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**THE SEC'S NEW FOCUS ON MUNICIPAL MARKETS**  
Monday, August 5, 2019 11:15-12:00

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## THE SEC'S NEW FOCUS ON MUNICIPAL MARKETS

Monday, August 5, 2019 11:15-12:00

### I. Who Cares?

#### A. Don't Bond Counsel or the Underwriter Take Care of This?

Not any more (though they might help)! New regulations and a renewed enforcement focus on municipal issuers puts it squarely on you, the County and its elected officials.

#### B. What Could Happen?

Jail time, for one. Fines. Public company bars. Having to fight the SEC or Department of Justice for years. A collateral bar, including potential loss of your law license.

A Concessionaire for a Town golf-course, beach and other facilities needed help arranging financing for capital improvements to those facilities as required under his concession agreement. He asked for the Town to guarantee the loan, but outside counsel advised that a guarantee was prohibited by the State's constitution. Asked to solve the problem, the Town attorney helped another outside law firm craft an ordinance that authorized a termination payment (in the event of default) equal to the amount of the capital-improvement loans.

The SEC charged Oyster Bay and Town officials with fraud for failing to disclose indirect loan guarantees to a political supporter when issuing new bonds. *SEC v. Oyster Bay*, No. 1:17-cv-006809 (USDC E.D. NY Nov. 21, 2017):

<https://www.sec.gov/litigation/complaints/2017/comp-pr2017-213.pdf>

After 18 months of litigation, Oyster Bay settled by consenting to retain an independent consultant for 2 years. (June 7, 2019). <https://www.law360.com/articles/1167205/attachments/0>

The Town official was acquitted of criminal charges, but still faces on-going SEC civil litigation.

### II. Continuing Disclosure under Rule 15c2-12

#### A. Why?

##### 1. Your client is the Issuer or Obligated Person

##### 2. Disclosure Obligations:

No matter who prepares the Official Statement ("OS"), it is the offering and disclosure document by which the Issuer (and any Obligated Person) describes the project, its funding and the Issuer and/or Obligated Persons, including their financial condition.

As a person involved in informing, creating and disseminating the OS (including its statements about the issuer, obligated person, the project and their financial condition), a municipal issuer (or obligated person) can have potential criminal, regulatory, and civil liability for materially false or misleading statements or omissions. *See Lorenzo v. SEC*, 139 S. Ct. 1094, 203 L. Ed. 2d 484, 2019 U.S. LEXIS 2295, Fed. Sec. L. Rep. (CCH) ¶ 100,382, 2019 WL 1369839 (U.S. Mar. 27, 2019)(one helping to disseminate a false or misleading statement can be primarily liable under Rule 10b-5(a) and (c), even if he did not author the statement as a “maker” under Rule 10b-5(b)), *expanding Janus v. First Derivative Traders*, 564 U.S. 135 (2011).

Although civil plaintiffs may not be able to base private federal securities claims on aider-and-abettor liability, prosecutors and regulators can, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). And private litigants may be able to do under State law, anyway.

### **3. Enforcement Actions.**

#### ***Issuance: Under-funded Pensions***

SEC Charged New Jersey (*first against a state*) with securities fraud for failing to disclose underfunded pension obligations when issuing municipal bonds (SEC News Rel. 2010-152, Rel. No. 33-9135, AP File No. 3-14009 (Aug. 18, 2010): <https://www.sec.gov/litigation/admin/2010/33-9135.pdf>

SEC obtained civil penalties in settled action against former San Diego officials (ex city manager, auditor, deputy manager and treasurer) (*first against elected municipal officials*) for non-disclosure of under-funded pension liabilities in municipal bond issuance. *SEC v. Uberuaga, et al.*, No. 08-cv-0621 (USDC S.D. Cal. Filed Apr. 7, 2008)(Lit Rel. No. 20522), settled Oct. 2010, SEC Press Rel. 2010-204: <https://www.sec.gov/litigation/complaints/2008/comp20522.pdf>

