Nowhere to Hide
The Latest Rules and How They Affect You (the Issuer)

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ICCCFO
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Part 1. Illinois Legislative Update

Part 2. Recent Federal Securities and Tax Enforcement Activity
Part 1
Illinois Legislative Update

A. Open Meetings Act (OMA)

- Requires an agenda to be posted at the principal office of the Issuer and at the location of the meeting at least 48 hours before the meeting


- On May 22, 2012 (effective date January 1, 2013), OMA amended to also require that the agenda set forth the general subject matter of any resolution or ordinance that will be the subject of final action at the meeting
B. Alternate Bonds

- Local Government Debt Reform Act amended
- New conditions for the issuance of alternate bonds:
  - Backdoor petition period lengthened from 30 to 45 days
  - Number of required petitioners reduced
  - Feasibility reports (if necessary to demonstrate coverage) must be prepared by a party not otherwise involved in the financing
- New conditions do not apply to:
  - Alternate bonds issued by governmental units with 500,000 or more inhabitants
  - Alternate bonds payable solely from enterprise revenues that finance or refinance projects concerning public utilities, public streets and roads or public safety facilities
  - Alternate bonds payable in whole or in part from a revenue source (e.g. state aid, sales taxes, CPPRT)
Illinois Legislative Update (continued)

C. County Board of Election Commissioners

- Election Code allows certain counties to vote to establish a county board of election commissioners
- On July 29, 2013, Governor signed into law a bill that establishes a county board of election commissioners for Lake County (no referendum required)
  - Lake County Board of Election Commissioners will replace the Lake County Clerk as the election authority
- New legislation also allows Peoria County to vote to establish a county board of election commissioners notwithstanding the operation of the City of Peoria under the City Election Law
  - If referendum is approved, the Peoria County Board of Election Commissioners will supersede the City of Peoria Board of Election Commissioners
Part 2
State of National Municipal Bond Market

- Predictions of Default
  - Meredith Whitney, 60 Minutes, December 2010
    - “Significant” municipal bond defaults starting in 2011, totaling "hundreds of billions" of dollars in losses.
  - Economist Nouriel Roubini, February 2011
    - $100 billion of municipal defaults during the next five years.

- Municipal Bankruptcies (more than 28 since 2010)
  - Three California Municipalities: Stockton, San Bernardino and Mammouth Lakes
  - Jefferson County, Alabama
  - Detroit

- Demise of bond insurers

- Rise of the REGULATORS!
Recent Federal Securities and Tax Enforcement Activity

1) SEC enforcement actions and the importance of disclosure and post-issuance compliance
SEC Enforcement Actions

A. Primary Market Disclosure
B. Secondary Market Disclosure
C. Federal Tax Issues
A. Primary Market Disclosure—Overview

- The official statement is a document prepared by, or on behalf of, the Issuer in connection with a primary offering of its bonds
- The official statement discloses all material information on the offering
- The official statement is the main source of anti-fraud liability in a municipal transaction
- The obligation for the accuracy and completeness of the disclosure lies with the Issuer
  - Experts may assist, but cannot completely discharge, the Issuer’s obligation
  - Issuer, Underwriter, Financial Advisor, Attorneys all have potential anti-fraud liability for material misstatements and omissions in an official statement
- Recent SEC Enforcement Actions Re Primary Market Disclosure:
  - City of San Diego (2008)
  - State of New Jersey (2010)
  - State of Illinois (2013)
  - West Clark Community Schools (Indiana) (2013)
A. Primary Market Disclosure—Rules

- Anti-Fraud Provisions
  - ‘34 Act – Section 10 & Rule 10b-5; ‘33 Act - Section 17(a)
  - Prohibits fraud in the offer or sale of securities
  - Unlawful to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading

- SEC Rule 15c2-12
  - Requires underwriters of municipal securities to:
    - Obtain, review and disseminate an official statement
    - Ensure that Issuer has undertaken (contracted) to provide certain continuing disclosures to the market (Continuing Disclosure Undertaking or CDU)
A. Primary Market Disclosure—Recent SEC Enforcement Actions

San Diego (2008)

- Pension plans were intentionally being underfunded; the extent of underfunding was not disclosed in official statements.
- SEC alleged that the city manager and others responsible for official statements made false and misleading disclosures intentionally.
- In 2008, SEC charged five San Diego officials with fraud in connection with such false and misleading financial statements in five bond offerings from 2002 and 2003.
- In 2010, SEC settled with most of the officials; personal fines ranged from $5,000 to $25,000.
State of New Jersey (2010)

- In 1997, with funded ratio over 100%, NJ stopped contributing to pension plan
- Pension plan funded ratio declined
- In 2004, NJ established a 5-year, ramp-up plan to achieve full funding
- In 2006, NJ abandoned the plan
- NJ continued to make disclosures about the plan after abandonment
- SEC alleged violations of federal securities laws
  - Specifically, making material misstatements and omissions regarding pension plan in bond offering documents (79 offerings totaling $26 billion issued between August 2001 and April 2007)
- In 2010, SEC issues cease and desist order
  - Settlement terms unknown
  - Generally understood that this included requirement to have disclosure counsel review and evaluate disclosure
A. Primary Market Disclosure—Recent SEC Enforcement Actions (continued)

