HAWKINS ADVISORY

SEC REPORT ON THE MUNICIPAL SECURITIES MARKET

On July 31, 2012, the United States Securities and Exchange Commission (the "SEC") released its Report on the Municipal Securities Market (the "Report").[1] The Report is a comprehensive analysis of the municipal securities market that contains legislative and regulatory proposals to address certain disclosure and market transparency concerns.

The Report is the first comprehensive analysis by the SEC (or its staff) of the municipal securities market since the September 1993 Staff Report on the Municipal Securities Market. More significantly, it represents the most comprehensive SEC legislative initiative concerning municipal securities disclosure since the Municipal Securities Full Disclosure Act of 1976.[2] SEC Commissioner Elisse Walter, in introducing the Report at a press conference, cautioned that the Report would not "sit on the shelves" and that the SEC is "going to go forward with what we recommend." Accordingly, draft legislation prepared by the SEC staff to implement the legislative proposals in the Report is likely to be released in the near future.

This Advisory summarizes the key recommendations set forth in the Report.

Disclosure - Legislative Initiatives

Primary and Continuing Disclosure. The Report recommends that legislation be enacted to provide the SEC with "authority to establish disclosure requirements and principles, timeframes and frequency of dissemination of municipal securities offerings and continuing disclosures," and further that any such legislation "provide tools to enforce such requirements." Currently, the SEC's enforcement authority against municipal issuers is limited to violations of the general antifraud provisions of the federal securities laws.[3]

The Report advises that the SEC would implement any new disclosure authority by use of a "principles-based approach," and, in recognition of the diversity of the municipal market, that disclosure content and frequency could be tailored to reflect the size of the issuer, the type of security, the frequency of issuance, and the amount of an issuer's outstanding securities.

Disclosure Controls. The Report states that the SEC "could consider the appropriate disclosure policies and procedures that municipal issuers should have to assure that they will satisfy their primary and ongoing disclosure obligations."[4]

Such statement regarding disclosure policies and procedures echoes prior statements of SEC staff and a recent SEC enforcement action. In a speech entitled "Lessons Learned from San Diego," (Dec. 11, 2007), then-SEC Enforcement Director Thomsen recommended as one of the "critical lessons" from that enforcement action that cities consider adopting "written policies and procedures that, at a minimum . . . clearly state the process by which the disclosure is drafted and reviewed." In the SEC enforcement action against the State of New Jersey,[5] the SEC concluded that the lack of disclosure policies was a key factor that resulted in the misleading statements:

> The State was aware of the under funding of the [pension system] and the potential effects of the under funding. However, due to a lack of disclosure training and inadequate procedures relating to the drafting and review of bond disclosure documents, the State made material [mis] representations and failed to disclose material information regarding [the pension system] in bond offering documents.

Conduit Borrowers. The Report recommends that a conduit *borrower* should not have an exemption from registration of its securities under the Securities Act of 1933 *solely* by reason of the conduit *issuer* being entitled to such an exemption because it is a municipal entity. Currently, section 3(a)(2) of the Securities Act of 1933 provides a securities exemption for both the municipal security of the conduit issuer and for the underlying obligation of the conduit borrower, subject to Rule 131.[6] Any other exemption available to the conduit borrower (e.g., private placement, non-profit entities, security guaranteed by a bank, etc.) would continue to apply.

Financial Statements. The SEC would seek "explicit authority . . . to establish the form and content of financial state-

[1] http://www.sec.gov/news/studies/2012/munireport073112.pdf

[2] *Municipal Securities Full Disclosure Act of 1976, Hearings before the Subcomm. on Securities of the S. Comm. on Banking, Housing and Urban Affairs,* 94th Cong., 2d Sess., on S. 2969 and S. 2574 (1976).

[3] Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 and section 17(a) of the Securities Act of 1933.

[4] Hawkins Delafield & Wood LLP has assisted with the development of written disclosure policies and procedures for, among others, the Cities of San Diego and San Francisco and the State of Rhode Island.

