

Client Alert

Current Issues Relevant to Our Clients

May 16, 2013

A municipal issuer may not be subject to the mandated continuous reporting requirements of the Exchange Act, but when it releases information to the public that is reasonably expected to reach investors and the trading markets, those disclosures are subject to the antifraud provisions. The fact that they are not published for purposes of informing the securities markets does not alter the mandate that they not violate antifraud proscriptions. Those statements are a principal source of significant, current information about the issuer of the security, and thus reasonably can be expected to reach investors and the trading market...

Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others (March 9, 1994).¹

Securities and Exchange Commission Cease-and-Desist Order Against the City of Harrisburg, Pennsylvania

The Commission's recent Cease-and-Desist Order against the City of Harrisburg found that post-issuance financial information made available by the City and public statements made by City officials contained material misstatements and omissions, and violated the antifraud provisions of the federal securities laws. The Order raises a number of continuing disclosure concerns for issuers and obligated persons in municipal bond transactions, including potential antifraud liability for issuers, obligated persons and their officers and employees. In its companion Report of Investigation, the Commission calls upon all issuers to adopt comprehensive policies and procedures to promote timely, accurate and complete disclosures.

Summary of the Order

On May 6, 2013, the Securities and Exchange Commission imposed a Cease-and-Desist Order against the City of Harrisburg, Pennsylvania for violations of the anti-fraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Commission.² The Commission alleged that public statements by City officials and financial information released by the City contained material misstatements and omissions regarding the City's financial position during a multi-year period in which the City also failed to comply with its continuing disclosure undertakings pursuant to Rule 15c2-12. Without admitting or denying the Commission's allegations, the City consented to the imposition of the Order, which enjoined the City from future violations of Section 10(b) of the Exchange Act and Rule 10b-5. The Order applied only to the City itself and did not apply to any City officials. No monetary fines or penalties were imposed by the Commission.

The City's alleged disclosure violations related to bonds issued to finance upgrades and repairs to a solid waste resource recovery facility owned by The Harrisburg Authority, as well as bonds issued by other component units of the City. In addition to its \$43 million of direct

general obligation bonds, the City also entered into general obligation guarantees for approximately \$455 million of bonds issued by The Harrisburg Authority and other component units. As alleged in the Order, by late 2008 the City was aware that it would not have sufficient revenues to meet its debt service obligations for 2009 (\$18 million), 2010 (\$64 million) and beyond.

The Order includes the following findings of the Commission:

- During the period from January 2009 to March 2011, the City failed to make timely filings of its annual financial information and various material event notices as required by its continuing disclosure undertakings for its general obligation bonds and general obligation-guaranteed debt.
- During this period, the City published consolidated annual financial reports (CAFRs) for 2007 and 2008, its operating budget and a mid-year fiscal report for 2009, and the Mayor's 2009 "State of the City" address. These documents, which were publicly available on the City's website, included material misrepresentations and omissions regarding the City's current general obligation bond ratings, the

amount of City guarantee payments made on the resource recovery bonds and the impact of the guarantee payments on the City's financial condition.

- During this period, the City had no policies and procedures to ensure compliance with its continuing disclosure undertakings or to ensure that its public financial information was accurate in all material respects.
- Between December 2008 and December 2009, \$87 million of bonds issued or guaranteed by the City traded in the secondary market "without investors having the benefit of material information regarding Harrisburg's financial condition."

The Commission noted that the City was placed into receivership by the Commonwealth of Pennsylvania in November 2011, and had defaulted on \$13.9 million of debt service payments on its general obligation bonds as of March 2013.

Report of Investigation

Simultaneously with its issuance of the Order, the Commission issued an accompanying Report of Investigation under Section 21(a) of the Exchange Act "to address the obligations of public officials relating to their secondary market disclosures for municipal securities."³ The Report included the following statements of the Commission:

- Investors may be more likely to rely upon statements from public officials where written undertakings pursuant to Rule 15c2-12 have not been fulfilled and required continuing disclosures are not available through the Municipal Securities Rulemaking Board's Electronic Municipal Market Access (EMMA) system.
- Public officials should be mindful that their public statements, whether written or oral, may affect the total mix of information available to investors, and should understand that these public statements, if they are materially misleading or omit material information, can lead to potential liability under the antifraud provisions of the federal securities laws.
- At a minimum, [public officials] should consider adopting policies and procedures that are reasonably designed to result in accurate, timely, and complete public disclosures; identifying those persons involved in the disclosure process; evaluating other public disclosures that the municipal securities issuer has made, including financial information and other statements, prior to public dissemination; and assuring that responsible individuals receive adequate training about their obligations under the federal securities laws.

