

Post Issuance Bond Compliance – SEC and IRS Increasing Enforcement Efforts

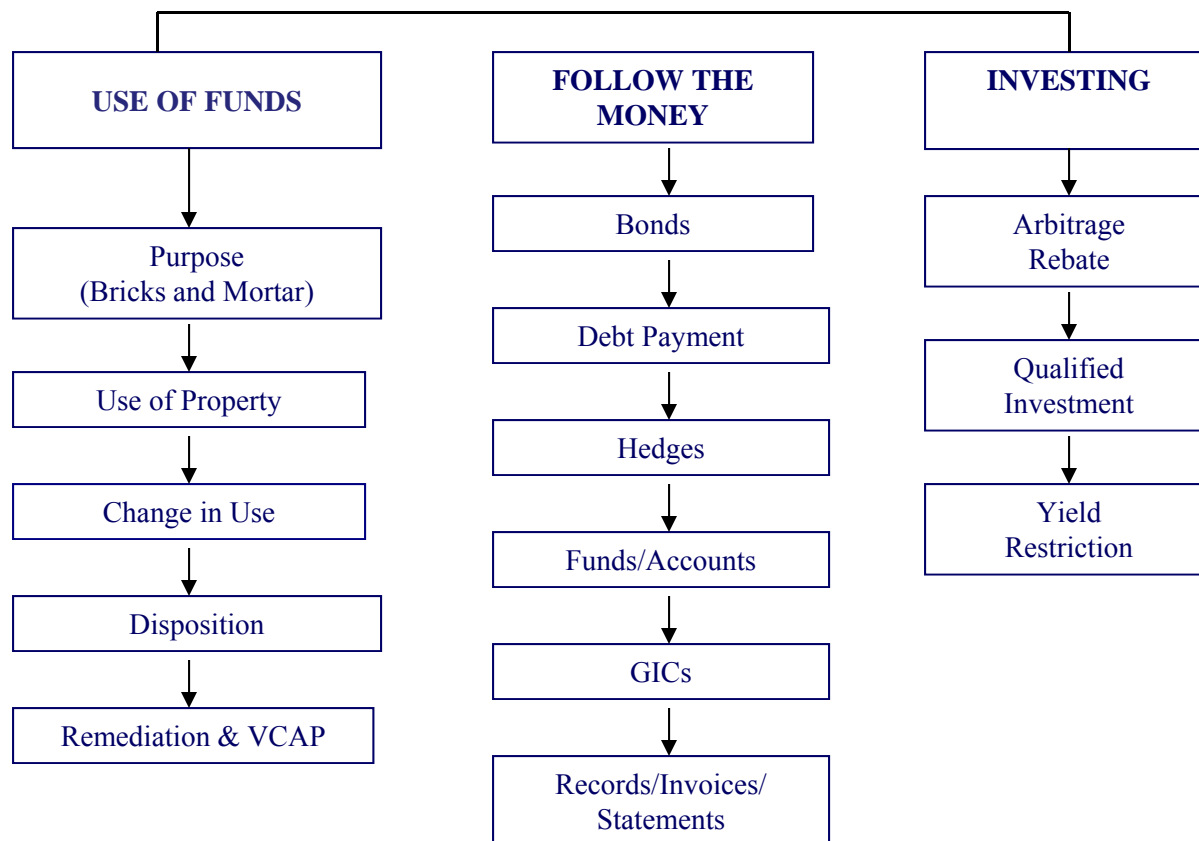
Presentation to:
CFMA/CSMA
2014 Spring Educational Conference

