municipal market created a set of Guidelines for O.S. content
- Other groups have suggested disclosure for particular market segments
- Look at practices in the industry; recent developments (e.g., State of New Jersey, City of San Diego, Orange County, Allen Park)
- In the end, issuer must use its own good judgment



# When Do Disclosure Rules Apply?

- New offerings
- Annual Report under Rule 15c2-12
- Any other circumstance where an Issuer is “speaking to the market”
  - Applies to an official with responsibility for such disclosures
  - At this time, securities law does not impose a requirement to update or correct any statement previously made, if there is no other reason to be making a statement to the market

# South Pasadena Unified School District Disclosure for Primary Offerings

- Official Statement is offering document to investors
  - equivalent to prospectus
- Must contain all material information for the particular bond sale
- Official Statement is South Pasadena Unified School District's document
- Underwriters, financial advisers and lawyers can help develop the Official Statement but South Pasadena Unified School District is ultimately responsible for content

# Annual Reports

- Audited Financial Reports
- Information (i.e. tables) identified in Continuing Disclosure Undertaking
- Additional voluntary information
- Consider Rule 10b5 implications – is there more you should be saying?
- Has anything happened since the date of the audited financial reports that has materially impacted your financial condition?

# SEC MCDC Program

- SEC implementing enforcement program aimed at public agencies which made material misstatements about their continuing disclosure compliance
- Program involves public agencies and underwriters self-reporting prior material misstatements
- Consent agreements with underwriters were issued in 2015; agreements with issuers are expected in 2016

# Investor Communications

- No obligation to do it
- Tension between market (and SEC) desire for transparency, and potential issuer liability
- No corollary to Regulation FD (requiring public companies to disseminate specified information which it provides to any investor)
- Establish a single point of contact
- Consider voluntary dissemination of information provided to specific investors

# Speeches/Presentations

- May be “speaking to the market”
- Depends on subject matter and audience

# Disclosure Process

- Seek input from key officials
- Superintendent and Assistant Superintendent, Administrative Services oversee and coordinate process
- Empower staff at all levels
- Disclosure Counsel/Underwriter's Counsel helps pull information together and produces a draft Preliminary Official Statement ("POS")
- Draft POS reviewed by working group
- "Due diligence" meeting before distribution of POS

# Disclosure Process

- Each department “signs off” for its particular section
  - Certification that information is accurate and complete
  - Certification remains in effect until sale or closing
  - Must notify Superintendent/Assistant Superintendent, Administrative Services if any information arises which affects the certification
- Board Members
  - Review key sections of POS related to South Pasadena Unified School District and its finances
  - Notify Superintendent/Assistant Superintendent, Administrative Services of any changes and questions



# Timing Considerations For Bond Sale

- Progression of an offering
  - POS/sale/final OS/closing
- Supplements are possible
  - Very rare and disruptive after sale
- Be mindful of public actions or releases likely to occur
  - State budget, District budget, interim reports
  - Assessed valuation and delinquency data

# Disclosure Topics for General Obligation Bonds

- Tax base (rates, delinquencies)
- Pension Plans and OPEBs (GASB 68)
- Labor negotiations
- State funding process
- Enrollment trends
- Historical revenues, expenses and coverage
- Multi-year projections
- Capital Improvement Program
- Litigation and investigations
- Impact of State budget on District
- Information on debt – types and amounts

# Disclosure Principles

- Provide main points but do not overwhelm readers with detail
- Highlight important developments “up front”
- Determine appropriate level of importance for any particular event or budgetary item
- Bringing all these factors together into final product is ongoing process of give and take

# Past and Current Hot Topics

- Pace of recovery from recession
- Possible impact of next economic downturn
- Status of fund balances and reserves
- Continuing disclosure compliance (MCDC)
- Pension and OPEB liabilities
- Effect of new GASB standards
- Investment Performance/Composition of Investments

# Disclosure Considerations

- Tomorrow's "hot topic" may be different than today's
- Disclosure must evolve to reflect changing circumstances
- Read the disclosure with "fresh eyes"
- If you think something may be a concern, raise the issue with colleagues and the working group
- There are no "stupid questions"
- Political sensitivity and confidentiality considerations are not exceptions to disclosure

# S.E.C. Enforcement

- Main avenue for attacks on disclosure is SEC enforcement
- SEC has power to bring civil actions or refer to Justice Department for criminal action
- SEC has brought actions against municipal issuers, as well as other participants in the market, such as underwriters, lawyers, advisers, etc.
- SEC actions against issuers have sometimes been more “mild” (negligence only) but for serious cases they have alleged recklessness or scienter

