Guidelines for Municipal Bond Underwriters - Post SEC Action against State of New Jersey

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The following is intended to provide some guidance to assist municipal underwriters in carrying out their securities law responsibilities in light of what the municipal markets have learned from the United States Securities Exchange Commission's (the "SEC") New Jersey Order[1]. One of the most distinctive elements of the New Jersey Order is that it represents the first time within the municipal markets that the SEC issued a cease-and-desist order predicated solely on negligence. In the other notable SEC orders involving municipal securities, the SEC's order largely related to either intentional or reckless securities disclosure deficiencies. In contrast, in the New Jersey Order, the SEC evidenced its willingness to bring a cease-and-desist order against a major issuer on the lower standard of negligence. Thus, while the securities laws always empowered the SEC to do this, the New Jersey Order appears to be a *de facto* change in the regulatory environment of municipal securities.

We should consider the New Jersey Order in light of the SEC's existing guidance on the securities law responsibilities of municipal underwriters. In its 1988 interpretative release[2] (the "1988 Release"), the SEC interpreted the securities laws as imposing on municipal underwriters the responsibility to review an issuer's official statement and to reasonably conclude that the issuer prepared materially sufficient disclosure. This is what the SEC said:

> "…the Commission wishes to emphasize the obligation of a municipal underwriter to have a reasonable basis for recommending any municipal securities and its responsibility, in fulfilling that obligation, to review in a professional manner the accuracy of the offering statements with which it is associated.
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> An underwriter, whether of municipal or other securities, occupies a vital position in an offering. The underwriter stands between the issuer and the public purchasers, assisting

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1 In the Matter of State of New Jersey, Securities Act Release No. 9135, Administrative Proceedings File No. 3-14009 (August 18, 2010).

2 Securities Exchange Act Release No. 26100 (Sept. 22, 1988), 53 FR 37778. In the 1988 Release the SEC both published for comment the proposed Rule 15c2-12 and released interpretative guidance for the securities law responsibilities of municipal underwriters. The SEC published the 1988 Release and would ultimately promulgate Rule 15c2-12 in large part as a result of its conclusions that the issuer and municipal underwriters had not engaged in adequate securities disclosure practices in a series of bond offerings by the Washington Public Power Supply System.

> the issuer in pricing and, at times, in structuring the financing and preparing disclosure documents. Most importantly, its role is to place the offered securities with public investors. By participating in an offering, an underwriter makes an implied recommendation about the securities. Because the underwriter holds itself out as a securities professional, and especially in light of its position vis-a-vis the issuer, this recommendation itself implies that the underwriter has a reasonable basis for belief in the truthfulness and completeness of the key representations made in any disclosure documents used in the offerings."

Accordingly, a municipal underwriter is responsible to investors to undertake a reasonable and professional review of an issuer's official statement and to reasonably conclude that the issuer prepared materially sufficient disclosure.

The SEC's interpretation of the securities law responsibilities of municipal underwriters has differed from its interpretation of the responsibilities of issuers. The SEC has historically focused its interpretation of the securities law responsibilities of issuers on the process and substance of preparing (as compared to reviewing) securities disclosure. But, while the SEC has interpreted securities laws as placing different emphases on the responsibilities of issuers and municipal underwriters, the securities laws that govern issuers are the same securities laws that govern municipal underwriters. Thus, although the New Jersey Order involved an issuer, by predicating the New Jersey Order solely on the alleged negligence of the State of New Jersey, the SEC has placed municipal underwriters as well as issuers on notice that the SEC is willing to hold all municipal market participants accountable to the standard of negligence.

Sometimes we can misunderstand what constitutes reasonable conduct by defining it based only on customary practices within the municipal markets. Customary practices can be relevant in defining what constitutes reasonable conduct but it is important to note that customary practices do not define or determine all of what constitutes reasonable conduct. In fact, not taking a customary precaution is probably better evidence of unreasonable conduct than is a customary practice evidence of reasonable conduct. Further, the historical experience that municipal credits rarely default can lure us all into a false sense of confidence that our practices and procedures are adequate. In seemingly as many ways as it can, the SEC is trying to signal to the municipal marketplace that it is convinced that the existing practices and procedures within the municipal markets are not reasonable and therefore are inadequate. We believe that the New Jersey Order represents an SEC view that should prompt municipal underwriters to evaluate their securities disclosure practices and procedures not based on what is customarily done but rather with an eye toward objectively evaluating their adequacy.