SEC charged Illinois with securities fraud for non-disclosure of under-funded pension liabilities in the issuance of municipal bonds. SEC Press Rel. 2013-37, *SEC v. Illinois*, Rel. No. 33-938, AP File No. 3-15237 (Mar. 11, 2013): <https://www.sec.gov/litigation/admin/2013/33-9389.pdf>

SEC charged Kansas for offering misrepresentations regarding underfunded pension liabilities. *In the Matter of The State of Kansas*, Rel. No. 33-9629, AP File No. 3-16009 (Aug. 11, 2014). <https://www.sec.gov/litigation/admin/2014/33-9629.pdf>

#### ***Issuance: When Undue Optimism is Fraud***

SEC charged Victorville, CA and airport authority with fraudulently inflating property values used in bond refinancing of TIF for redevelopment. SEC Press Rel. 2013-75, *SEC v. City of Victorville, et al.*, No. EDCV13-0776 (USDC C.D. Cal. Apr. 29, 2013).

SEC levied **first financial penalty against municipal issuer** for misleading OS that buried independent consultant's **questions about the economic viability of the project** financed. *In the Matter of The Greater Wenatchee Regional Events Center Public Facilities District*, Rel. No. 33-9471, AP File No. 3-15602 (Nov. 5, 2013). <https://www.sec.gov/litigation/admin/2013/33-9471.pdf>

False statements re **project viability**, financial status of movie studio project. *In the Matter of City of Allen Park, MI*, Rel. Nos. 33-9677. 34-73539, AP File No. 3-16259 (Nov. 6, 2014). <https://www.sec.gov/litigation/admin/2014/33-9677.pdf>

SEC settled action against Port Authority of NY and NJ for failing to disclose **known risk that portion of project might be unauthorized**. *See v. Port Authority...*, Rel. No. 33-10278, AP File No. 3-17763 (SEC Jan. 10, 2017): <https://www.sec.gov/litigation/admin/2017/33-10278.pdf>

#### ***Other Issuance:***

SEC charged Miami-area hospital operator with fraud from misstating present and future revenues **due to output error from new billing system**, in non-GAAP-compliant financials. *In the Matter of Public Health Trust of Miami-Dade County, FL*, Rel. No. 33-9450, AP File No. 3-15472 (Sept. 13, 2013). <https://www.sec.gov/litigation/admin/2013/33-9450.pdf>

SEC obtained a TRO to stop further bond issues by Harvey, IL after discovering **diversion of proceeds from prior limited obligation bond issues**. *SEC v. City of Harvey, Illinois*, No. 1:14-cv-04744 (USDC N.D. Ill. June 24, 2014). <https://www.sec.gov/litigation/complaints/2014/comp-pr2014-122.pdf>

### **B. Isn't it Awkward?**

#### **1. The Tower Amendment & Municipal Securities Regulation**

In the wake of the New York City bankruptcy, Congress passed the Securities Acts Amendments of 1975, creating the Municipal Securities Rulemaking Board (“MSRB”) as a self-regulatory body having jurisdiction over the municipal securities industry, subject to SEC oversight (and delegating enforcement authority to FINRA – the Financial Industry Regulatory Authority).

But the Tower Amendment (by Sen. John Tower, R-Tex) prohibited the SEC or MSRB from directly regulating municipal issuers or requiring them to file registration or pre-offering documents. The Tower Amendment springs from federalism concerns under the Constitution's Tenth Amendment reservation to the States of those powers not expressly delegated to the Federal government.

#### **2. Changing Role Expectations**

With “regulation creep” at the SEC (see below on Rule 15c2-12) and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 in response to the 2007-2008 financial crisis, municipal markets have come under greater regulatory scrutiny. Enforcement actions

have increased. And new regulations have forced changes to previously-standard roles and practices among municipal issuers, obligated persons, underwriters, advisers and bond counsel.

