Lessons Learned for Senior and Sole Managers in Negotiated Offerings
Per SEC Action Against the State of New Jersey

August 2011

Prepared for Members of the Bond Dealers of America
by Nixon Peabody LLP

The following is intended to provide public finance bankers serving in senior and sole managed capacities[1] in negotiated offerings with some lessons learned from the United States Securities Exchange Commission's (the "SEC") New Jersey Order[2] and other notable municipal market cease and desist actions to assist them in carrying out their securities law responsibilities. In this memorandum, while the terms "senior and sole managers" and "underwriter" are intended to mean the firm as a whole, it is the public finance investment bankers who often lead a firm's due diligence efforts. In most municipal underwriting firms, the responsibilities for the underwriting of a bond transaction is divided between an investment banking division and a sales, trading and underwriting division. In these cases, the investment bankers are usually responsible for directly interfacing with the issuers and therefore primarily take responsibility for completing most, if not all, of the due diligence responsibilities for the firm. Also, in these cases, the sales, trading and underwriting desk is responsible primarily to identify the investors to whom the firm will distribute the bonds. While the due diligence responsibilities of a firm acting as a senior or sole manager in a municipal underwriting transaction are that of the firm and no particular division, this memorandum is directed toward the investment bankers who in most firms are assigned the firm's responsibility to conduct the due diligence inquiry.

While the SEC entered the cease and desist order against the State of New Jersey only, during this time of heightened focus by the SEC on the municipal marketplace, it would appear appropriate for public finance professionals to apply the SEC's statements in the Order to disclosure obligations generally. 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

1 For a discussion of the responsibilities of co-managers, see the discussion below.

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

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. While the securities laws have always empowered the SEC to do this, the New Jersey Order may have been 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 senior and sole managers. In its 1988 interpretative release[3] (the "1988 Release"), the SEC interpreted the securities laws as imposing on senior and sole managers 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.
>
> 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 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 senior and sole manager 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 senior and sole managers 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 senior and sole managers, the securities laws that govern issuers are the same securities laws that govern senior and sole managers. 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,

---

3 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 SEC has placed senior and sole managers 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 concerned about the existing disclosure practices and procedures within the municipal markets. We believe that the New Jersey Order represents an SEC view that should prompt senior and sole managers 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. This paper attempts to provide senior and sole managers sufficient direction to navigate this *de facto* regulatory change in the absence of 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 senior and sole managers may remain vulnerable if they do not systematically engage in important practices. Since the SEC has not provided definitive guidance, the following observations can neither be exhaustive nor determinative of what the SEC may view as satisfying its requirements.. We believe, however, that they are good ways for senior and sole managers to establish that they have conducted themselves reasonably.

1. <u>**Study and Understand the Credit**</u>

Senior and sole managers need to be sure that they do not solely 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 senior and sole manager 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 senior and sole manager to appreciate the unique strengths and weaknesses of each credit.

The New Jersey Order and the SEC's cease-and-desist order against the City of San Diego[4] (the "San Diego Order") offer good lessons in this regard. The credit problems

[4] In the Matter of City of San Diego, California,, Securities Act Release No. 8751, Administrative Proceedings File No. 3-12478 (November 14, 2006).

underlying the disclosure problems in the New Jersey Order and the San Diego Order related to pension obligations. In the years in which much of the alleged inadequate disclosure occurred, neither the rating agencies nor investors appreciated the importance of the issues and potential credit implications surrounding pension obligations.

2. **Don't Ignore Red Flags**

In some of the notable SEC municipal actions, there was a sense among those who worked with the issuers in question that they had always recognized that the issuer had a cultural problem. For example, in some instances, the issuer consistently intimidated working group members or strongly discouraged meaningful questions by working group members. Looking back on their experiences, the working group members realized that it was this pattern of behavior itself that offered them the best opportunity to recognize that there were bigger problems.

An issuer's working culture often influences the quality of an issuer's disclosure. Senior and sole managers should be sensitive to any cultures that present red flags that can suggest problems, such as cultures that intimidate working group members, are notably careless or do not provide consistent, accurate answers. These tendencies can ultimately influence the adequacy of an issuer's disclosure. We are not encouraging senior and sole managers to scrutinize the "culture" of an issuer for its own sake in an effort to try to uncover red flags. What we are encouraging senior and sole managers to do is to not ignore red flags when they are apparent to them. These red flags may be the best sign to senior and sole managers that there is a potential problem.

The remainder of this document is available only to members of the Bond Dealers of America. For more information about this document or the BDA please contact Mike Nicholas in the BDA's DC office at mnicholas@bdamerica.org or 202-204-7901.