May 8, 2014

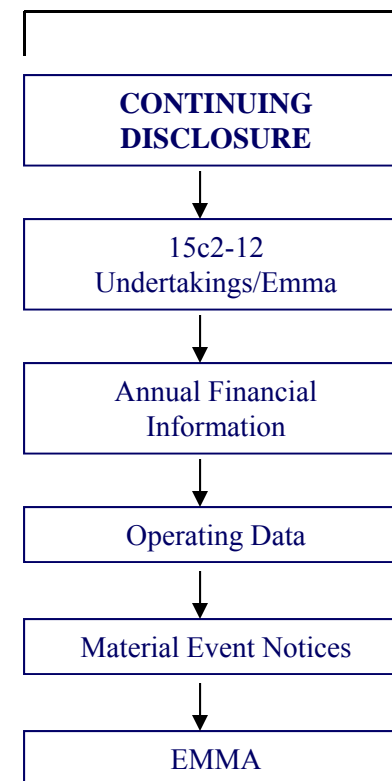
Frederic H. Marienthal III
Partner
Kutak Rock LLP
Frederic.Marienthal@KutakRock.com

Overview of Post Issuance Compliance

IRS



SEC



Three primary categories of post issuance requirements:

- ▶ Securities Matters (Disclosure)
- ▶ Tax Matters
- ▶ Additional Contractual Obligations

Two basic areas of federal securities law impact disclosure by governmental entities

- ▶ “Antifraud provisions” (Section 17a of the 1933 Act and Rule 10b-5 of the 1934 Act)
- ▶ Continuing disclosure obligations (Rule 15c2-12)

What do we mean by “continuing disclosure”?

Following the issuance of municipal securities, the requirement to report to the market certain financial and operating data concerning the issuer or other “obligated person” (person obligated to support the payment of the bonds) on a periodic (generally annual) basis and, in addition, the requirement to report to the market the occurrence of specified events relating to the issuer, obligated person or the municipal securities.

Questions for consideration:

- ▶ Why disclose?
- ▶ What type of information?
- ▶ Provided by whom, to whom?
- ▶ When?
- ▶ What if you don't?

Why?

The Municipal Securities Regulatory Framework

- ▶ The Tower Amendment-limited jurisdiction over issuers of municipal securities
- ▶ Indirect regulation through SEC Rule 15c2-12, imposing requirements on the underwriter of municipal securities
 - 1975 – mandatory registration of brokers /dealers; MSRB created
 - 1989 – underwriters required to obtain and review “deemed final” official statement before offering or purchasing municipal securities
 - 1994 – continuing disclosure agreements with issuer and obligated persons required
 - 2008 – EMMA established; small issuer exemption changed
 - 2010 – amendments to continuing disclosure requirements affecting certain exemptions and reporting requirements

Key Issuer Requirements Resulting from 15c2-12

- ▶ Provision of annual financial and operating information
- ▶ Provision of audited financial statements when available
- ▶ Notice of material events
- ▶ Exemptions
 - Limited offerings in denominations of \$100,000 or more (though note some voluntary continuing disclosure undertakings)
 - Recent change eliminating exemptions for variable rate demand obligations
- ▶ Filings to be made with EMMA
- ▶ Obligation documented in Continuing Disclosure Agreement/Undertaking

Changes to Event Notice Requirements

- ▶ Notice to be provided not in excess of 10 business days after occurrence of event
- ▶ Materiality standard modified in several cases
- ▶ New events added

Notice Events

- (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, **the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the security**, or other **material** events affecting the tax status of the security;

Notice Events (cont.)

- (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**;
 - (13) Merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business;
 - (14) Appointment of a successor or additional trustee or the change of name of a trustee, if material.
-

Is this really that important? Yes!

Some Context: Indicators of Renewed Emphasis on Continuing Disclosure and the Municipal Securities Market Generally

- ▶ A New Era of Municipal Bonds Without AAA Bond Insurers
- ▶ Concerns About Looming Municipal Bankruptcies
- ▶ Dodd-Frank Focus on Municipal Securities Matters
- ▶ GAO Studies
- ▶ SEC Concerns About Municipal Disclosure; SEC Staff Report
- ▶ MSRB/FINRA Activity
- ▶ Investor Demands
- ▶ SEC Enforcement Actions
- ▶ **SEC MCDC Initiative**
<http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541090828>

Consequences to Issuer of Failing to Comply with Continuing Disclosure Agreements