### **C. The Disclosure Rule & Its Continuing Disclosure Events**

In the aftermath of the Washington Public Power Supply System default on \$2.25Bn in 1983 (“Whoops” was the largest municipal default in U.S. history to that point – before Detroit, then Puerto Rico), the SEC promulgated Rule 15c2-12 in 1989 and amended since. *See* Rel. No. 34-26985 (June 28, 1989), Rel. No. 33741 (SEC Mar. 9, 1994), Rel. No. 34-34961 (SEC Nov. 10, 1994).

Because the Tower Amendment prevents the SEC from regulating municipal issuers directly, its solution was to require participating underwriters to do it.

#### **1. Rule 15c2-12.**

The Rule prohibits brokers, dealers, and underwriters (municipal securities dealers) from participating in a primary offering (of \$1M or more) unless the underwriter requires the issuer to

- (b)(1) “deem final” the OS
- (b)(3) contract to provide the OS

...that’s how issuers and obligated persons can be on the hook for misleading statements or omissions in the OS...and to

- (b)(5)(i) contract to provide to the MSRB (as it may prescribe)
  - (A) Annual financials
  - (B) Audited financials
  - (C) Continuing updated disclosures with respect to the offered bonds (“Event Notices”):
    1. Payment delinquencies (P&I)
    2. Non-payment related defaults
    3. Unscheduled draws on debt service reserves
    4. Unscheduled draws on credit enhancements
    5. Substitution or failure of credit / liquidity providers
    6. Adverse Tax Opinions / Events
    7. Modifications to holders’ rights
    8. Bond calls; tender offers
    9. Defeasances
    10. Release, substitution or sale of property securing repayment
    11. Ratings changes
    12. Bankruptcy, insolvency or receivership

13. M&A or sale of all issuer assets
14. Appointment of successor trustee

## **2. Continuing Disclosure Enforcement Actions.**

SEC charged Harrisburg, PA with securities fraud for using outdated or incomplete financial information in budget report, annual and mid-year financial statements – the *first time* the SEC has charged a municipality for misleading statements outside offering documents. SEC Press Rel. 2013-82, *SEC v. City of Harrisburg, PA*, Rel. No. 34-69515, AP File No. 3-15316 (May 6, 2013): <https://www.sec.gov/litigation/admin/2013/34-69515.pdf>

SEC charged South Miami with defrauding investors by misrepresenting the tax-exempt eligibility of second-tranche bond issue for a downtown redevelopment project, when it had jeopardized tax exemption by misapplying proceeds from first-tranche issue. *In the Matter of City of South Miami, Florida*, Rel. No. '33-9404, AP File No. 3-15329 (May 22, 2013): <https://www.sec.gov/litigation/admin/2013/33-9404.pdf>

SEC charged Miami and budget director with offering fraud for misleading statements about interfund transfers and misleading annual financial reports. *SEC v. City of Miami, Florida*, No. 1:13-cv-22600 (USDC S.D. Fla. July 19, 2013): <https://www.sec.gov/litigation/complaints/2013/comp-pr2013-130.pdf>

SEC charged Indiana school district and underwriter with fraud for misrepresenting prior continuing-disclosure compliance. *In the Matter of West Clark Community Schools*, Rel. Nos. '33-9435, '34-70057, AP File No. 3-15391 (July 29, 2013): <https://www.sec.gov/litigation/admin/2013/33-9435.pdf>

SEC charged water district and officials with false reporting of adherence to prior debt-coverage ratio covenants during new issue. *SEC v. Westlands Water District*, Rel Nos. 33-10053, 34-3752, AP File No. 17162 (March 9, 2016). <https://www.sec.gov/litigation/admin/2016/33-10053.pdf>

SEC charged town officials of Ramapo, NY with fraudulent financials to hide deteriorating financial condition. *SEC v. Town of Ramapo, NY* (Apr.

2016): <https://www.sec.gov/litigation/complaints/2016/comp-pr2016-68.pdf>

Town officials later agreed to fines, lifetime bars and resignation. *Lit. Rel. No. 18-24861* SEC June 8, 2018); *Lit. Rel. 18-24351* (Nov. 15, 2018)

<https://www.sec.gov/litigation/litreleases/2018/lr24161.htm>

<https://www.sec.gov/litigation/litreleases/2018/lr24351.htm>

Former town supervisor, St. Lawrence, convicted in first muni-bond criminal securities action and sentenced to 2.5 years in prison. *Reuters* (Dec. 13, 2017).

