Maryland GFOA Fall Conference

Recent Developments in Tax and Securities Laws

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Overview

- Introductions
- Tax Law Update
  - IRS regulations on “Issue Price”
  - Other potential upcoming regulations
  - Bank capital leasing (without bond counsel)
- Securities Law Update
  - SEC enforcement actions - Edward Jones and Stina Wishman
  - Status of Municipalities Continuing Disclosure Cooperation (MCDC) Initiative
- Q & A

IRS Regulations on Issue Price

- What is issue price?
  - Generally, the first price that is paid for the bonds by an investor (as opposed to an underwriter or other entity that expects to resell the bonds shortly after buying them)
  - In a bank "direct purchase", issue price is usually the price paid by the bank for your bonds. (Bond counsel gets a representation from the bank purchaser that the bank intends to hold the bonds as an investor without a present intention to resell.)
  - Private placements are similar to direct purchases.
  - But what about public offerings?

Issue Price (continued)

- Since 1993, regulations have provided that for public offerings, issue price is the first price at which at least 10% of each maturity is sold to investors (and for bona fide public offerings, it can be based upon reasonable expectations as of the sale date).
- This rule has worked well for issuers, underwriters and bond counsel for over 20 years.
- In 2013, IRS proposed new regulations which would have changed the rule from reasonable expectations as of the sale date to actual facts as of whatever date you have them.
- Bond community was horrified; in 2015 IRS withdrew the 2013 proposal and put out a new one.

Issue Price (continued again)

- 2015 Proposed Regulations will require actual facts, but if an underwriter does not sell at least 10% of the bonds of each maturity on the sale date, there is still a way to determine the issue price.
- Why do you care?
  - Regulations impose a due diligence requirement on issuers.
  - Underwriters (especially in competitive bids) will be more likely to price your bonds to sell (meaning cheaply = you get less money or pay higher interest rates).
  - Underwriters will want less time between sale date and closing.

Other potential upcoming regulations

- Final Regulations on Private Use Allocation and Accounting (be on the look out - expected soon)
  - Expected to contain rules regarding public/private partnerships (P3) that might better define when tax-exempt financing is available for a P3 project
  - Could contain revised rules for measurement and tracking of private use
  - Could contain revised rules for tax-exempt financing of a project which is expected to have a future change in use
- Regulations on "political subdivisions" which will change the rules regarding which entities can issue tax-exempt bonds
  - Expected to restrict further what entities can issue tax-exempt obligations
  - Not likely to have a large impact on Maryland issuers, but we will need to wait and see

Bank capital leasing (without bond counsel)

- Bank capital leasing
  - Standard “subject to appropriation” capital equipment lease or capital building lease used as a financing mechanism for municipal equipment or building projects
- Becoming more common without bond counsel
- Read documents carefully
  - Often contain tax representations (similar to a tax-exempt bond tax or arbitrage certificate), including representations about bank qualification, arbitrage compliance, private use compliance and post-issuance compliance procedures
  - Make sure you know who is filing the Form 8038-G and that it actually gets filed
  - Make sure you, as finance officers, know what your public works people are doing

Securities Law Update

- SEC Enforcement
  - Recent SEC actions against Edward Jones and Stina Wishman

- Status Update on MCDC Initiative

The case against Edward Jones

- Order against Edward D. Jones & Co., L.P. dated August 13, 2015
- Cease-and-desist proceedings found that Edward Jones willfully violated Sections 17(a)(2) and (3) of the Securities Act of 1933 (the "1933 Act") and Section 15B(c)(1) of the Securities Exchange Act of 1934 (the "1934 Act") and Municipal Securities Rulemaking Board Rules G-17, G-11(b) and (d), G-27 and G-30.
- As an underwriting co-managing syndicate member for new issue negotiated municipal securities, Edward Jones in certain situations failed to make bona fide public offerings
- In the secondary market for municipal securities, Edward Jones failed to have internal controls to prevent certain improper trading practices
- Monetary penalties totaled around $20,000,000

The case against Edward Jones

- Edward Jones' misconduct harmed its customers by causing them to pay higher prices for municipal bonds, and in one instance resulted in an adverse federal tax determination for a municipal issuer.
- In the secondary market, Edward Jones was been unable to adequately monitor whether the markups it changed for certain transactions were reasonable
- Underwriters using Agreement Among Underwriters (AAU) obliged to make a public offering of all of the bonds at the initial offering price in effect at the time allocated bonds by the issuer and senior manager
- Question: Who is responsible for Issue Price Certificate? What should parties expect from syndicate members?