[5] SEC Rel. No. 33-9135 (Aug. 18, 2010).

[6] SEC Rule 131, 17 CFR §230.131. Rule 131 defines as a "separate security" an obligation evidenced by governmental debt that is payable "by or for [an] industrial or commercial enterprise" from payments made under a "lease, sale, or loan arrangement."

ments used in municipal securities offerings and establish standards and designate a private-sector body as the GAAP standard setter for municipal issuer financial statements," in order to facilitate comparisons between issuers. In recognition of certain states having their own accounting principles, the Report advises that any such legislative authority would be solely for purposes of the federal securities laws. The SEC would also seek authority to require that municipal issuers have their financial statements audited, whether by an independent auditor or a state auditor.

Safe Harbor for Forward-Looking Statements. The SEC advised in its 1994 Interpretive Release[7] that when an issuer "releases information to the public that is reasonably expected to reach investors and the trading markets, those disclosures are subject to the antifraud provisions." On the other hand, the SEC has encouraged issuers to provide more frequent and more comprehensive continuing disclosure than that required by Rule 15c2-12[8] continuing disclosure agreements.

The SEC is considering providing a "safe harbor" for forward-looking information, which would (i) be available only to those municipal issuers that provide ongoing disclosure on a "current and timely basis" and (ii) apply only to private rights of action (i.e., would not apply to SEC enforcement actions).[9]

IRS Information. The SEC would seek an amendment to the Internal Revenue Code that would permit the IRS to disclose return information to the SEC and SEC staff in connection with the civil enforcement of the federal securities laws. Such disclosure by the IRS is not currently authorized. The Report states that such new authority would allow "Commission enforcement actions relating to municipal securities . . . [to] be more consistent, comprehensive, and timely."

Enforcement of Continuing Disclosure Agreements. Continuing disclosure agreements entered into in connection with Rule 15c2-12 are contractual agreements, and, as such, the SEC is not authorized to enforce compliance with such agreements. The SEC heard testimony at its field hearings[10] that continuing disclosure agreements are sometimes violated; for example, annual financial information is either not filed or is filed late, material event notices are not filed, or material that is filed does not conform to the agreement. The Report states that the SEC would seek legislative authority "to require trustees or other entities to enforce the terms of continuing disclosure agreements."

Disclosure - Regulatory Initiatives

Annual Muni Conference. The Report states that the SEC could organize annual conferences on the municipal securities markets "to allow market participants to confer with one another and to share with the Commission important developments in the municipal securities market."[11]

Interpretive Release. Because the SEC does not currently have jurisdiction over municipal issuers except with respect to enforcement of the general antifraud provisions, the SEC is limited to providing guidance to municipal issuers by three methods: (i) SEC enforcement actions, (ii) interpretive releases, and (iii) "section 21(a) reports." [12] The SEC is expected to issue a new interpretive release that would update the most recent such release, namely the 1994 Interpretive Release. The 1994 Interpretive Release had provided guidance regarding, among other things, (i) disclosure of conflicts of interest and other relationships, (ii) disclosure of the terms and risks of securities, and (iii) the importance of the timeliness of financial statements.

An interpretive release allows the SEC to provide guidance to market participants and to "identify areas where the Commission thinks that improvement is still needed." Commissioner Walter had invited suggestions on what a new interpretive release should address. The National Association of Bond Lawyers ("NABL") submitted two comment letters in response to that invitation.[13] The NABL letters suggested areas in which SEC guidance would be useful, including: (i) the extent to which the guidance in the Orange County Report (see fn. 12) regarding an issuer's officials' responsibilities in approving primary market disclosure documents also applied to secondary market disclosures, (ii) when remarketings may be considered "primary offerings" for purposes of Rule 15c2-12, and (iii) the use of disclaimers in official statements.