SEC charged Oyster Bay and town official with fraud for failing to disclose indirect loan guarantees to political supporter when issuing new bond. *SEC v. Oyster Bay*, No. 1:17-cv-006809 (USDC E.D. NY Nov. 21, 2017): <https://www.sec.gov/litigation/complaints/2017/comp-pr2017-213.pdf>

Oyster Bay settled by consenting to an independent consultant for 2 years. (June 7, 2019).  
<https://www.law360.com/articles/1167205/attachments/0>  
The town official was acquitted of criminal charges, but faces on-going SEC civil litigation.

**D. The MCDC Initiative.**

The SEC has continued to pit market participants “against each other,” in order to regulate in ways that it might not be able to do directly.

**1. MCDC: “Come in from the Cold.”**

In early 2014, the Commission’s enforcement staff announced the “Municipalities Continuing Disclosure Cooperation Initiative” (“MCDC”). That Initiative offering favorable settlement terms to those issuers who had not complied with their continuing disclosure obligations and the underwriters who had not required them to do so.

And as required by rule, with each new issue, issuers and underwriters had certified compliance with continuing disclosure commitments in all prior bond issuances.

And, of course, the MCDC terms required any issuer or underwriter who was self-reporting (to get those favorable terms) to identify (“give up”) all other issuers or underwriters having participated in unwarranted certifications of prior compliance.

<https://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml>

**2. MCDC: Continuing Disclosure Enforcement Actions.**

SEC charges California school district in first MCDC action. *In the Matter of Kings Canyon Joint Unified School District*, Rel. No. 33-9610, AP File No. 3-15966 (July 8, 2014).  
<https://www.sec.gov/litigation/admin/2014/33-9610.pdf>

SEC settled actions against 71 issuers and obligated persons under MCDC initiative. *SEC Press Release No. 2016-166 (Aug. 24, 2016)*: <https://www.sec.gov/news/pressrelease/2016-166.html>

The SEC charged a total of 72 underwriters – comprising 96% of the market share for municipal underwritings in connection with the program. *SEC Press Rel. No. 2016-18 (Feb. 2, 2016)*.

**E. New Amendments: “Material Financial Obligations”**

The SEC recently amended the Continuing Disclosure Rule again to add two new categories of required continuing disclosure. *See* Rel. No. 34-83885, <https://www.sec.gov/rules/final/2018/34-83885.pdf> (SEC Aug. 15, 2018)(eff. Oct. 30, 2018, compliance date Feb. 27, 2019).



**1. “Financial Obligation” (New Event No. 15)**

**New 15c2-12(b)(5)(i)(C)(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;

**New 15c2-12(b)(5)(i)(C)(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;

**New 15c2-12(f)(11)(i)**

The term *financial obligation* means a:

(A) Debt obligation;

(B) Derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or

(C) Guarantee of paragraph (f)(11)(i)(A) or (B).

(ii) The term *financial obligation* shall not include municipal securities as to which a final official statement has been provided to the Municipal Securities Rulemaking Board consistent with this rule.

**a. Debt Obligation**

*Does cover* what formerly were called “*capital leases*:” “leases that operate as vehicles to borrow money generally would be debt obligations and thus would be defined as financial obligations under the Rule.” *Final Rule Rel. at 44; generally id. at 41-47*. But excludes “operating leases.”

*Clearly covers direct placements.*

*Includes bank loans* if material and affect security holders. *See, e.g., Final Rule Rel. at 37, 130, 148.*

*Does not* encompass “ordinary course” or “operating” liabilities:

The Commission believes that a definition of the term “financial obligation” that distinguishes debt, debt-like, and debt-related obligations from obligations incurred in an issuer’s or obligated person’s normal course of operations appropriately focuses the amendments on the types of obligations that could impact an issuer’s or obligated person’s liquidity, overall creditworthiness, or an existing security holder’s rights.

