Bond Case Briefs

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Continuing Disclosure in the Municipal Bond Market: Importance of Compliance.

When Congress passed the Tax Cuts and Jobs Act (TCJA) late last year, a much-heralded provision of TCJA was the reduction in the federal corporate income tax rate, from 35 percent to 21 percent. However, that reduction has had unforeseen consequences for the municipal bond industry. The reduction in the tax rate is expected to result in efforts by banks to increase the interest rates charged by banks for current outstanding loans to municipalities and 501(c)(3) tax-exempt organizations. Whether a bank may increase the interest rate on a loan will depend on the language of the loan documents. Even if the loan documents permit the bank to unilaterally increase the interest rate, some banks may be hesitant to do so, as the request may be received poorly, potentially jeopardizing the bank's ongoing relationship with the borrower.

Due to these concerns and others, there is speculation that banks will revisit their tax-exempt debt portfolios in 2018, scaling back their holdings and purchasing less tax-exempt debt in the future. For municipalities that traditionally have financed their capital needs through bank loans, the pool of available banks for such loans may shrink, with the remaining choices offering less attractive financial terms. Municipalities may also be turned off by the prospect of another bank placement of their debt after receiving notices of interest rate increases on their existing debt due to the passage of the TCJA.

Therefore, some municipalities may be considering a public offering of bonds after being out of the market for a few years. While the basics of a municipal bond transaction have not changed, a municipality that hasn't been in the market for a few years should expect to see some differences in how the transaction unfolds. Municipalities should anticipate seeing a heightened emphasis by the underwriter on confirming the municipality has met its continuing disclosure undertaking responsibilities and is able to continue to meet those responsibilities in the future.

Municipal bonds are regulated by the U.S. Securities and Exchange Commission (SEC) and the Municipal Securities Rulemaking Board (MSRB). Under the securities laws, the SEC and the MSRB are prohibited from requiring any issuer of municipal securities to make any filings with the SEC or the MSRB prior to the sale of securities. The MSRB is further limited in its ability to require any municipal issuer to furnish it or any purchaser or prospective purchaser with any documents.

Despite this prohibition, the SEC and the MSRB have been successful in requiring municipal issuers to make specific disclosures and to file documents of various types with the MSRB, through SEC Rule 15c2-12. Under this rule an underwriter of municipal bonds (which may be regulated by the SEC) may not market the bonds unless it obtains a written commitment from the municipal issuer to make periodic disclosure filings. The written commitment of a municipal issuer to make periodic disclosure filings is generally called a "Continuing Disclosure Agreement," or CDA.
Under the CDA, the municipal issuer agrees to file with the MSRB its financial statements and certain operating data on an annual basis. In addition, under the CDA the issuer agrees to file with the MSRB notices of the occurrence of certain significant events (such as rating changes or defaults on the bonds). The filings are made with an electronic system established by the MSRB called the

Electronic Municipal Market Access system, or EMMA .

Municipal issuers that have not undertaken a public offering of bonds in recent years may be familiar with these “basics” of continuing disclosure, but may not be aware of the heightened interest the SEC has shown lately on this issue and ensuring that municipal issuers comply with their continuing disclosure obligations. Many in the industry trace this heightened interest to 2014, with the announcement by the SEC of its Municipalities Continuing Disclosure Cooperation (MCDC) Initiative.

Under MCDC, municipal issuers and underwriters were afforded the opportunity to self-report if they were involved in bond issues in the last five years in which the offering documents for the bonds did not accurately report the issuer’s historic compliance with Rule 15c2-12. For example, a municipal issuer might have chosen to self-report under MCDC if it had failed to disclose in an offering document that it had failed to file annual financial information for a prior bond issue, as required by its CDA. To encourage self-reporting, the SEC offered both a carrot (favorable, standardized settlement terms) and a stick (increased sanctions for unreported violations discovered later).

The MCDC Initiative ended on Sept. 10, 2014, and the SEC subsequently brought enforcement actions against a number of municipal issuers located throughout the country that had self-reported a variety of violations. Municipalities caught up in the enforcement initiative did not face monetary penalties in accordance with the settlement guidelines established by the SEC. Instead, the settlements generally focused on ensuring future compliance with the rule, by requiring issuers to establish appropriate policies and procedures and training regarding continuing disclosure obligations.

The SEC has continued its aggressive enforcement of this issue since the MCDC Initiative ended. In the last few years it has brought actions against issuers and individual officials of issuers, alleging inadequate disclosure in offering documents. For example, in August 2017, the SEC settled charges against the Beaumont Financing Authority of the City of Beaumont, California that the authority made false statements about its prior compliance with its continuing disclosure obligations in five bond offerings. The SEC had discovered the violations in connection with its investigation of municipal issuers and underwriters that had chosen not to participate in the MCDC Initiative.

To settle the charges, the authority had to agree to retain (at the authority’s expense) an independent consultant to review its continuing disclosure policies and procedures and make recommendations for appropriate changes to them. Generally, the authority was required to accept the consultant’s recommendations in order to comply with the settlement. The appointment of an independent consultant would not have been a condition of a settlement under MCDC—if the authority had self-reported.

A municipal issuer entering the bond market in 2018 should expect to see during the underwriting process a heightened level of attention placed on continuing disclosure compliance. Municipalities may be surprised to learn that in connection with the underwriting process they must file one or more notices on EMMA, disclosing that they failed to comply with their continuing disclosure undertakings. In addition, an underwriter may request that a municipality engage a dissemination agent to assume responsibility for future EMMA filings before the underwriter will proceed with a public offering of the municipality’s bonds, if the underwriter has concerns regarding the municipality’s ability to comply with its continuing disclosure responsibilities in the future.

Municipalities that are faced with a request to engage a dissemination agent, or that simply want to lessen the administrative burden placed on their staff in connection with this regulatory mandate, have options when it comes to seeking third-party support. For instance, the attorneys and specialists of the McNees public finance group provide dissemination agent and continuing disclosure support services to municipal issuers, both in connection with an initial public offering of bonds, and on an ongoing basis after the bonds are sold. Contact us to learn more.

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