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 **NORTON ROSE FULBRIGHT**

The Metropolitan Water District of Southern California: Disclosure Responsibilities Under the Federal Securities Laws

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Why this Training?

- United States Securities and Exchange Commission repeatedly emphasizes that disclosure is primarily the issuer's (Metropolitan's) responsibility because issuer officials and staff are in the best position to know material facts.
- Board potentially violates securities laws by authorizing disclosure it knows to be false or by not raising material issues that are within its knowledge that could affect the security for the Bonds.
- Training helps to focus on responsibilities with respect to disclosure and to help identify material issues.
- SEC is increasingly active in enforcing disclosure violations in the municipal market -- particularly against issuers and issuer officials and staff. We will review certain of those actions.
- SEC can bring antifraud actions based on negligence or control person liability (lack of reasonable disclosure process).

Disclosure Principles (All Disclosure Documents)

- Investors want to know information that could materially affect, positively or negatively, Metropolitan's ability to repay the money it borrows through bond issues.
- Disclosure should:
 - Provide main points but do not overwhelm readers with detail
 - Explain what revenue sources (security) is being used to repay the bonds and disclosing things that can affect the availability of that revenue source (materiality).
 - Highlight important developments or events that could affect the pledged revenue source appropriately. Supply issues. Demand issues. Expenses and litigation.
 - Determine appropriate level of importance for any particular event, revenue source or budgetary item keeping big picture in mind
 - Focus on developments specific to Metropolitan and not general market or other forces
 - Be the result of an ongoing process including consultation with disclosure counsel.

When do Disclosure Rules Apply?

- Primary Disclosure/new offerings (POS and Official Statement): **Issuer has primary responsibility** because issuer and issuer officials and staff are in best position to know material facts.
- Continuing disclosure. Annual and material event reporting.
- Any other circumstance where an Issuer is “speaking to the market” such as voluntary disclosure. *Generally no requirement to update or correct statements previously made – even Rule 15c2-12 does not require a notice filing for “other material events.” Political statements and other individual statements of Issuer officials would generally not be considered to be “speaking to the market” unless the Issuer was not providing official disclosure as required by law.*

Primary Offering Process (Drafting POS/OS)

- How Appendix A fits into Metropolitan's disclosure document (POS/OS) and how investors use this information.
- Input from involved staff and officials with the best knowledge about issues that materially affect disclosure (e.g. counsel with respect to significant (material) litigation).

Federal Securities Laws -- The Securities Act of 1933

- 1933 Act has two substantive rules:
 - Registration requirement
 - Antifraud rule
- Municipal securities are exempt from the registration requirement, but are subject to antifraud rule
- Section 17(a)(2) prohibits any person from, directly or indirectly, obtaining money or property by means of any untrue statement of a *material* fact or by a misleading omission.
- Violations can be based on negligence. There does not need to be an intent to deceive.

Securities Exchange Act of 1934 and Rule 10b-5

- 1934 Act contains antifraud provisions
- 1975 amendments to 1934 Act made it clear that antifraud provisions apply to government issuers

Rule 10b-5 states “It shall be unlawful for any person ...

- a) To make any untrue statement of a material fact or to 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 ...”
- No material misstatements
 - No materially misleading omissions

The “Materiality” Standard

- “[w]hether or not there is a substantial likelihood that a reasonable investor or prospective investor would consider the information important in deciding whether or not to invest.”
- Materiality is determined in context of all the facts and circumstances, but usually on a retroactive basis in court cases or SEC enforcement actions.
- *Cannot reduce materiality to a set percentage of revenues (5%). This can be a helpful point to start discussions but other factors will apply.*

The “Materiality” Standard (continued)

- Disclosure regarding complex, uncertain and evolving risks (cybersecurity, climate) should focus on what the issuer (Metropolitan) is actually doing with respect to each type of risk even if it is not doing anything with respect to a particular risk. SEC staff view is that merely stating that a risk exists and that it is a uncertain risk that could materially and adversely affect the issuer is “insufficient” to guide investors in a meaningful manner.
- When information pertains to a possible future event, “materiality will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event.”
- Politically sensitive information still must be disclosed (greed can be the downfall of corporate issuers – sometimes politics is the downfall of municipal issuers).