*Final Rule Rel. at 38.*

*Does not* encompass judgments or arbitration awards (removed from Proposal). *Final Rule Rel. at 55-57.*

**b. Derivative Instrument**

**entered into, or pledged as security or a source of payment for an existing or planned debt obligation,**

Definition “captures any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument to which an issuer or obligated person is a counterparty.” *Final Rule Rel. at 47-52.*

**c. Guarantee for either**

“guarantee of a debt obligation or a derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation.” *Final rule Rel. at 53-55.*

**d. But not municipal securities disclosed in a final filed OS**

**2. Or Agreement to Terms Affecting Holders (New Event No. 15)**

Encompasses any agreement to or modification of new or existing terms that might affect holders of outstanding securities.

**3. Materiality**

The Commission refused to specify a particular test for materiality, but “continues to believe that materiality determinations should be based on whether the information would be important to the total mix of information made available to the reasonable investor” or whether an omission would have “significantly altered” that total mix. *Final Rule Rel. at 23-25, citing TSC Indus. Inc. v. Northway, Inc., 426 U.S. 438, 440 (1976).*

**4. Events “Which Reflect Financial Difficulties” (New Event No. 16)**

**Includes** “notice of default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, provided the occurrence reflects financial difficulties.” *Final Rule Rel. at 59-60.*

**5. Recent Enforcement Actions – hold if any soon**

**III. Municipal Adviser Regulation**

Dodd-Frank (Section 15B) ushered in a new regulatory regime for Municipal Advisors (“MA’s”) – the formerly unregistered “financial advisors” in the municipal securities space.

The Act covers: Anyone who solicits or provides advice to or for a municipality or *obligated person* regarding *municipal financial products* or securities (including structure, timing, terms or similar aspects). The Act expressly includes financial advisors (“FA’s”), guaranteed-investment-contract (“GIC”) brokers, third-party marketers, placement agents, solicitors, finders and swap advisors.

It imposed new registration, professional qualification, compliance, oversight, pay-to-play and antifraud provisions. Most importantly, it holds MA’s to a fiduciary standard to issuers (but only ordinary care to obligated persons). It exempts those otherwise registered and serving in their roles as broker, dealer, underwriter or investment adviser. It also exempts advisors to issuers or obligated persons who already have their own independent registered municipal advisor (an “IRMA”)

**A. Doesn’t Affect Me.**

It will not affect you directly, but because of the Rules, you will see new disclosures, engagement letters and other changes.

**B. Roles.**

There will be more people at the table, with their own MA’s, and less ability for multiple representations due to conflicts and required disclosures.

**C. Disclosures & Agreements**

1. **G-42:**
  - a. Required Disclosures
  - b. Engagement Letter / Contract
  - c. Compensation
  - d. Scope
  - e. Termination
  - f. Require updating with material changes
2. **Preliminary Underwriter Letter of Intent**
3. **IRMA letters**
4. **RFP/RFQ Response Letter**
5. **Model Negative Consent Letter**  
(invested funds not municipal securities proceeds)

**D. Recent Enforcement Actions – HOLD IN CASE**

**IV. Pay-to-Play**

**A. G-37 Regime Extended to MA’s and IA’s.**

**B. Recent Enforcement Actions**

SEC charged former Detroit mayor, treasurer and investment adviser in influence peddling scam re city pension plan investments. SEC Press Rel. 2012-88, *SEC v. Kilpatrick*, No. 12-cv-12109 (USDC E.D. Mich. Filed May 9, 2012): <https://www.sec.gov/litigation/complaints/2012/comp-pr2012-88.pdf>

SEC charged former mayor of Markham, Illinois with fraud in violation of pay-to-play rules by soliciting a bribe from a contractor. *SEC v. Webb*, No. 17-8685 (USDC N.D. Ill. Dec. 1, 2017): <https://www.sec.gov/litigation/complaints/2017/comp23998.pdf>