

HOT TOPICS IN DISCLOSURE FOR MUNICIPAL BONDS & ARBITRAGE ISSUES IN A RISING INTEREST RATE ENVIRONMENT

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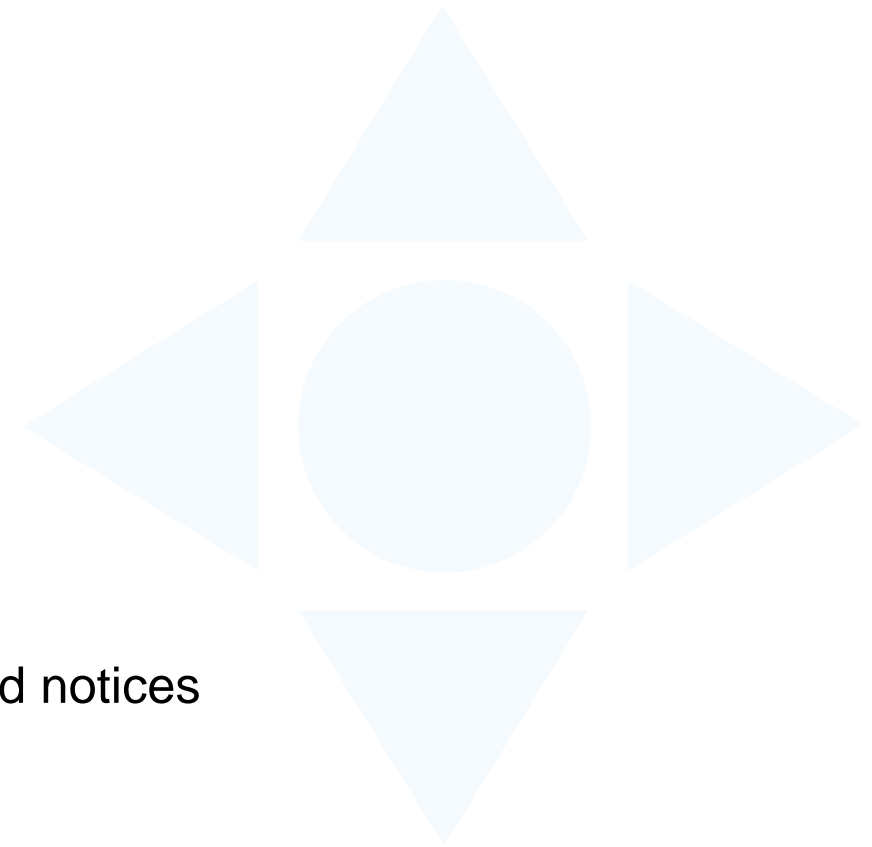
DISCLOSURE FOR MUNICIPAL BONDS

◆ Primary Disclosure

- Offering Documents
 - Preliminary Official Statements
 - Contains information on offered bonds and on the issuer/obligated person
 - Deemed “final” but for certain information to be determined at pricing
 - Official Statements
 - Final with all pricing information (but can be supplemented)
 - Dated as of the date of pricing

◆ Secondary Disclosure

- Continuing Disclosure Agreements
 - Ongoing obligation to update the market via annual financial information and notices
 - SEC Rule 15c2-12



REQUIREMENT TO SPEAK TRUTHFULLY TO THE MARKET

❖ **Section 10(b) of the Securities and Exchange Act of 1934 and SEC Rule 10b-5**

- Prohibits misstatements or omissions of material facts in connection with the purchase and sale of municipal securities and in connection with continuing disclosures
- Requires a finding of intent or recklessness, an extreme departure from the standard of ordinary care

❖ **Section 17(a) of the Securities Act of 1933**

- Makes it unlawful to "employ any device, scheme, or artifice to defraud", "obtain money or property" by using material misstatements or omissions, or to "engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser"
- Only requires a finding of negligence to determine that an antifraud violation has occurred

❖ A fact is "material" if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision

❖ What happens if a government issues bonds without proper disclosure in its offering documents...

SEC CHARGES ROCHESTER, NY, CITY'S FORMER FINANCE DIRECTOR AND SCHOOL DISTRICT CFO (AND MUNICIPAL ADVISOR) WITH MISLEADING INVESTORS (JUNE 2022)

- ❖ Allegation that officials misled investors with bond offering documents that included outdated financial statements for the City School District and did not indicate that the District was experiencing financial distress
- ❖ 42 days after bond offering, the District's auditors revealed that the District had overspent its budget by nearly \$30 million, resulting in a downgrade of the city's debt rating and requiring the intervention of the State of New York
- ❖ SEC's complaint against the City, Finance Director and Municipal Advisor, filed in the U.S. District Court for the Western District of New York, charges them with violating the antifraud provisions of the securities laws
- ❖ School District CFO agreed to settle SEC's charges by consenting to a court order prohibiting him from participating in future municipal securities offerings, and ordering him to pay a \$25,000 penalty

SEC CHARGES CA SCHOOL DISTRICT AND FORMER CFO WITH MISLEADING INVESTORS IN BOND OFFERING (JUNE 2021)