- ▶ Does not constitute an event of default under bond resolution or indenture; only remedy is action for specific performance.
- ▶ Underwriter must have reasonable basis for recommending municipal securities to investing public, including reasonable basis for believing Issuer will comply with continuing disclosure undertaking
- ▶ Underwriter duty to investigate Issuer's past compliance
- ▶ Duty to disclose any instance of Issuer's failure to comply in prior five years; potential impact on sale of new bonds
- ▶ Required Issuer representations re: past compliance
- ▶ Remedial actions may be required for Underwriter to have reasonable basis to believe future compliance by Issuer
- ▶ SEC MCDC Initiative
- ▶ SEC Enforcement Actions

Who is Responsible for Dissemination?

- ▶ Public Entity
- ▶ Trustee
- ▶ Paying Agent/Registrar
- ▶ Investment Banker
- ▶ Private Party Dissemination Agent (e.g., DAC www.dacbond.com)

LESSON #1 – STATE OF NEW JERSEY

In August 2010, the State of New Jersey settled claims that it misled investors with respect to \$26 billion in municipal bonds in its disclosure (or lack thereof) regarding underfunding of its pension funds.

The state did not advise the public that it could not make contributions to the pension funds without cutting other services or increasing taxes.

First time the SEC has ever taken action against a state.
SEC ordered a cease and desist.

LESSON #2 – SAN DIEGO, CALIFORNIA

In October 2012, the SEC announced that four former San Diego city officials (City Manager, Auditor & Comptroller, Deputy City Manager and City Treasurer) agreed to pay financial penalties for roles in misleading investors in municipal bonds, again with respect to information relating to underfunded pension and health care obligations.

The SEC alleged that the official knew of the underfunding, and the City would have difficulty funding their obligations unless new revenues were obtained or other services cut.

(Three of the city officials were fined \$25,000 and one fined \$5,000.)

An SEC official stated in connection with the fines that “*municipal officials have a personal obligation to ensure that investors are provided with complete and accurate information about the issuer’s financial condition.*”

This was the first time the SEC secured a financial penalty against city officials in a municipal bond fraud case.

LESSON #3 – STATE OF ILLINOIS

In March 2013, the SEC charged the State of Illinois with securities fraud for misleading bond investors about the State's approach to funding its pension obligations.

The SEC ordered a cease and desist and other remedial measures.

LESSON #4 – CITY OF VICTORVILLE, CALIFORNIA

In April 2013, the SEC charged the City of Victorville, the Southern California Logistics Airport Authority (which was controlled by the City), the assistant city manager and former director of economic development of the city, and others of defrauding investors by inflating valuations of property securing a 2008 tax increment bond issue.

The inflated values allowed the Airport Authority to issue substantially more bonds. Also, the inflated values meant that investors were given false information about the security to repay the debt.

An SEC official stated that “Public officials have the same obligation as corporate officials to tell the truth to their investors.”

LESSON #5 – CITY OF SOUTH MIAMI, FLORIDA

In May 2013, the SEC charged the City of South Miami, Florida, with defrauding investors about the tax-exempt financing eligibility of a project because the City used the bond proceeds for something other than the purposes identified in the bond documents.

The project involved mixed use retail and a public parking garage, which eventually became under control of a private developer.

The SEC looked at the lease between the private developer and the conduit issuer, which is not a document that usually is intended to reach the investor.

Among other things, because the developer obtained control of the project, the bond's tax exempt status was in jeopardy.

The City, along with its conduit issuer, paid \$1.4 to preserve the tax exempt status of the bonds and adopted other remedial measures.

LESSON #6 – CITY OF HARRISBURG, PENNSYLVANIA

In May 2013, the SEC announced the resolution of an enforcement action against the City of Harrisburg, Pennsylvania, for violation of securities law due to the City's failure to provide annual financial information to the marketplace following the issuance of the City's bonds.

This resulted in requiring investors to rely on other publicly available information about the City posted on the City's website.