The case against Stina Wishman

- Former head of municipal syndicate desk at Edward Jones – settled at same time as the Edward Jones matter was
- Failed to make bona fide public offerings to Edward Jones' customers at initial offering prices in certain instances when the firm acted as an underwriting co-managing syndicate member for new issue negotiated securities
- SEC imposed monetary penalties in addition to bar from practicing

SEC's New Interest in Municipal Issuers

- SEC new focus on municipal market issuers and professionals
- Increasing enforcement activity in municipal securities market
- Municipal securities are generally exempt from registration requirements under Securities Act of 1933
  - Are subject to anti-fraud provisions of the securities laws

Objectives of antifraud provisions

- Objectives of 1933 Act and 1934 Act
  - Disclosure of material information about securities to allow investors to make informed decisions
  - Prohibit misrepresentation or other fraudulent conduct in connection with the purchase or sale of securities
- Municipal securities exempt from registration are not exempt from the antifraud provisions
  - Section 17(a) of 1933 Act
  - Section 10(b) of 1934 Act and Rule 10b-5

MCDC Initiative background

- On March 10, 2014, the SEC's Enforcement Division introduced an initiative to encourage self-reporting:
  - By municipal securities issuers, obligated persons, and underwriters of possible securities law violations; and
  - Related to misrepresentations in offering documents concerning an issuer's prior compliance with its continuing disclosure obligations
- "*Municipal bond disclosures must provide investors with an accurate portrayal of a project's prospects and the municipality's ability to repay those who invest*[.]" — Andrew J. Ceresney, Director of the SEC Enforcement Division
- The Municipalities Continuing Disclosure Cooperation Initiative (MCDC Initiative) is the latest SEC effort in a long campaign to require timely, accurate, and uniform secondary market information from municipal securities issuers

MCDC Initiative: An Overview

- Under the MCDC Initiative, the Enforcement Division will recommend "favorable settlement terms" upon self-reporting, including:
  - Not levying a financial penalty against issuers
  - Tiered financial penalties against underwriters – with penalties range from $20,000 to $500,000, depending on the size and number of offerings reported
- Issuers settlement terms to include: establish appropriate policies and procedures and training regarding continuing disclosure obligations within 180 days of the institution of the proceedings;
- comply with existing continuing disclosure undertakings, including updating past delinquent filings within 180 days of the institution of the proceedings;
- cooperate with any subsequent investigation by the Division regarding the false statement(s), including the roles of individuals and/or other parties involved;
- disclose in a clear and conspicuous fashion the settlement terms in any final official statement for an offering by the issuer within five years of the date of institution of the proceedings; and
- provide the Commission staff with a compliance certification regarding the applicable undertakings by the issuer on the one year anniversary of the date of institution of the proceedings.

MCDC Enforcement: Underwriters

- A total of 58 actions announced in two waves
- SEC provided an identical federal securities law analysis in each of its actions against underwriting firms
  - Rule 15c2-12(f)(3) requires "that a final official statement set forth any instances in the previous five years in which an issuer of municipal securities, or obligated person, failed to comply in all material respects with any previous continuing disclosure undertakings"
  - According to SEC, underwriters participated in offerings in which statements regarding an issuer's or obligated person's past continuing disclosure compliance were materially false or misleading, and the underwriter failed to discover such material misrepresentations and omissions through adequate due diligence

MCDC Enforcement: Underwriters

- Each order includes a CDA noncompliance example
- Examples illustrate that SEC took a broad view of materiality standard
- A statement or omission must be “misleading as to a material fact”
- A fact is material “if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”
- Omitted information is considered material if there is a “substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available.”