- ❖ Allegation that School District and CFO provided investors with misleading budget projections showing a healthy, positive ending general fund balance, when really the District was engaged in significant deficit spending and on track to a negative ending fund balance
- ❖ CFO managed the bond offering and was aware of reports showing that budget projections were contradicted by known actual expenses. CFO signed multiple certifications falsely attesting to the accuracy and completeness of the information included in the offering documents
- ❖ SEC's complaint against CFO, filed in U.S. District Court for the Southern District of California, charges her with violating Section 17(a) of the Securities Act of 1933
- ❖ CFO settled with SEC and agreed to be enjoined from participating in any future municipal securities offerings and to pay a \$28,000 penalty. School District also agreed to settle with the SEC and consented to an order requiring it to engage an independent consultant to evaluate its policies and procedures related to its municipal securities disclosures

SEC CHARGES CITY OF MIAMI AND FORMER BUDGET DIRECTOR WITH MUNICIPAL BOND OFFERING FRAUD (2013 - OLDIE BUT BADDIE)

- ❖ City and Budget Director made materially false and misleading statements and omissions about certain interfund transfers in multiple bond offerings and in the city's fiscal year ACFRs
- ❖ Budget director orchestrated the transfers from the city's Capital Improvement Fund to its General Fund in order to mask increasing deficits in the General Fund
- ❖ City had already been reprimanded by SEC for similar conduct
- ❖ Jury held City and Budget Director liable for multiple counts of antifraud violations of the federal securities laws

AND WHAT ABOUT AFTER BONDS ARE ISSUED?

- ❖ SEC staff issued a legal bulletin in 2020
- ❖ Confirms prior SEC guidance that the antifraud provisions apply to any statement of a municipal issuer that is reasonably expected to reach investors and the trading markets
 - EMMA filings
 - Information on government websites
 - Statements made by government officials
- ❖ Statement is material if there is a substantial likelihood that it would be viewed by a reasonable investor as significantly altering the “total mix” of information available
 - SEC enforcement action against City of Harrisburg, PA (misleading material info released by City administration + failure to file audited financial statements)

WHAT DOES THIS MEAN FOR TENNESSEE ISSUERS?

- ❖ Municipal issuers cannot just rely on third parties to make sure their disclosure is correct
- ❖ Municipal officers, particularly finance directors and mayors, need to carefully review disclosure documents to make sure they are accurate and do not omit material information
- ❖ While your financial adviser and disclosure counsel, if you have one, can help with this process, ultimately the responsibility for disclosure is on the municipal officials
- ❖ Municipal issuers should keep securities laws in mind when they “speak to the market” through disclosure on websites and through press releases

ARBITRAGE ISSUES IN A RISING INTEREST RATE ENVIRONMENT



WHY ARE YOU SUBJECTING ME TO A DISCUSSION OF ARBITRAGE WHEN I AM JUST TRYING TO ENJOY TGFOA?

- ❖ What is arbitrage anyway and why does the federal government care about it?
- ❖ Why has arbitrage become a hot topic (at least for bond lawyers who don't know what else to talk about)?
 - Short term interest rates are higher than the long-term cost of borrowing
 - Municipal governments are able to make arbitrage profits on their project funds for the first time in many years
 - If a governmental issuer fails to meet an arbitrage rebate exception for a project fund, the issuer may have to write a generous check for arbitrage profits to the Internal Revenue Service

THE TWO KEY QUESTIONS RELATING TO ARBITRAGE

- ❖ Am I allowed to invest bond proceeds at a yield in excess of the yield on the bonds?
- ❖ If so, am I allowed to keep whatever arbitrage profits that I earn?