Roles of Professionals with Respect to Disclosure

Why doesn't paying all of these professionals for their services absolve Metropolitan and its officials and staff of responsibility for disclosure misstatements and omissions?

- Disclosure Counsel
- Bond Counsel
- Underwriters and Underwriter's Counsel
- Municipal Advisor
- Accountants
- Feasibility Consultants

Most do not have an obligation to verify information provided by Metropolitan. (Allen Park) No protection if Issuer withholds information from professionals. (Montebello USD)

SEC Enforcement Actions – Lessons for Issuers

- **Does it matter if specific harm to investors can be demonstrated?**
No. Unlike private litigants the SEC is not required to allege harm with respect to disclosure violations.
- In SEC's view, prior use of "cease and desist" orders did not send strong enough message to issuers and issuer officials and staff.
- SEC continues to impose civil penalties against municipal officials.
 - Westlands Water District: \$50,000 penalty against general manager/general counsel. \$20,000 penalty against former assistant general manager.
 - City of Harvey, Illinois: \$10,000 penalty against sitting mayor and \$30,000 (plus disgorgement and interest) against former comptroller.
 - City of Allen Park, Michigan: \$10,000 penalty against former mayor.
 - Rhode Island Economic Development Commission: \$25,000 penalty against former executive director. \$25,000 penalty against former deputy director.
- SEC is increasingly focused on individual issuer official conduct making it important to have an understanding of what the federal securities laws actually prohibit and what types of conduct can trigger those prohibitions.

SEC Enforcement Actions – Lessons for Issuers

- Orange County, California – **Governing Board Responsibility**
- SEC charged Treasurer and Assistant Treasurer but also issued a broad-ranging Report of Investigation concerning the conduct of individual members of the Board of Supervisors. SEC found that:
 - Board should have taken steps appropriate under the circumstances to ensure adequate disclosure of the County’s finances;
 - Board cannot rely on its professional advisors for information within its knowledge, for example, budget information;
 - public officials cannot authorize disclosure known to be false or in reckless disregard of the facts; and
 - SEC considers Board approval of disclosure documents (or review and comment by the Board) as part of the reasonableness of the overall disclosure process (control person liability). Board approval is not always required but depends on the organization.

SEC Enforcement Actions – Lessons for Issuers

- Allen Park, Michigan – **Control Person Liability for Municipal Officials.**
- **What did the SEC do?** In 2014, the SEC for the first time imposed “control person” liability on a municipal official. Under this doctrine, a control person may be held liable for the securities law violations of the persons over whom he or she exercises control. (Remember Orange County Board of Supervisors example).
- SEC focused on the Mayor of Allen Park’s status as a person of control within City structure even though City Administrator handled the bond issue. For “control person” liability, the SEC is not required to prove that control persons have knowledge of fraudulent activity. Participation in the fraud is unnecessary. Issuer must supply the defense that they “acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.” Section 20(a) of 1934 Act.
- Control person liability poses new risks for municipal officials. The implementation of disclosure policies and procedures as well as training programs may help establish the “good faith” defense for issuer officials and staff in supervisory positions.

Summary

- Board potentially violates securities laws by authorizing disclosure it knows to be false or by not raising material issues that are within its knowledge that could affect the security for the Bonds.
- Word for word review of disclosure is not required but Board should raise questions about any material issues or areas of concern to make sure they are disclosed appropriately.
- SEC increasingly focused on bringing charges against individual municipal officials.
- Generally the counsel and advisors you hire do not have to do an independent investigation of facts about Metropolitan – they assist you based on the facts that you communicate to them.
- Remember antifraud violations can arise from negligence or status as a control person and not an intent to deceive.

The logo consists of a stylized, upward-pointing chevron shape in a gold color, positioned above the first letter of the text.

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