State of Illinois (2013)

- As a result of level contributions and rising costs, by 1995, the IL pension systems were significantly underfunded.
- In 1995, IL instituted a funding plan to achieve a 90 percent funded ratio for each pension system by 2045.
- However, contributions under the plan were to be phased in over a 15-year ramp period.
- From 1996 to 2010, IL unfunded liability increased by $57 billion.
- SEC alleged that IL official statements between 2005 and 2009 ($2.2 billion in securities in multiple offerings) were materially misleading.
- IL did not disclose to investors the statutory underfunding or phase in.
- SEC concluded that reasonable investors would have viewed such information as significantly altering the total mix of information regarding the financial condition and future prospects of IL.
A. Primary Market Disclosure—Recent SEC Enforcement Actions (continued)

*West Clark Schools (Indiana) (2013)*

- School District entered into a CDU in connection with a 2005 bond issue
- School District represented it was fully compliant with the 2005 CDU in an official statement for a 2007 bond issue
- SEC charged School District with falsely representing its CDU compliance in the official statement
- SEC also charged the underwriter of the 2007 bonds with failing to conduct sufficient due diligence to determine if the School District’s representation was true
- CDU non-compliance was “a fact [the underwriter] could easily have verified”
- School District, Underwriter and SEC entered into a settlement agreement; Underwriter paid $580,000 in fines and disgorgement; School District agreed to certain remedial actions
A. Primary Market Disclosure—SEC Enforcement Actions—Takeaways

- Disclosure should not be a routine procedure of inserting new numbers in the last official statement
- Issuers should adopt, and follow, policies and procedures for updating and reviewing disclosures
- Such policies and procedures:
  - May involve formalization of existing procedures (e.g. hiring disclosure counsel or other municipal finance professionals to assist with disclosure)
  - Should set forth responsibilities of staff with respect to disclosure
  - Should set forth responsibilities of governing board with respect to disclosure
    - Delegation of responsibility to staff and/or outside professionals must be reasonable
B. Secondary Market Disclosure—Overview

SEC Rule 15c2-12

- Prohibits an underwriter from underwriting bonds unless the Issuer has agreed to provide certain information and event disclosures to the market (CDU)
- CDU filings must be made on EMMA (Electronic Municipal Market Access) portal
- Bondholders may sue for specific performance
- Issuers must disclose CDU non-compliance in official statements (five year look back)

Primary Market Penalty for Secondary Market Disclosure Failure?

- Access to market: underwriter must reasonably believe Issuer will comply with CDU in order to underwrite bonds
- Increased borrowing costs?

Recent SEC Enforcement Actions Re Secondary Market Disclosure:

- West Clark Community Schools (Indiana) (2013)
- Harrisburg (2013)
- Miami (2013)
B. Secondary Market Disclosure—Rules

- If new issue is less than $1,000,000: **No CDU**
- If new issue is sold directly to a bank: **No CDU** (generally)
- If new issue is at least $1,000,000 and Issuer has over $10,000,000 of debt, Issuer must agree to provide:
  - Annual financial information
  - Audited financial statements
  - Reportable events
- If new issue is at least $1,000,000 and Issuer has less than $10,000,000 of debt, Issuer must agree to provide:
  - Audited financial statements
  - Reportable events
B. Secondary Market Disclosure—Recent SEC Enforcement Action

“Reportable Events”

- There are 14 Reportable Events
- Most common:
  - Payment delinquencies
  - Non-payment defaults
  - Bond calls
  - Adverse tax opinions
  - Rating changes
B. Secondary Market Disclosure—Recent SEC Enforcement Action (continued)

Harrisburg (2013)

- Harrisburg guaranteed $260 million of debt issued to finance improvements to an incinerator
- From 2009-2011, Harrisburg failed to comply with an existing CDU
- As a result, investors had to rely on other statements from Harrisburg, including information on its website, 2009 State of the City address and annual and mid-year fiscal reports, even though such information was not “explicitly intended” for investors
- In the view of the SEC, this available information was materially misleading
- SEC ordered Harrisburg to cease and desist from violating anti-fraud provisions of the federal securities laws
- Harrisburg agreed to various remedial measures
- SEC did not impose a financial penalty
B. Secondary Market Disclosure—Recent SEC Enforcement Action (continued)

*Miami* (2013)

- SEC charged the City and budget director with violations of the anti-fraud provisions of securities laws and filed a complaint in federal court.
- SEC also claimed the City violated a 2003 cease-and-desist order due to prior violations of the anti-fraud provisions.
- SEC alleges that during 2007 to 2009, the City transferred funds from its capital projects fund to its general fund in order to mask losses in the general fund and maintain its bond rating.
- SEC further alleges the City and budget director misrepresented and concealed the transfers.
- CDU filings and offering documents during this time should have included transfers.
B. Secondary Market Disclosure—SEC Enforcement Action—Takeaways