Such information included the State of the City Address given by the Mayor and a mid-year fiscal report, both of which materially misstated and failed to disclose material information about the City's lowered credit rating and looming financial crisis.

This was the first time the SEC has looked beyond the disclosure provided in official statements or annual filings on EMMA. The City was required to adopt certain procedures to ensure compliance with the security laws.

LESSON #7 – CITY OF MIAMI, FLORIDA

In July 2013, the SEC filed a lawsuit against the City of Miami, Florida, and the City's former budget director, charging them with securities fraud for making faulty disclosure in connection with three 2009 bond offerings.

The suit alleges that the City and former budget director made “materially false and misleading statements and omissions” about interfund transfers designed to cover up a growing general fund deficit and get more favorable bond ratings for the offerings.

The City was under a cease and desist order from 2003 and the SEC is seeking monetary penalties against the City for failing to abide by the SEC's earlier order.

The SEC said: “Although cities and municipal issuers are distinct legal entities, in fact they act through individuals... 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.”

LESSON #8 – WEST CLARK COMMUNITY SCHOOLS (INDIANA)

In July 2013, the SEC charged the West Clark Community Schools, an underwriter of the schools obligations and others with falsely claiming in bond documents that the issuer was meeting its secondary market disclosure obligations.

In its bond documents, West Clark affirmatively stated that it had complied with all material disclosure requirements from earlier bond offerings.

In fact, it had not filed required annual reports.

The SEC ordered certain remedial measures.

LESSON #9 – PUBLIC HEALTH TRUST OF MIAMI-DADE COUNTY, FLORIDA

In September 2013, the SEC issued a cease-and-desist order against the Public Health Trust of Miami-Dade County, Florida, a quasi-governmental entity that operates a public hospital system, relating to misrepresentations and omissions in a 2009 bond offering which significantly misstated the entity's revenues, misrepresented that the financial statements attached to the official statement were prepared in accordance with GAAP, misrepresented projected loss in the official statement, and misrepresented unaudited information in the official statement.

Lesson #10 - Wenatchee, Washington, November, 2013

- ▶ The SEC charged a municipal issuer with inadequate disclosure involving bonds issued for payment of an event center. The inaccuracies focused on the representation by the issuer that there were no independent reviews of financial projections when, in fact, outside consultants twice reviewed the financials. Also, the official statement failed to disclose that the financial projections had been revised upward based in part upon optimistic assurances by civic leaders that the community would support the project, or that the city's remaining debt capacity would limit the ability to support any future long term bonds.
- ▶ Without admitting or denying the allegations, the Issuer agreed to settle with the SEC and paid a \$20,000 fine plus undertook other remedial measures.

LESSON LEARNED #1 – STRONG INTERNAL CONTROLS

Set up internal controls and systems that produce financial reports and disclosure documents that are accurate and complete, including written policies and procedures that:

- Identify who is responsible for what;
- Clearly state the process by which the disclosure is drafted and reviewed; and
- Provides checks and balances so that too much power and information is not placed with just one person.

LESSON LEARNED #2 – PROVIDE TRAINING

Provide training to municipal officials and employees regarding applicable disclosure requirements and financial reporting provisions. The SEC has repeatedly said that the ultimate responsibility for preparing disclosure documents cannot be assigned to the independent auditor, disclosure counsel or other professionals. The ultimate responsibility rests with the issuer and its officials.

- ▶ Provide practical training on disclosure and financial requirements
- ▶ Training should include members of the governing body, as well as staff members

LESSON LEARNED #3 – KEEP THE BIG PICTURE IN MIND

Don't let completing a disclosure process checklist (or getting the POS out) override the need to provide full and fair disclosure to investors buying the bonds.

- ▶ Have a disclosure team that first identifies financial problems and issues;
- ▶ Members of the team should conduct their own due diligence; and
- ▶ Members of the team should carefully scrutinize the disclosure documents themselves.

