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Limited Offering Exemption May Be Too High a Compliance Risk

Limited offering exemptions, once a common exemption from the official statement requirements under the federal securities laws, may soon be rarely utilized by underwriters for fear that compliance risks are too high.

That's according to representatives from dealer groups speaking at the 2023 GFOA Annual Conference, who bemoaned the speed and volume with which the Securities and Exchange Commission is producing rule proposals and recapped much of what was said at last week's SEC Municipal Disclosure Conference.

Michael Decker, senior vice president for research and public policy at the Bond Dealers of America, addressing the room full of issuers, attempted to reassure them that there is no direct risk to themselves associated with the limited offering exemption.

"Nobody is going to come after the issuer," Decker said. "The effect you're likely to see is that some underwriters are likely to say we don't want to use this exemption anymore, because the compliance risks are too high. I would just say be prepared."

The limited offering exemption allows underwriters to underwrite deals for which the issuer has not produced an official statement, if the bonds are being sold to 35 or fewer sophisticated investors and the underwriter has a "reasonable basis" to believe that those investors will not sell the bonds on the secondary market.

The Commission has urged those concerned they're in violation of the exemption to reach out and contact the SEC at LimitedOfferingExemption@SEC.gov, similar to the self-reporting encouragement offered when the SEC sought industry-wide settlements in the Municipalities Continuing Disclosure Cooperation Initiative, which was introduced in 2014 to address potentially widespread violations of federal securities laws.

But many regard this new initiative as forcing certain requirements on the market in a particularly aggressive fashion and with it, changing how broker-dealers and underwriters handle compliance.

"MCDC, as well as prior statements from the SEC and enforcement actions from the SEC, really changed the compliance role of the broker-dealer firms in the muni space," said Leslie Norwood, managing director and associate general counsel of the Securities Industry and Financial Markets Association. "A record retention requirement is being imputed for (Rule) 15c2-12, where one is not specifically written into 15c2-12 but regulators have created one out of enforcement."

"Here again, we see the SEC imputing a record retention requirement with regards to the limited offering exception, where nothing is written specifically into the rule," Norwood said, referring to the idea that broker-dealers needed to document their reasonable basis for belief that the bonds would not end up trading. "Regulation by enforcement."

LeeAnn Gaunt, chief of the SEC enforcement division's Public Finance Abuse Unit, said around the time that MCDC was concluding in 2016 that MCDC both raised the level of awareness of continuing disclosure problems and led to improvements in the market. But how far they'll take this enforcement of the limited offering exemption remains uncertain.

But the fact that the Commission seems to pick up a niche issue (Gaunt said at last week's SEC Municipal Disclosure Conference that she'd only recently heard of the exemption) and enforce it en masse does cause concern for other areas, such as green bonds.

For the muni market, there are two major concerns when it comes to ESG so far. The first is climate risk disclosure which, has to do with climate risks which could impact issuers' ability to repay debt and what issuers are doing to mitigate those risks. The other is labeled bonds, which simply means designating bonds as ESG. It's this latter which is causing some concern for BDA's members, Decker said.

"There's not really a standard for what constitutes a green bond," Decker said. "There are third party evaluating organizations that will tell you to meet their standard for what is a green bond but it's not clear that, 10 years from now or 20 years from now when the SEC really starts to dig into this in an MCDC like way, are they going to accept those standards."

Norwood and Decker agreed that the Commission continues to stack rulemaking proposals on top of each other that have caused a dizzying effect but it also gives the muni market a good opportunity to express its thoughts on the many proposals, and express individual concerns.

"This SEC administration has been very aggressive in their regulatory agenda across markets," Decker said. "On the other hand, staff went out of their way to say they really welcome feedback." He views this as an opportunity to take them up on it.

By Connor Hussey

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