- SEC clearly expects underwriters to enforce market access penalty for CDU non-compliance.
- Issuers that repeatedly fail to make CDU filings may not be able to access public market.
- Issuers that fail to make CDU filings may also face SEC action for other statements that reach the market, if materially misleading.
- Statements that are reasonably expected to reach the securities market, even if not prepared for that purpose, cannot be materially misleading.
C. Federal Tax Issues—Overview

Issuer may need to monitor compliance with:

- Arbitrage Rebate
- Private Activity Rules
- BAB and RZEDB Rules

Various consequences of non-compliance with tax rules:

- Interest treated as taxable
- Loss of BAB/RZEDB subsidy, if applicable
- Additional arbitrage rebate may be owed (non-paid or underpaid rebate amounts, plus interest)
- Penalties
- Disclosure to the market

Recent SEC Enforcement Action Re Federal Tax Issues

- South Miami (2013)
C. Federal Tax Issues—Rules

Arbitrage Rebate

- **Arbitrage**: Spread between the interest due on tax-exempt bonds and the earnings on the investment of such tax-exempt bond proceeds in higher yielding taxable securities.
- **Rebate**: Issuer must pay (or rebate) arbitrage profits to federal government.
- **Exceptions**:  
  - Small Issuer Exception  
  - Spend Down Exceptions
C. Federal Tax Issues—Rules (continued)

Private Activity

- “Private business use” occurs when more than 5% of bond proceeds finance a public facility that is used by nongovernmental trade or business
  - Examples of private use:
    - Sale, transfer or lease of property to private user
    - Management of property by private user under a management contract
- “Private payment or security” occurs when more than 5% of bond proceeds are secured by an interest or derived from payments related to “private business use” of the property
  - Example of private payment:
    - Payments of lease rentals to the issuer by a private operator
C. Federal Tax Issues—Recent SEC Enforcement Action

*South Miami* (2013)

- City borrowed $6.5 million in 2002 and $5.5 million in 2006 in two pooled, conduit bond offerings to finance a parking structure
- City violated the private activity rules by leasing proceeds of the 2002 borrowing to a private developer and restructuring a lease agreement with the private developer
- In order to preserve the bonds’ tax-exempt status, the City entered into agreements with the IRS, paying $260,345 to the IRS and defeasing certain of the bonds
- SEC charged the City with failing to disclose the fact that the City had jeopardized the tax-exempt status of the bonds
- City settled with the SEC and agreed to retain third-party consultant to oversee its policies, procedures and internal controls for municipal bond disclosures
C. Federal Tax Issues—SEC Enforcement Actions—Takeaways

- ** Arbitrage Rebate post-issuance compliance tips:**
  - Obtain computation of bond yield and establish procedure to track investment returns
  - Monitor compliance with temporary period expectations for expenditure of bond proceeds
  - Monitor compliance with spending exceptions to rebate, if relevant
  - Arrange for timely computation of rebate liability, if relevant

- **Private Activity post-issuance compliance tips:**
  - Allocate bond proceeds and funds from other sources to ensure that bond proceeds are used for qualifying costs
  - Map out what outstanding bond issue financed which facilities and in what amounts; monitor private use of bond-financed facilities to ensure compliance with applicable percentage limitations
  - Identify in advance any new sale, lease or license, management contract, or other arrangement involving private use
  - Promptly consult with bond counsel as to any possible private use—remedial actions may be available

**Need to stay compliant with tax rules—jeopardizing tax exemption is material and needs to be disclosed to bondholders in CDU**
2) IRS compliance checks, VCAP and audits
IRS Enforcement—Overview

- The Tax Exempt Bonds (TEB) office has a staff of more than 90 people.

- In the past fiscal year, the TEB office:
  - Executed 46 closing agreements under its voluntary closing agreement programs (VCAP), obtaining $110 from these settlements
  - Closed 1,481 audits
  - Completed 453 compliance checks of advanced refundings and Build America Bonds

“We continue to emphasize the abusive transaction area and have a lot of work going on in that area. We have seen a number of settlements related to abusive transactions this year.” – Cliff Gannett, acting director of government entities at the IRS

IRS Enforcement—Overview - continued

- Three types of IRS enforcement activity
  - Compliance check questionnaires
    - Evaluates the post-issuance and record retention policies, procedures and practices of Issuers
    - Requests information on the use and investment of bond proceeds
    - Not specifically related to a particular bond issue
    - May address a particular type of bonds/borrower/issuer
    - Voluntary (?)
  - Voluntary Closing Agreement Program (VCAP)
    - Self report violations
    - Expectation is that the Issuer will receive more favorable treatment from IRS than in audit context
  - Audit
Questions
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