Rule 15c2-12. The SEC proposed the legislative changes summarized above, but states in the Report that if the necessary legislation is not obtained it would consider amending Rule 15c2-12 to address various disclosure concerns, including (i) amending the definition of "final official statement" to include certain required disclosures (e.g., describe any retail order period, risks of the offered securities, and disclosures

[7] SEC Rel. Nos. 33-7049, 34-33741 (Mar. 9, 1994).

[8] 17 CFR §240.15c2-12.

[9] Although described as being limited to forward-looking statements, a safe-harbor that addresses concerns with the broad 1994 Interpretive Release language may encourage issuers to provide budgetary data, unaudited quarterly statements, and generally any other information that is otherwise already produced for another purpose but not currently being disseminated to investors.

[10] In 2010 and 2011, SEC Commissioner Walter and the SEC staff held public field hearings in San Francisco, California; Washington, DC; and Birmingham, Alabama, to receive input from market participants for purposes of the Report. John M. McNally, of Hawkins' Washington, DC office, provided testimony on behalf of the National Association of Bond Lawyers at the initial field hearing in San Francisco.

[11] The SEC hosted Municipal Market Roundtables in 1999, 2000, and 2001, but has not done so since.

[12] A section 21(a) report refers to a report issued by the SEC pursuant to section 21(a) of the Securities Exchange Act of 1934, which authorizes the SEC to issue reports to provide guidance to the market concerning violations of the federal securities laws. It is generally employed when the SEC determines that there may not have been sufficient guidance regarding the described conduct, and the SEC is in effect advising that any such conduct in the future may result in an enforcement action. The last significant 21(a) report in the municipal market context was the Orange County Report regarding the responsibilities of members of a governing body in approving disclosure documents. SEC Rel. No. 34-36761 (Jan. 24, 1996).

[13] Letter from John M. McNally, then-President, NABL, dated Sept. 2, 2011, and letter from Kathleen C. McKinney, then-President, NABL, dated May 14, 2010.

about the underlying obligor regardless of the existence of credit enhancement) and (ii) requiring issuers to "have disclosure policies and procedures in place regarding their disclosure obligations, including those arising under continuing disclosure undertakings."

MSRB. The SEC will work with the Municipal Securities Rulemaking Board (the "MSRB") "especially in identifying potential rule changes or new rules that could address some of the issues discussed in the Report." The MSRB rules apply to broker-dealers, municipal securities dealers, and municipal advisors. The Report states that "[n]ew rules or rule changes could include amending Rule G-19 (suitability) in a manner consistent with recent amendments by FINRA . . . and otherwise harmonizing MSRB rules with similar FINRA rules." FINRA is the Financial Industry Regulatory Authority. FINRA has jurisdiction over brokers and dealers, however FINRA's rules do not apply to transactions in or business activities related to municipal securities.[14] This reflects the view of Congress in creating the MSRB that it should be "the primary medium for regulation of the municipal securities industry."[15]

Disclosure - Market Initiatives

The Report suggests various areas in which it would be useful for the industry to develop "best practice" guidelines, including (i) disclosure policies and procedures for primary and continuing disclosure, (ii) availability of interim financial information, and (iii) improved timeliness of financial information both in primary offerings and on an annual basis.[16]

Market Structure

In addition to providing legislative, regulatory, and market disclosure initiatives, the Report makes several suggestions to address a perceived lack of price transparency. These include: (i) amending MSRB rules to require municipal securities dealers to report "yield spread" information, in addition to existing interest rate, price, and yield data, (ii) enhanced retail investor tools on EMMA, including enhanced search functionality, available yield curves, etc., (iii) education initiatives for retail investors, (iv) amending MSRB rules to require confirmations to provide the amount of any markup or markdown on "riskless principal" trades, and (v) amending MSRB rules to require municipal bond dealers to seek "best execution" of customer orders.

[14] Section 15A(f) of the Securities Exchange Act of 1934.

[15] S. REP. NO. 94-75, at 48 (1975).

[16] Although the Report advises that the SEC will use a "principles-based approach" in developing disclosure content, it may be inferred that the SEC would directly address in rulemaking the areas suggested as market initiatives if market participants do not do so.

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