The Report of Investigation concluded with a statement that the City had subsequently adopted "formal and tailored" written policies and procedures with regard to public statements regarding financial information and its continuing disclosure obligations.

Discussion

The Commission's 1994 Interpretive Guidance on the disclosure obligations of municipal securities issuers (quoted above) was issued concurrently with its proposal to add continuing disclosure requirements to Rule 15c2-12. In support of its proposal to add annual reporting of financial information and material event notice requirements to the Rule, the Commission's statement argued that:

Since access by market participants to current and reliable information is uneven and inefficient, municipal issuers presently face a risk of misleading investors through public statements that may not be intended to be the basis of investment decisions, but nevertheless may reasonably be expected to reach the securities markets.⁴

The Harrisburg Cease-and-Desist Order deals with an issuer that failed to meet its continuing disclosure obligations for an extended period of time during which its financial condition was deteriorating, ultimately leading to the City's insolvency and default on its general obligation bonds and general obligation guarantees. The Commission found that the City's failure to meet its continuing disclosure obligations in a timely manner left the secondary market with "incomplete and outdated information" causing investors "to seek out other public statements the City made regarding its fiscal situation..."⁵

The Commission's recent cease-and-desist orders against the State of New Jersey and the State of Illinois were brought under Section 17(a) of the Securities Act of 1933 for deficient disclosure of those States' pension funding obligations in connection with their primary offerings of bonds.⁶ In contrast, the Harrisburg Order does not address the disclosures regarding the City's finances contained in the official statements for the City's general obligation bonds and the bonds issued to finance the upgrades to the resource recovery facility. The Order focuses solely on financial information provided by the City and statements made by City officers after these bonds were issued, and subjects this information and statements to antifraud scrutiny under Section 10(b) of the Exchange Act and the Commission's Rule 10b-5.

The City was clearly in the most difficult circumstances that can be faced by a local government — its financial position had deteriorated to the point where it had cut staffing and services and its efforts to increase revenues

at the resource recovery facility failed. The search for solutions through the local political process with the Mayor and City Council, as well as with the Commonwealth of Pennsylvania, generated considerable controversy but no solutions. While it is tempting to apply the adage that “hard cases make bad law” to the Order, we believe that there are important lessons for all issuers and obligated persons in municipal bond transactions.

Compliance with Continuing Disclosure Undertakings.

First and foremost, full and timely compliance with continuing disclosure undertakings is essential. In the Commission’s view, the City’s failure to comply with its undertakings during the relevant time period forced investors to look for other available information regarding the City’s finances. Had the City been in compliance with its undertakings, it would seem that the Commission’s antifraud analysis would have focused more on the accuracy and completeness of the information contained in the City’s annual financial information reports and material event notices than on information that was posted to the City’s website or on speeches given by elected officials.⁷ On the other hand, as discussed below, the Commission found disclosure deficiencies in the City’s 2007 and 2008 CAFRs which were documents that the City should have filed under the annual financial information reporting requirements in its continuing disclosure undertakings.

Contents of Continuing Disclosure Filings. The Commission specifically found in the Order that the City’s 2007 and 2008 CAFRs “contained material misrepresentations and omissions with respect to Harrisburg’s credit ratings and the potential impact of the [resource recovery facility] debt on the City’s financial health.” With regard to the City’s 2008 CAFR, the Commission found that the management’s discussion and analysis and the subsequent events footnote were materially misleading because they failed to affirmatively disclose the amounts of guarantee payments on resource recovery facility bonds that the City would be required to make in future years, and the impact those payments would have on the City’s financial position and prospects.

