Bond Case Briefs

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NABL: More from the SEC.

The SEC Commissioners again this week gave muni market participants a great deal to think about. First was a speech by Commissioner Daniel Gallagher which revisited some of the themes he raised in a speech last May concerning how liabilities, particularly pension liabilities, should be disclosed. Later in the week, SEC Chair Mary Jo White gave a speech concerning disqualifications, exemptions and waivers under the securities laws, subjects which are of interest to broker-dealers who may enter into consent decrees under MCDC. While Chair White's speech did not specifically talk about the muni market or MCDC, her remarks were enlightening not only about disqualifications and waivers but also about what she thinks is the
best approach to enforcement.

Commissioner Gallagher noted "growing calls for changes to the bond disclosure regime, particularly in the muni space." In particular, he said

> The failure by municipal issuers to provide adequate disclosures of underfunded pension plans is an unpardonable sin. Politically-powerful state workers' unions, and state constitutional protections for benefits, make the reduction of these liabilities extremely difficult. The failure to set aside adequate funds to cover these liabilities creates a material risk that future payments to bondholders would need to be sacrificed. This risk is not merely theoretical; we have seen it play out already in Detroit's bankruptcy.

He goes on to say that "municipalities have taken advantage of heretofore lax governmental accounting standards to hide the yawning chasm in their balance sheets." He acknowledged that the new GASB standards regarding pensions were an improvement and can result in better disclosure of pension liabilities but he called for GASB to bring back the Annual Required Contribution, which he described as "an easy point of reference to help investors and voters compare the contribution that would be required to steadily chip away at these accumulated liabilities with that which was actually appropriated." (The definition of Annual Required Contribution and other pension-related terms can be found in the appendix to NABL's Considerations in Preparing Disclosure in Official Statements Regarding an Issuer's Pension Funding Obligations(Public Defined Benefit Pension Plans).)

However, as beneficial as Commissioner Gallagher finds the GASB rules, their use is voluntary. Commissioner Gallagher's solution is "a legislative fix to mandate the use of GASB standards for municipal issuers." That mandate could take the form either a grant of authority for the SEC to recognize GASB standards as it recognizes FASB or – and this is what got some attention – conditioning the exemption of municipal securities under the securities laws on the use of GASB standards.

One could read the text of the speech to mean that he was talking about the exemption of interest on municipal securities from federal income tax, but a footnote makes it clear he was talking about securities laws. Conditioning tax exemption on providing certain pension disclosures, though, has been proposed by Congressman Devin Nunes (R-CA) (H.R. 1628 in the 113th Congress). Congressman Nunes is a senior member of the House Ways and Means Committee and an original co-sponsored of his bill was Rep. Paul Ryan (R-WI), now chair of that committee and a representative from a state whose governor and legislature have been involved in disputes with unions, particularly public employee unions, that have gotten national attention. Congressman Nunes' proposal should not be discounted.

Chair White's speech dealt generally with the automatic disqualifications under the securities laws and the process by which the Commission grants waivers from those disqualifications. Whether waivers will be granted in MCDC cases has become a concern among some broker dealers.

Chair White also discussed her view of what incentives are most effective in inducing compliance with the securities laws and she was very clear:

> In my experience, in the enforcement arena, the most effective deterrent is strong enforcement against responsible individuals, especially senior executives. In the end, it is people, not institutions, who engage in unlawful conduct. And the greatest disincentive for wrongdoing occurs when people believe that their own liberty, reputations and livelihoods are on the line and they recognize that real, personal consequences will follow from their misconduct. "It isn't worth the price" becomes the equation, an equation that is harder to have internalized by an impersonalized institution. (Emphasis added).

We could well see more enforcement actions against issuer officials.

National Association of Bond Lawyers

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