# Consequences of Bad Disclosure

- SEC Investigation – fees for lawyers and consultants
- Adverse publicity
- Reduced market access
- May have to impose new procedures and oversight to settle SEC actions

# What Can Go Wrong?

- Orange County – (**Board approved Official Statement without review.**  
Failed to disclose risk of pool investments.)
  - Board that authorizes securities is responsible for disclosure
  - Reliance on professionals must be reasonable

“A public official who approves the issuance of securities and related disclosure documents may not authorize disclosure that the public official knows to be materially false or misleading; nor may the public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading.

When, for example, a public official has knowledge of facts bringing into question the issuer’s ability to repay the securities, it is reckless for that official to approve disclosure to investors without taking steps appropriate under the circumstances to prevent the dissemination of materially false or misleading information regarding those facts.”



# What Can Go Wrong? (cont)

- San Diego (City voluntarily files secondary market disclosure on pension and retiree healthcare liability and errors in financial statements.)

- City commissions a review of its disclosure practices
- Conclusions from review:

“the City’s procedures, policies and practices for disclosure and financial reporting are inadequate in major respects. Undermining the reliability of its public disclosure have been, among other factors, the (1) the City’s **excessive reliance on outside professionals** to generate its disclosure documents, (2) its **lack of procedures** to verify the accuracy of those documents and (3) the **absence of high-level oversight** to judge the clarity and completeness of information provided to the investment markets.”

# What Can Go Wrong? (cont)

- State of New Jersey (State fails to disclose material information on two pension plans and specifically under funding)
  - Failure left investors unable to evaluate State's financial condition
  - State Treasurer **did not read Official Statement**
  - State Treasurer had **no written policies or procedures** relating to review or update
  - State Treasurer **did not provide training** concerning disclosure obligations

# What Can Go Wrong? (cont)

- In 2007, State hires disclosure counsel and enhanced disclosure process by instituting formal written policies and procedures and an annual mandatory training program

“Treasury had no written policies or procedures relating to the review or update of the bond offering documents. In addition, Treasury did not provide training to its employees concerning the State’s disclosure obligations under the accounting standards or the federal securities laws. Accordingly, the State’s procedures were inadequate for ensuring that material information concerning [the pension plans] or the State’s financing of [the pension plans] was disclosed and accurate in bond offering documents.”

# What Can Go Wrong? (cont)

- West Clark Community Schools District (Indiana) – The SEC charged that the District included **fraudulent misstatement** in a 2007 Official Statement when it stated **that it was in compliance with its disclosure obligations** related to prior bond offerings. However, the district had not submitted any of the required annual reports or notices for a previous 2005 bond offering, and the underwriter did not conduct adequate due diligence with respect to continuing disclosure compliance. (The District entered into consent order to settle the charges.)
- City of Harrisburg (Pennsylvania) – The SEC charged the City with securities fraud based on **material misstatements in budget documents, audited financial reports and public statements.** Generally SEC actions are based on Officials Statements or continuing disclosure filings, however the SEC stated that, since the City failed to make required annual disclosure filings, investors were forced to rely on the public documents and statements. (The City entered into a consent order to settle the charges.)

# What Can Go Wrong? (cont)

- City of Miami (Florida) – The SEC charged the City and its Budget Director with making materially false and **misleading statements and omissions to investors and rating agencies about certain interfund transfers** in bond offerings and in the city’s audited financial reports. SEC Report: “[the Budget Director] orchestrated the transfers from the city’s Capital Improvement Fund to its General Fund in order to mask increasing deficits in the General Fund, which is viewed by investors and bond rating agencies as a key indicator of financial health.” (The City is contesting the charges.)

# What Can Go Wrong? (cont)

- City of South Miami (Florida) – The SEC charged the City with making material misstatements in documents provided to the issuer of bonds to finance a City project, which the issuer relied on in connection with the issuance of the bonds. The **misrepresentations related to the City's compliance with various tax requirements**, and were not specifically contained in the Official Statement for the bonds. (The City entered into a consent order to settle the charges.)