Most issuers of municipal bonds satisfy the annual financial information reporting requirement of their continuing disclosure undertakings by filing their CAFRs on EMMA.⁸ CAFRs are prepared under generally accepted accounting principles (or statutory accounting standards in some States) to meet a governmental entity’s financial reporting obligations under State law and to provide financial information to its constituents. In the Commission’s view, the information regarding a governmental entity’s financial position and prospects contained in a CAFR or other publicly-available financial report is subject to antifraud scrutiny and is required to be complete and accurate in all material respects within the meaning of the federal securities laws.

For municipal securities issuers and obligated persons, the Harrisburg Order indicates that CAFRs, other financial and operating information and material event notices that are filed on EMMA should be understood as “speaking to the market” (i.e., information reasonably expected to reach investors in the bond market). At a minimum, this indicates that a review of all EMMA filings should be made by financial and legal personnel that are conversant with disclosure standards under federal securities law. A particular challenge for the personnel conducting this review will be to confirm that the information in these filings is not only accurate but *complete in all material respects*. This review should be a component of an issuer’s or obligated person’s written policies and procedures regarding securities disclosure.

Written Policies and Procedures; Training. The Commission looked favorably on the City’s remedial adoption of formal written policies and procedures regarding securities disclosure that included compliance with its continuing disclosure undertakings, the designation of the City’s Business Administrator as the official responsible for the filing of financial information and notices on EMMA, and annual training of City personnel involved in disclosure matters regarding the requirements of the federal securities laws. The City’s disclosure policy has been posted on its website⁹ and filed on EMMA.

We continue to recommend that issuers and obligated persons consider the adoption of comprehensive disclosure policies that are appropriate for their circumstances in order to promote the timely filing of complete and accurate disclosure information. Periodic professional training of the officials and personnel responsible for disclosure matters is also recommended. Posting of the disclosure policy to EMMA and the “Investor Relations” tab on the issuer’s website serve to put investors and the bond markets on notice as to the contents of the policy and the proposition that the issuer takes its disclosure obligations seriously. Lastly, in order for written disclosure policies and procedures to provide protection against charges of inadequate or deficient disclosure, they must be implemented and followed. Periodic reporting to the issuer’s governing body of disclosure policy compliance can help ensure full implementation of the policy.

Designated Investor Information on Websites. Most State and local governments post their CAFRs, financial statements, operating budgets and other financial and operating information on their websites. The public availability of this information promotes transparency of governmental operations, citizen participation and other salutary purposes. In the Harrisburg Order, the Commission found that “Municipal issuers have an obligation to make sure that information that is released to the public that is reasonably expected to reach investors and the trading markets, even if not specifically published for that purpose, does not violate the antifraud provisions.”

Although the Commission did not make a specific finding in this regard, it seems that any information that is publicly available on an issuer's website should be treated as information that is reasonably expected to reach investors and the trading markets.

Clearly, it is impractical and untenable for any State or local government to regularly review and monitor all of the information that is available on its website for compliance with the antifraud requirements of federal securities law. The best approach, which has already been implemented by many State and local governments, is for an issuer to establish a designated "Investor Relations" or "Investor Information" tab on its website that includes information specifically intended for use by investors and the bond markets. Such information should include all of the information posted by the issuer to EMMA (or links to where such information appears on EMMA), as well as supplemental information, such as operating budgets or capital plans, that may be of interest to investors. The posting of investor information on an issuer's website should be covered by and subject to the issuer's written disclosure policies and procedures. The "Investor Relations" tab would also include a disclaimer that it is the only portion of the website that is subject to the issuer's disclosure policies and procedures, and that the information contained in other parts of the issuer's website should not be relied upon by investors.

Political Speech and the Antifraud Provisions. One interesting aspect of the Harrisburg Order was the Commission's finding that the Mayor's 2009 State of the City Address "was misleading because it omitted to state the amount of [resource recovery facility] debt the City would likely have to repay from its General Fund, and the impact the repayment obligation was already having on Harrisburg's finances." While it seems self-evident that a "State of the City/County/State" address is Constitutionally-protected political speech that should not be subject to scrutiny under the antifraud provisions (at least in the absence of a clear intent to affect the markets), the Order made no such distinction. The implications of this are troubling given that elected officials regularly discuss and debate financial matters in public speeches, campaign materials and interviews.