MCDC Enforcement: Underwriters

- Broad range of examples from complete non-compliance to failure to cross-reference public information that was otherwise timely
- Compare:
  - A 2013 negotiated securities offering in which an issuer failed to disclose that since 2009 it had not made any filings it had previously undertaken to make, and had not filed notices of late filings for each of those
  - A 2012 competitive securities offering and a 2012 negotiated offering in which an issuer failed to disclose that it filed an annual financial report eight months late, and failed to file a required notice of late filing for that report. While the required annual financial report had been included in an official statement before the deadline, the issuer failed to provide within EMMA a cross-reference to that official statement

MCDC Enforcement: Underwriters

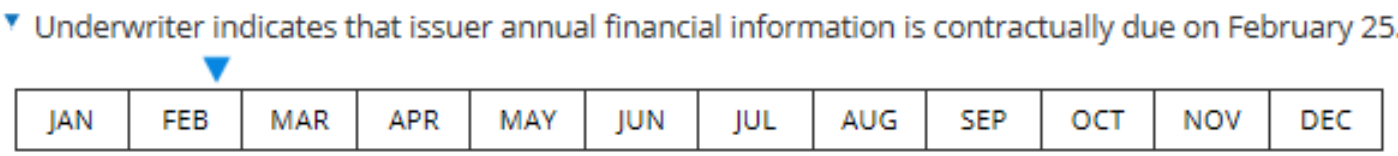
- In its MCDC orders, the SEC did not distinguish between misstatements and omissions
- Misstatement:
  - Where issuer states that in the previous five years it has complied in all respects with its previous continuing disclosure undertakings which in fact there have been instances of material noncompliance

  or

  - Where issuer did not fully disclose the extent of its noncompliance
- Omission:
  - Official Statement makes no statement as to issuer's compliance with its previous continuing disclosure requirements
    - The U.S. Supreme Court has stated that "[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5" or Section 10(b), and thus does not constitute a fraud
    - "[F]irms are entitled to keep silent (about good news as well as bad news) unless positive law creats a duty to disclose."

MCDC Enforcement: Underwriters

- Examples focus on noncompliance regarding financial information and operating data
- Late filings referenced ranged from 16 days to 1,204 days late
- Reference lack of failure to file notices
  - Already publicly available?



- Issuers and obligated persons included in examples were not specifically named

MCDC Enforcement: Underwriters

- Negotiated v. Competitive Offering
  - In the examples citing competitive offerings, the SEC notes that the firm acted as underwriter in a prior offering
- Dissemination Agents and Trustees
  - In the examples provided by the SEC, the SEC does not take into consideration whether a failure was the result of the issuer's actions or its trustee's or dissemination agent's actions
- Public Websites and Publications
  - In the examples provided by the SEC, the SEC does not take into consideration whether financial information was otherwise available on a public website (other than EMMA) or in a publication

MCDC Enforcement: Underwriters

- Many of the compliance issues identified through the MCDC process were the result of issuers and obligated persons committing to provide continuing disclosure information beyond Rule 15c2-12 disclosures (such as committing to annually update a table in the official statement)
- An ongoing issue will be whether continuing disclosure agreements should be narrowed to help ensure compliance

Self-Reporters Who Have Not Settled

- Likely to be another set of enforcement actions against underwriters before the SEC moves on to issuers and obligated persons
- Expect to hear from the SEC
- Not clear whether SEC will cross-reference underwriter and issuer/obligated person self-reports
- Gather all materials and documents
  - Document retention policies
  - IT systems
  - Compliance training
- Preserve the attorney-client privilege
- Individuals subject to exposure require separate counsel
  - Conflict of interest

Non-Reporters

- Statute of limitations has continued to run
- Where underwriter has elected to self-report, but issuer has not reported, or vice versa, SEC may act directly
- SEC can proceed both:
  - Informally
  - Formally

SEC Initiates Investigation

- Obtain counsel
- Retain/preserve documents
- Preserve the attorney-client privilege
- Seek to narrow the scope of broad document requests
- Evaluate whether there is a duty to disclose

Informal Investigation

- SEC has not yet sought authority to issue subpoenas for compelling documents and testimony
- Informal inquiries are not publicly disclosed
- SEC likely to approach issuers or underwriters and ask for:
  - Voluntary production of documents
  - Witness testimony
- Results of an informal inquiry
  - No evidence of violation
  - Evidence of violation

Formal Investigation

- Does not require prior informal investigation
- Generally remains non-public
- Begins with formal order of investigation
- Witnesses receive greater procedural protections
- Concludes with either:
  - No action
  - Enforcement action

Questions & Answers

- Feel free to ask questions during our remaining time, or contact either of us after the Conference.

- Thank you for attending!

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