LESSON LEARNED #4 – DISCLOSE BAD NEWS

No one, particularly elected officials, want to disclose bad news about a municipality's financial status but securities laws require disclosure of both the good and the bad. In the long run, proper disclosure is cheaper and less unsettling than being caught with inadequate or misleading disclosure.

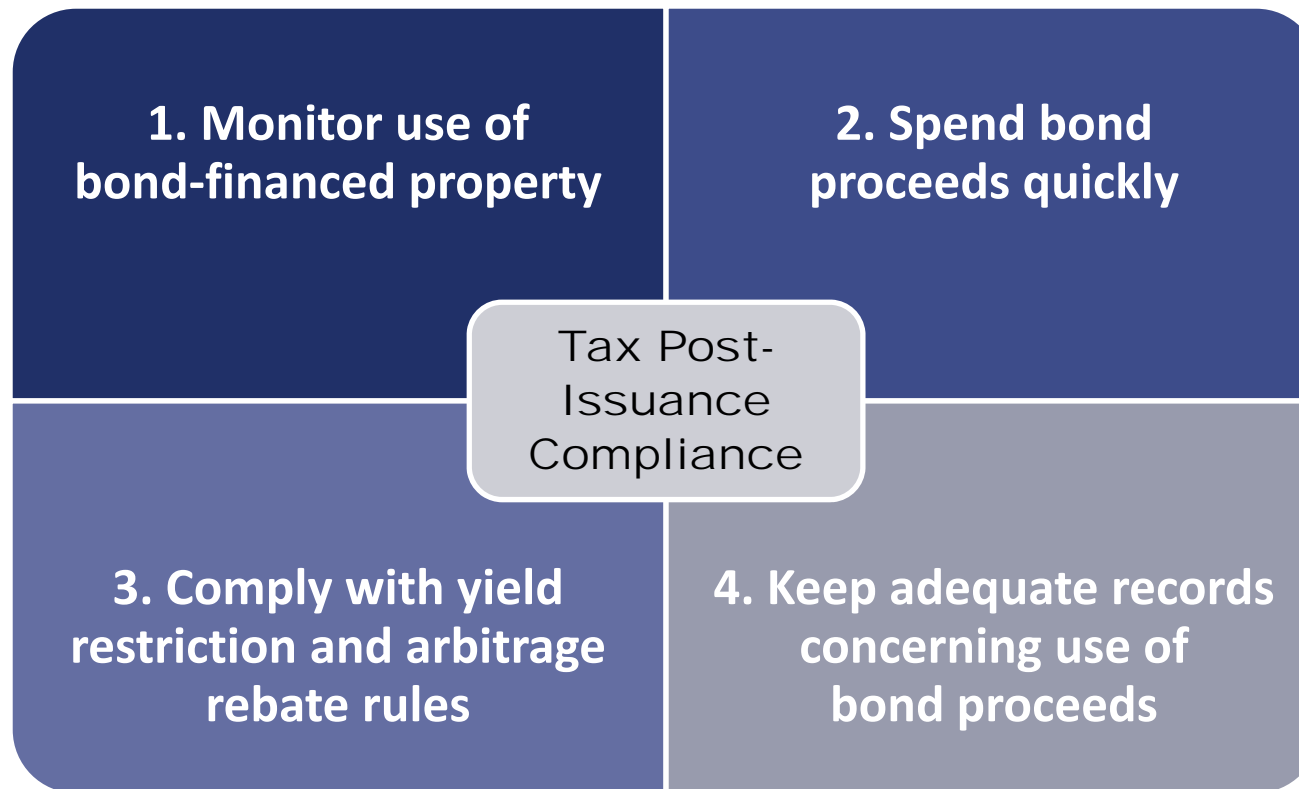
LESSON LEARNED #5 – HIRE EXPERIENCED PROFESSIONALS TO ASSIST WITH DISCLOSURE

Hire professionals that have the skills and resources to do the job. “Too often, cities seem to place too much emphasis on other factors – political connections, going with the lowest bid, or giving business to local business persons.”