We suggest that issuers consider designating a spokesperson, or limited number of officers or officials and employees as spokespersons, who are authorized to make public statements regarding the issuer's finances and obligations. A statement as to the identity of such spokesperson would be placed on EMMA as well as on the issuer's website. This would permit an issuer to avail itself of the argument that statements by other officials of the issuer are more properly characterized as political speech or statements to encourage economic development or tourism (for example) rather than "speaking to the market."

Liability of Public Officials. The Commission did not charge any of Harrisburg's elected officers, officials or employees with securities law violations. The Commission did charge local government officials with securities law violations in the San Diego enforcement action a few years ago (and ultimately fined these officials), and in its recently-filed action involving the City of Victorville, California. A recent speech by Commissioner Daniel Gallagher indicates that the Commission will consider naming local government officials individually in future enforcement proceedings:

Although cities and municipal issuers are distinct legal entities, in fact they act through individuals. And they meet their primary and continuing disclosure obligations under State and Federal law through the conduct of public officials. So when we find material misstatements or omissions by public officials in connection with municipal securities, we can, should, and will take action to hold the appropriate public officials accountable.¹⁰

Commissioner Gallagher's remarks pointedly reinforce the Commission's statement in the Report of Investigation that statements by public officials "can lead to potential liability" under the antifraud laws.

For More Information

If you would like to discuss any of the topics covered in this Client Alert, please contact your regular Chapman attorney or visit us online at chapman.com.

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1 SEC Release Nos. 33-7049, 34-33741 (the “1994
Interpretive Guidance”) at pp. 13-14. An unofficial copy of
the 1994 Interpretive Guidance can be found here:
[www.nabl.org/uploads/cms/documents/sec_guidance_antifra
ud.pdf](http://www.nabl.org/uploads/cms/documents/sec_guidance_antifraud.pdf)

2 *In the Matter of the City of Harrisburg, Pennsylvania*,
Securities Exchange Act of 1934, Release No. 69515 (May 6,
2013). The Cease-and-Desist Order is available here:
<http://www.sec.gov/news/press/2013/2013-82.htm>

3 *Report of Investigation in the Matter of the City of
Harrisburg, Pennsylvania Concerning the Potential Liability
of Public Officials with Regard to Disclosure Obligations in
the Secondary Market*, Securities Exchange Act of 1934,
Release No. 69516 (May 6, 2013). The Report of
Investigation is available here:
<http://www.sec.gov/news/press/2013/2013-82.htm>

4 1994 Interpretative Guidance at pp. 13-14.

5 During the relevant time period, Harrisburg’s financial
difficulties were widely reported in the local and national
press. See, e.g., *An Incinerator Becomes Harrisburg’s
Money Pit*, The New York Times (May 20, 2010), available
here:
<http://www.nytimes.com/2010/05/21/us/21harrisburg.html>

6 *In the Matter of the State of New Jersey*, Securities Act of
1933, Release No. 9135 (August 18, 2010), available here:
<http://www.sec.gov/news/press/2013/2013-82.htm>
In the Matter of the State of Illinois, Securities Act of 1933,
Release No. 9389 (March 11, 2103), available here:
<http://www.sec.gov/news/press/2013/2013-37.htm>

7 The Report of Investigation stated that “investors may be
more likely to rely upon statements of public officials” when
required continuing disclosures have not been made.

8 EMMA can be accessed here: <http://www.emma.msrb.org/>

9 The City’s disclosure policy can be found here:
[http://pl1462.pairlitesite.com/wp-
content/uploads/2013/05/City-of-Harrisburgs-Continuing-
Disclosure-Policy.pdf](http://pl1462.pairlitesite.com/wp-content/uploads/2013/05/City-of-Harrisburgs-Continuing-Disclosure-Policy.pdf)

10 The full text of Commissioner Gallagher’s prepared remarks
can be found here:
<http://www.sec.gov/news/speech/2013/spch051013dmg.htm>