# What Can Go Wrong? (cont)

- City of Victorville (California) – The SEC charged the City with securities fraud in connection with a 2008 bond offering, by utilizing **inflated values relating to property securing the bonds**. The SEC charged that the City and the bond underwriter were aware of the facts the property values were overstated. (The City is contesting the charges.)
- State of Illinois – The SEC charged the State with misleading investors by **omitting** material information relating to the **unfunded liabilities of its pension system**. (The State entered into a consent order to settle the charges.)

# What Can Go Wrong? (cont)

- Greater Wenatchee Regional Events Center Public Facilities District (Washington) — The SEC charged the District with securities fraud in connection with a 2006 bond offering, by **falsely stating** that **revenue projections** had not been independently reviewed when in fact they had been and questions had been raised regarding the viability of the projections and for failing to disclose that financial projections had been revised upward based upon optimistic assurances by civic leaders that the community would support the center. (The District entered into a consent decree and paid a \$20,000 penalty representing the first time that the SEC had assessed a financial penalty against an issuer.)



# What Can Go Wrong? (cont)

- City of Allen Park (Michigan) – The SEC found that City bond offering documents or other public statements **repeated original plans for movie studio project without disclosing the deterioration of the project** nor the substantial impact it would have on ability to service the bond debt.
- The City **used outdated budget information** in offering documents that failed to disclose a known budget deficit of at least \$2 million.

# What Can Go Wrong? (cont)

## Allen Park - Settlement with the City:

- The SEC's cease and desist order against the City found violation of Section 17(a)(2) of the Securities Act and Section 10(b) of the Securities Exchange Act and Rule 10b-5(b). The order suggests City evidenced scienter (intent to deceive, manipulate or defraud), and recites that recklessness can establish scienter under 10b-5.
- The City agreed to cease and desist from future securities law violation. No fines were levied against the City.
- The SEC considered certain remedial measures (including **agreement to adopt written policies and procedures**, to disclose the cease and desist order in any offering in the next two years and to **undertake disclosure training**). The City settled the enforcement action without admitting or denying the SEC's findings.

# What Can Go Wrong? (cont)

## Allen Park - Settlement with the City Administrator:

- The SEC's complaint alleged that the City Administrator violated Section 17(a)(2) of the Securities Act of 1933 ("reckless or negligent") and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5(b) ("at a minimum, recklessness").
- The SEC found that the City Administrator (a) was a primary source of information used in drafting offering documents; (b) received copies of the draft offering documents; (c) provided comments that were incorporated in the final version of the offering documents; and (d) certified the statements contained in the offering documents.
- The City Administrator entered into settlement agreement, which included an order not to violate the federal securities laws in the future and not to participate in an offering of municipal securities in the future, but no payment of a fine.

# What Can Go Wrong? (cont)

## Allen Park - Settlement with the Mayor:

- The SEC complaint alleged that the **Mayor is liable as a control person** under Section 20(a) of the Exchange Act, based on his direct or indirect control of the City Administrator and the City and violated Section 17(a)(2) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5(b).
- Under the City Charter, the Mayor “appoints a City Administrator, subject to the approval of the City Council.”
- The Mayor entered into settlement agreement, which included an order not to violate the federal securities laws in the future, not to participate in an offering of municipal securities and **payment of a \$10,000 fine.**

# What Can Go Wrong? (cont)

- Westlands Water District – The SEC found that the Water District bond official statement contained misleading debt service coverage ratio information due to failure to disclose (1) extraordinary accounting transactions and (2) a later adjustment to prior year expenses.
- Westlands Water District – Settlement:
  - SEC's cease and desist order found violation of Section 17(a)(2) of the Securities Act.
  - District ordered to pay \$125,000.
  - General Manager ordered to pay \$50,000 from personal funds.
  - Assistant General Manager ordered to pay \$20,000 from personal funds.

# MCDC Initiative

- Nationwide initiative encouraging issuers and underwriters to self-report misstatements in offering documents regarding compliance with the issuer's previous continuing disclosure undertakings under Rule 15c2-12
- Self-reporting issuers agreed to enter into consent orders with the SEC if such misstatements were deemed material; non-reporting issuers would be subject to stricter penalties if the SEC later determined that such misstatements were material
- Reporting Underwriters were subject to fines

# Summary

- Schedule periodic training
- Review policies and procedures from time to time
- Make sure that responsible officials are familiar with disclosure
- Review the entire POS
- Seek information and ask questions of the officials, employees and professionals who supplied information to be included in the POS
- Ask follow up questions to determine the reasonableness of any assumptions or estimates that were used in the POS