Post-Issuance Tax Matters

- ▶ What are the basic post-issuance tax rules?
- ▶ What has changed?
- ▶ How does this impact you?
- ▶ What else is the IRS up to?

The Most Important Tax Rules



Rules 1 and 2: Monitor Use and Spend Quickly

- ▶ Monitor use of bond-financed property
 - Don't allow (too much) private business use (10% rule)
 - Avoid unrelated use of bond-financed property (5% rule)
 - Be careful before entering into leases, power purchase agreements and management or service contracts – they may be treated as giving rise to private business use (qualified management contract rules)
- ▶ Spend bond proceeds quickly
 - Generally, spend bond proceeds within three years
 - Talk with counsel before spending bond proceeds on facilities not identified in the tax documents

Rule 3, Part 1: Yield Restriction

- ▶ Don't earn too much on investment of “proceeds”
 - This is called “yield limitation” in the tax documents
 - Rule: “Proceeds of an issue cannot be invested at above the yield on the bonds, except (a) during temporary periods, or (b) as part of a reasonably required reserve, or (c) as part of a minor portion.”
 - Project funds qualify for temporary period exception if:
 - ◆ 85% of proceeds expected to be spent in 3 years
 - ◆ Within 6 months, have binding obligation to spend 5%
 - ◆ Diligently spend proceeds

Rule 3, Part 2: Rebate Requirement

- ▶ Pay (all) earnings to the federal government
 - This is called “rebate requirement” in the tax document
 - Rule: Arbitrage earnings (earnings in excess of the bond yield) must generally be paid to (“rebated”) to the U.S. Treasury.
 - Complete rebate computation every five years and within 60 days of retirement
 - No need to pay rebate if “spending exceptions” are met:
 - ◆ 6-month spending exception
 - ◆ 18-month spending exception
 - ◆ 2-year spending exception for construction issues

Rule 4: Keep Records

- ▶ Keep the following records regarding the bonds:
 - Records of rebate payments
 - Records of rebate calculations
 - Records concerning investment of proceeds
 - Records concerning use of bond-financed property
- ▶ Maintain records for at least 3 years after the later of retirement of (1) the original bonds or (2) any bonds issued to refinance the original bonds
- ▶ Post-issuance compliance policies must address recordkeeping

New Developments in Tax Post-Issuance Compliance

Two new boxes on IRS Form 8038-G!

Part VI Miscellaneous

35	Enter the amount of the state volume cap allocated to the issue under section 141(b)(5)	35	\$0	00
36a	Enter the amount of gross proceeds invested or to be invested in a guaranteed investment contract (GIC) (see instructions)	36a	\$0	00
b	Enter the final maturity date of the GIC ▶			
c	Enter the name of the GIC provider ▶			
37	Pooled financings: Enter the amount of the proceeds of this issue that are to be used to make loans to other governmental units	37	\$0	00
38a	If this issue is a loan made from the proceeds of another tax-exempt issue, check box <input type="checkbox"/> and enter the following information:			
b	Enter the date of the master pool obligation ▶			
c	Enter the EIN of the issuer of the master pool obligation ▶			
d	Enter the name of the issuer of the master pool obligation ▶			
39	If the issuer has designated the issue under section 265(b)(3)(B)(i)(II) (small issuer exception), check box <input type="checkbox"/>			
40	If the issuer has elected to pay a penalty in lieu of arbitrage rebate, check box <input type="checkbox"/>			
41a	If the issuer has identified a hedge, check here <input type="checkbox"/> and enter the following information:			
b	Name of hedge provider ▶			
c	Type of hedge ▶			
d	Term of hedge ▶			
42	If the issuer has superintegrated the hedge, check box <input type="checkbox"/>			
43	If the issuer has established written procedures to ensure that all nonqualified bonds on this issue are remediated according to the requirements under the Code and Regulations (see instructions), check box <input type="checkbox"/>			
44	If the issuer has established written procedures to monitor the requirements of section 148, check box <input type="checkbox"/>			
45a	If some portion of the proceeds was used to reimburse expenditures, check here <input type="checkbox"/> and enter the amount of reimbursement ▶			
b	Enter the date the official intent was adopted ▶			

the best of my knowledge
information, as necessary

1. "Do you have post-issuance compliance policies?"
2. "Do you have remedial action procedures?"