Neither in the New Jersey Order nor elsewhere has the SEC detailed exactly what it considers to be adequate practices and procedures. Our task, therefore, is to fashion guidelines that provide municipal underwriters sufficient direction to navigate this *de facto* regulatory change without any specific guidance by the SEC. To do this, we have focused on those areas in which, based on our experience, we have seen practices develop and those areas in which municipal underwriters may remain vulnerable if they do not systematically engage in important practices. Since the SEC has not provided definitive guidance, these guidelines can neither be exhaustive nor determinative of what constitutes reasonable. We believe that they are good ways for municipal underwriters to establish that they have conducted themselves reasonably.

1. **Study and Understand the Credit**

Municipal underwriters need to be sure that they do not rely on what the rating agencies require to rate bonds or what investors require to purchase bonds as a substitute for independently evaluating the credit supporting bonds. The most important disclosure practice for any municipal underwriter is to study the credit supporting a bond issuance to understand the strengths, weakness and risks of investing in those bonds, including the industry or type of credit supporting the bonds, the structure of the bonds, tax treatment of the bonds and the issuer's finances and operations. Each credit is different and studying all of these factors will require a municipal underwriter to appreciate the unique strengths and weaknesses of each credit.

2. **Reflect upon and Be Sensitive to an Issuer's Culture**

An issuer's working culture often influences the quality of an issuer's disclosure. Municipal underwriters should be sensitive to any cultures that intimidate working group members, are notably careless or are even incompetent. These tendencies can ultimately influence the adequacy of an issuer's disclosure.

Problems within a working culture of an issuer can serve as red flags to municipal underwriters. If there is a major securities disclosure deficiency, the SEC can point to a dysfunction in an issuer's culture to assume a municipal underwriter was or should have been more aware of a problem that it actually was.

3. **Ask the Right Questions**

A municipal underwriter should carefully consider how to frame good questions to obtain the right kind of information. Issuers may not fully understand what information investors consider important and a municipal underwriter's good and thorough questions may prove essential in bringing out all of an issuer's information. Municipal underwriters should inquire whether the issuer has developed disclosure procedures and instituted training programs for their employees involved in any element of the disclosure process.

Municipal underwriters should not exclusively rely on a common set of questions but should also ask questions that focus on any unique characteristics and weaknesses of a credit. In addition, municipal underwriters should ask questions that help identify known, material trends within an issuer's financial and operating condition and not simply focus on the accuracy of historical information.

The process of asking the right questions is important for two reasons. First, it may avoid disclosure deficiencies in the first place. In our experience, most errors in disclosure relate to omissions (*i.e.*, a problem in what is not said) rather than misstatements (*i.e.*, a problem in what is said). Consequently, good questions asked by municipal underwriters may prove to be valuable in avoiding these omissions. Second, if a municipal underwriter does not ask any questions at all or if a municipal underwriter asks just routine questions in each of its transactions, then the SEC can question whether the municipal underwriter had a reasonable basis for concluding that the issuer had prepared full and complete securities disclosure.

4. Review the Right Documents

Municipal underwriters should carefully review the official statement or other disclosure document and the financial statements of an issuer. This will educate the municipal underwriter about the issuer's credit and may also uncover important and material information that an issuer may have provided in obscure sections of an official statement or in the notes to the financial statements.

Other documents may also be important. Often times, the issuer has conducted studies or prepared reports that evaluate financial or operational feasibility, problems or prospects. These studies or reports can cast crucial light on trends or developments within the finances or operations of an issuer even if those studies or reports are only in draft form. In the case of pension disclosure, actuarial valuations may provide crucial information regarding the trending of an issuer's contributions to its pension plan. In other cases, a material contract of an issuer may contain material termination rights or contingent liabilities that present unique and material information to investors. We also think that a municipal underwriter should make it a practice to review the issuer's own website and perform Google or other searches for articles about the issuer. As a part of the review of an issuer's credit, municipal underwriters or their counsel should critically evaluate if there are any other significant documents that may provide material information to investors.

5. Receive the Right Letters, Opinions and Certificates

Municipal underwriters should be sure to receive an appropriate set of letters, opinions and certificates. In the municipal markets, disclosure counsel, underwriter's counsel, city attorneys, county counsel and others typically provide negative assurance letters to the underwriters as a way for the underwriters to establish that they conducted a reasonable investigation. If a municipal underwriter does not receive such a letter from an attorney who was integrally involved in the preparation of the disclosure and that attorney has knowledge of a material fact that was not disclosed, the SEC can cast doubt on whether the municipal underwriter acted reasonably. Municipal underwriters should also receive reliance on any bond counsel opinion and other customary opinions. While an opinion itself may not seem significant, the failure of a municipal underwriter to receive a customary opinion can look in retrospect to be more unreasonable than it seemed at the time of the transaction.