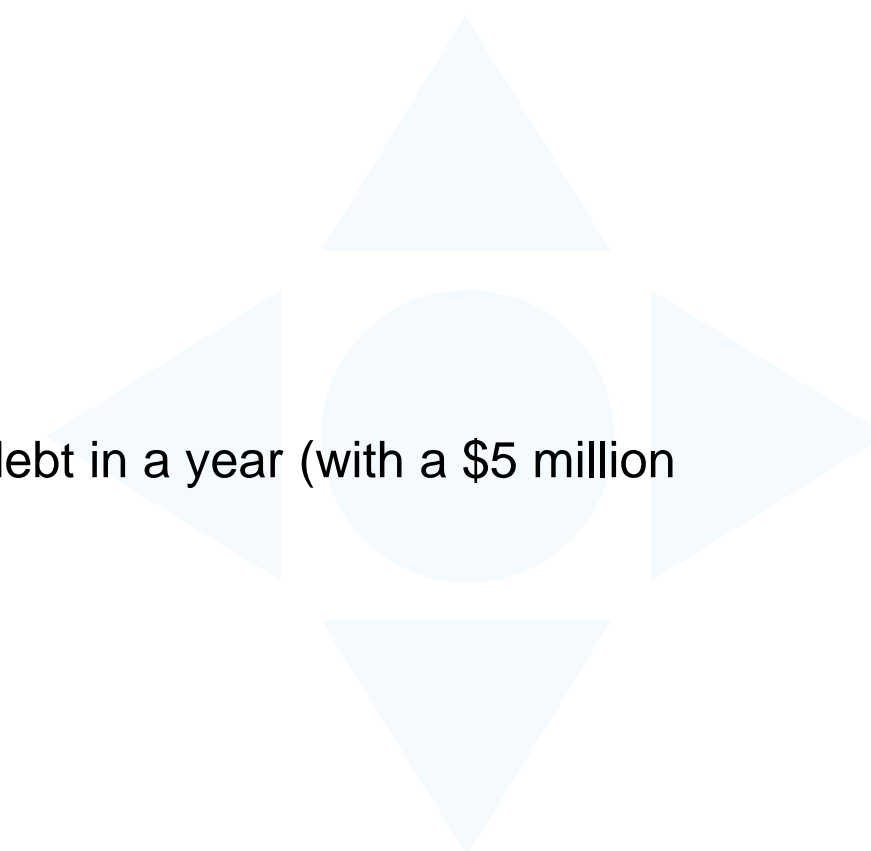


WHEN CAN I INVEST BOND PROCEEDS AT AN UNRESTRICTED YIELD?

- ❖ Generally IRS guidelines provide for a 3-year temporary period for bond proceeds for projects
- ❖ To be eligible for this temporary period, the issuer must expect to spend at least 85% of bond proceeds within that 3-year period, expect to enter into a material contract in the first 6 months and pursue the projects to be financed with due diligence
- ❖ If the issuer has proceeds remaining at the end of the 3-year temporary period, those proceeds should be invested at a yield that does not exceed the yield on the bond financing

WHEN CAN I KEEP ANY ARBITRAGE EARNINGS ON BOND PROCEEDS?

- ◆ Generally, an issuer has to rebate any arbitrage profits on bond proceeds to the federal government unless the issuer meets a rebate exception
- ◆ There are 4 primary rebate exceptions:
 - 6-month exception
 - 18-month exception
 - 24-month exception for construction issues
 - Small-issuer exception for issuers issuing less than \$5 million of tax-exempt debt in a year (with a \$5 million increase for school financings)



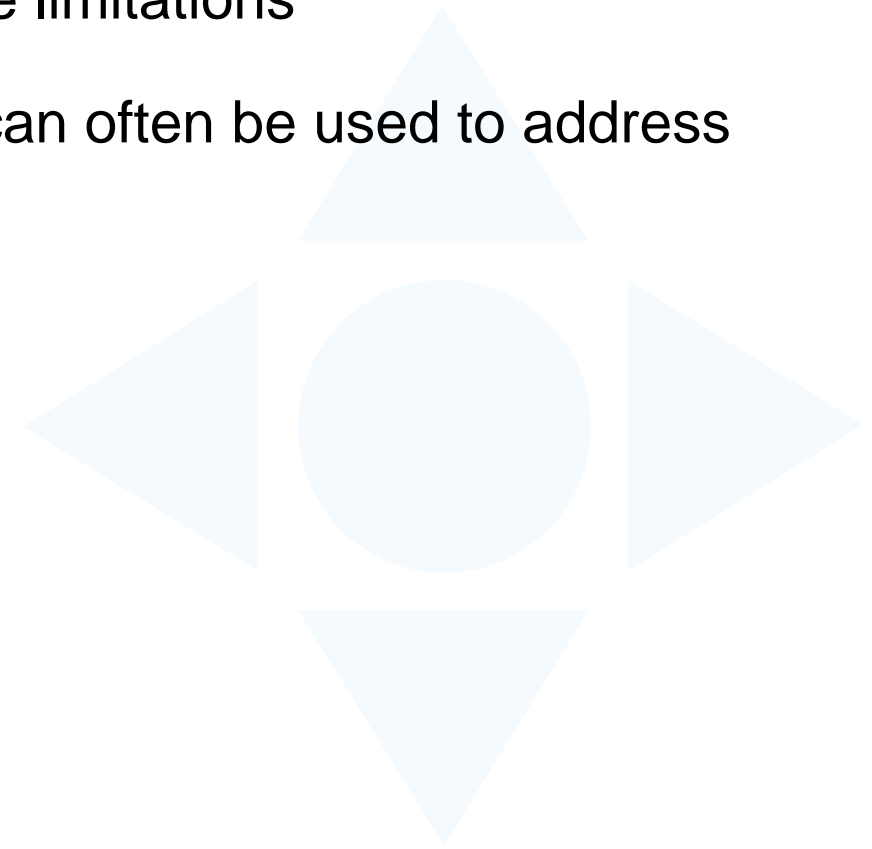
WHERE ELSE DO I NEED TO WORRY ABOUT ARBITRAGE?

- ◆ Debt service reserve funds
- ◆ Debt service funds
- ◆ Working capital financings



INVESTING PROCEEDS SUBJECT TO ARBITRAGE LIMITATIONS

- ◆ Investments need to be a fair market value; not a negotiated rate with your lender to avoid arbitrage
- ◆ SLGs and tax-exempt bonds can sometimes be used to avoid arbitrage limitations
- ◆ Yield reduction payments, which are very similar to rebate payments, can often be used to address any arbitrage problems



QUESTIONS?



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