Development 1: Compliance Policies, Procedures and Personnel

- ▶ Implement policies and procedures to ensure and prove compliance
 - IRS will ask about compliance policies in an audit
- A. Designate responsible personnel
 - ✓ May be internal or external responsibility or combination
 - ✓ Centralized responsibility
- B. Establish system to monitor investment of proceeds and schedule periodic review and rebate calculations
 - ✓ Involve bond counsel before bidding investment contracts or executing swaps
- C. Establish system to monitor expenditure of proceeds

Development 1: Compliance Policies (cont'd)

- D. Establish system to monitor use of financed projects
 - ✓ Consider how to maintain communications with persons not involved in bond financing
 - ✓ Ensure management contracts are reviewed by bond counsel prior to executing
- E. Keep records with respect to expenditures and investment of bond proceeds until at least 3 years after the retirement of the original bonds and any bonds that refinance that original bonds
- F. Make a final allocation of bond proceeds within 18 months of placed in service date

Development 1: Compliance Policies (cont'd)

G. Staff training and ongoing education

- ✓ Be wary of isolating all key information in one person
- ✓ Know what the bond and tax documents say
- ✓ Talk to bond counsel – we are happy to help!

Development 2: Remedial Action Procedures

- ▶ Know what your remedial action options are
 - Remedial actions are actions that can be taken to fix excessive private business use (resulting from, e.g., sale of financed facilities)
 - Examples of remedial actions include redemption or defeasance of bonds, use proceeds of sale for good uses
- ▶ VCAP

Some Suggestions for Now...

- A. Conduct a full audit of bond and tax documents with bond counsel
- B. Document and address any issues discovered
- C. Adopt ongoing compliance policies
 - ✓ Know what the bond and tax documents say
 - ✓ Remember your continuing disclosure obligations
 - ✓ Talk to bond counsel – we are happy to help!
- D. Call your bond counsel and tell us how we can help!

Elements of a Post Issuance Tax Compliance Program

- ▶ Written policies & procedures
- ▶ Create a team, assigned to manage compliance process
- ▶ Designate an accountable individual to manage compliance process
- ▶ Record retention
- ▶ Arbitrage rebate & yield restriction compliance
- ▶ Private business use compliance
- ▶ Periodic review process
- ▶ Staff training and education

Emerging Best Practices:

- ▶ Maintain an up-to-date and complete inventory of outstanding bonds and refunded bonds
- ▶ Bond policies and procedures integrated with organizational policies and procedures
- ▶ Job descriptions include bond responsibilities
- ▶ Internal audit includes bond compliance review periodically
- ▶ Process in place to alert responsible personnel to changes in requirements
- ▶ Periodically train personnel responsible for compliance
- ▶ Communicate regularly with bond counsel

OTHER CONTRACTUAL OBLIGATIONS

Review your bank loan documents and covenants carefully!

Annual Reports & Certifications

- ▶ Evidence of Appropriation & Budget
 - ▶ Certificate re: Reserves/Surplus Funds
 - ▶ Certificate re: insurance coverage
 - ▶ Annual audit
 - ▶ Bond Reserve Requirement (may change)
 - ▶ Certificate re: that legal requirements of bond documents met/no default
-

OTHER CONTRACTUAL OBLIGATIONS

(cont.)

Periodic Reports & Certifications:

- ▶ Monthly Construction Reports
- ▶ Quarterly Financial Reports – comparative
- ▶ Insurance Consultant Review and Certification

Contact

Frederic H. Marienthal

Partner

Kutak Rock LLP

Frederic.Marienthal@KutakRock.com

Kutak Rock LLP

Suite 3000

1801 California Street

Denver, CO 80201

(303) 297-2400

www.kutakrock.com