Municipal underwriters should also be sure to receive customary closing certificates from authorized officers of an issuer. An authorized officer who has good knowledge of the issuer's finances and operations should certify about the material sufficiency of the official statement or disclosure document and about other customary matters.

Municipal underwriters should also consider when a certified public accountant should deliver a consent letter or even some comfort of the information presented in the official statement. The practice of this varies greatly in the municipal markets and there are no clear rules. Ultimately municipal underwriters should consider the facts and circumstances of a given bond offering and determine whether receiving a consent letter or some comfort is the most reasonable thing to do.

What about Competitively Bid Transactions?

Competitively bid transactions present probably the most difficult area for municipal underwriters to understand this *de facto* regulatory change. In the 1988 Release, the SEC itself acknowledged the difficulties that municipal underwriters face in carrying out their securities law responsibilities in competitively bid transactions. The SEC stated that:

> "…the Commission recognizes that municipal underwriters may have little initial access to background information concerning securities that have been bid on a competitive basis. Therefore, the fact that offerings are competitively bid, rather than sold through a negotiated offering, is an element to be considered in determining the reasonableness of the underwriters' basis for assessing the truthfulness of key representations in final official statements."

At the same time that the SEC recognized these difficulties, it also expressed in the 1988 Release considerable concern about the practices of municipal underwriters in competitively bid transactions[3].

In light of the fact that the SEC predicated the New Jersey Order only on the alleged negligence of the State of New Jersey, municipal underwriters should re-consider their approaches to competitively bid transactions in light of the SEC's concerns in the 1988 Release. In the 1988 Release, the SEC laid out what it considered to be a reasonable approach for municipal underwriters to carry out their securities law responsibilities in competitively bid transactions.

> "The Commission believes that in a normal competitive bid offering, involving an established municipal issuer, a municipal underwriter generally would meet its obligation to have a reasonable basis for belief in the accuracy of the key representations in the official statement where it reviewed the official statement in a professional manner, and received from the issuer a detailed and credible explanation concerning any aspect of the official statement that appeared on its face, or on the basis of information available to the underwriter, to be inadequate. In reviewing the issuer's disclosure documents, therefore, underwriters bidding on competitive offerings should stay attuned to factors that suggest inaccuracies in the disclosure or signal that additional investigation is necessary. If these factors appear, the underwriter should investigate the questionable disclosure and, if a problem is uncovered, pursue the inquiry until satisfied that correct disclosure has been made."

Thus, the SEC believes that municipal underwriters should be able to maintain reasonable practices and procedures in many competitive bid offerings. Thus, municipal underwriters should be able to follow most if not all of the guidelines we provide above in many competitively bid transactions, even if the way that the municipal underwriter carries out those guidelines is different than in a negotiated underwriting. Municipal underwriters can study the credit of the bonds, ask appropriate questions, review appropriate documents and take other

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[3] In the 1988 Release, the SEC stated:

> "The Commission believes that the conduct of the underwriters in the [Washington Public Power] Supply System offerings, and the position advanced by some members of the industry, with respect to their responsibilities in competitively bid offerings, raise serious concerns that warrant additional review."

reasonable steps. There may be no formal due diligence conference call, no letter from the accountants and the opinions of counsel may be limited in scope but the municipal underwriter may have the opportunity to ask the issuer directed questions. In those situations, municipal underwriters should take those steps even if other municipal underwriters typically do not take those steps.

Notwithstanding the difficulties that municipal underwriters face in competitively bid transactions, if a municipal underwriter cannot take reasonable steps to ensure the accuracy of the securities disclosure in a competitively bid transaction, the securities laws do not excuse the municipal underwriter from their standards. In such a case, the mere fact that other municipal underwriters largely do the same elsewhere is unlikely to provide much of a defense. In the end, if the municipal underwriter cannot confirm that the issuer has taken reasonable steps and precautions to ensure adequate securities disclosure, then the SEC may call into question the reasonableness of the municipal underwriter's conduct as well. As the SEC states in the 1988 Release:

> "With respect to competitively bid offerings of municipal securities, members of the municipal securities industry have argued that the uncertainty of the bidding process and time pressures associated with these offerings make it difficult for underwriters to conduct an investigation of the issuer or its statements. The fact that an offering is underwritten on a competitive basis does not negate the responsibility that the underwriter perform a reasonable review."

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