

# Client Alert

February 2020

## SEC Issues Staff Legal Bulletin On Applying Antifraud Liabilities to Public Statements of Municipal Issuers in the Secondary Market

### Introduction

On February 7, 2020, the staff of the SEC's Office of Municipal Securities ("OMS") issued a Staff Legal Bulletin ("Bulletin" or "Staff Guidance") regarding the application of the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder to statements by municipal issuers and obligated persons (each, a "municipal issuer") in the secondary market. [Here](#) is a link to the Bulletin. The Bulletin summarizes and 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. The Staff Guidance provides new insights into the views of SEC Staff regarding continuing disclosure practices in municipal securities issues. The Staff Guidance is summarized below.

### Background

The Staff Guidance emphasizes that, though much improved since the creation and implementation of the Electronic Municipal Market Access ("EMMA") system, investor and market access to current and reliable information about municipal issuers remains uneven and inefficient. The Staff Guidance notes the variety of ways that municipal issuers disclose information about themselves, including EMMA disclosures, public announcements, press releases, media interviews and discussions with various interest groups. In addition, information about municipal issuers is collected and disseminated publicly by state and local governments. In the Staff's view, these diverse types of statements provide significant, current information about a municipal issuer and can reasonably be expected to reach investors and trading markets, even if they are not published or conducted for purposes of informing the securities markets. Noting questions raised by market participants about the application of the antifraud provisions to issuer statements, including annual and continuing disclosures, the Staff Guidance outlines previous Commission statements regarding the scope and application of the antifraud provisions to municipal issuer statements, primarily the 1994 Interpretive Release<sup>1</sup> and the City of Harrisburg, PA enforcement action (and accompanying report) discussed below. The Staff Guidance provides a broad and current formulation of how the antifraud provisions apply to municipal issuer statements.

### The Current Staff Guidance Formulation and the Importance of a Staff Legal Bulletin

The Staff Guidance emphasizes that the antifraud provisions apply to *all* municipal issuer statements that provide information that is reasonably expected to reach investors and the trading markets, whoever the intended primary audience and whatever the medium of delivery. "Statement" or "Statements" is broadly defined to include any publicly available written or oral communication of a municipal issuer, regardless of the intended audience or medium of delivery. The Staff Guidance refers to this as a "standard" and stresses that the antifraud provisions apply to all statements by a municipal issuer whether on EMMA or elsewhere, whether written or oral, regardless of the extent to which the municipal issuer has fulfilled its

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<sup>1</sup> See Rel Nos. 33-7049, 34-33741 (March 9, 1994) (the "1994 Interpretive Release").

continuing disclosure undertakings and notwithstanding changes of municipal issuer disclosure practices technology, investor expectations, and regulatory framework. In outlining previous Commission statements, the Staff Guidance offers a broad, current formulation of how the antifraud provisions apply to municipal issuers.

A Staff legal bulletin is not an SEC rule, regulation or Commission statement. However, while a Staff legal bulletin has no legal force or effect, and may not be formally recognized in administrative or court proceedings, a bulletin does represent the current views of the SEC Staff – presumably the staff of the Office of Municipal Securities and the staff of the Public Finance Abuse Unit of the SEC’s Enforcement Division – that is regularly applying SEC rules, regulations and laws to municipal issuers and municipal securities continuing disclosure. For example, Staff Legal Bulletins are regarded as important, practical guidance for SEC-reporting companies when complying with SEC rules and regulations, from disclosing shareholder proposals to corporate disclosures in registered offerings and ongoing reporting. In short, an issuer and its counsel are well advised to be familiar with applicable SEC legal bulletins when engaged in primary offerings and ongoing disclosures.

It is worth noting that the framework or approach of OMS Staff in the Staff Guidance is grounded in corporate disclosure concepts. Much like the corporate framework used to introduce the financial obligation reporting amendments to Rule 15c2-12 in 2019, the Staff states it views regarding disclosure obligations of municipal issuers in the context of “entities whose securities are publicly traded” and suggests that municipal issuers disclose current information in a variety of ways “like public companies”. As discussed below, the Staff Guidance takes into account many of the unique aspects of the municipal market, but the guidance is not unlike Staff legal bulletins that are issued and followed in the reporting company context.

## **SEC-OMS Views on Antifraud Provisions**

The Staff Guidance presents OMS’s views on (a) certain elements of Section 10(b) and Rule 10b-5, including intent, scienter and materiality, (b) the scope of coverage of the antifraud provisions with respect to statements made by municipal issuers in the secondary market that are reasonably expected to reach investors and the trading markets, including examples of various, current modes of municipal issuer statements and (c) the importance of disclosure policies and procedures in complying with antifraud provisions.

## **Elements of Antifraud Provisions Relevant to Municipal Issuer Statements to Secondary Market**

Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5 are referred to as the “antifraud provisions” and generally prohibit misstatements or omissions of material facts in connection with the purchase and sale of municipal securities. The antifraud provisions apply to municipal issuer continuing disclosures and to municipal issuer statements to the secondary market.

*Scienter Standard.* The Staff Guidance reminds issuers that “scienter” – a mental state of intent – is required to find a violation of the antifraud provisions. Specifically, scienter is demonstrated by finding “recklessness”, an extreme departure from the standard of ordinary care. However, it is important to remember, as is referenced in a footnote in the Staff Guidance, that the SEC does and can proceed against municipal issuers for disclosure violations under Section 17(a) of the Securities Act of 1933. Different than requiring intent like Rule 10b-5, Section 17(a) only requires a finding of negligence or gross negligence to determine that an antifraud violation has occurred. While Section 10(b) and Rule 10b-5 would be the typical standard applied to secondary market disclosures, recent, other enforcement actions regarding disclosure violations by municipal issuers have been based on Section 17(a) negligence, a lesser standard than Section 10(b) scienter. Nonetheless, the Staff Guidance is helpful in reminding municipal issuers that recklessness and extreme departure from ordinary care is the standard typically applied in evaluating municipal issuer liability for secondary market statements to investors and the trading markets.

*Materiality and “Total Mix” of Information.* In helpful analysis for municipal issuers, the Staff Guidance reminds issuers that a fact or factual statement is material if there is a substantial likelihood that the information would have been viewed by a reasonable investor as significantly altering the “total mix” of information available. The Staff Guidance emphasizes that “total mix” analysis is a fact and circumstance assessment for an issuer and could differ among municipal issuers. Importantly, “total mix” of information assessment may differ depending on whether issuer information is “uneven or inefficient” in the secondary market or is regularly available through EMMA or other investor relations website. To illustrate this “total mix” analysis for municipal issuers, the Staff Guidance relies on the SEC’s 2013 Harrisburg Report that accompanied the SEC’s Enforcement action against the City of Harrisburg, Pennsylvania.<sup>2</sup> In that case, the city administration recurrently released information that omitted or misstated material information about the City’s financial condition, while during the same time period failing to submit annual financial information, audited financial statements, notices of failure to provide annual financial information and material event notices.

*Information Reasonably Expected to Reach Investors.* The Staff Guidance emphasizes that a municipal issuer’s failure to fulfill its continuing disclosure undertakings, as was the case with Harrisburg, is not necessary for a municipal issuer to be subject to antifraud liability. Rather, according to Staff, “*all statements of a municipal issuer that are reasonably expected to reach investors and the trading markets are subject to the antifraud provisions, regardless of the municipal issuer’s compliance with its continuing disclosure obligations*”. While this guidance is consistent with a compilation of past statements from the SEC on antifraud liability for municipal issuer statements, this new formulation offers a broad, expansive view of the applicability of antifraud provisions to municipal issuers. According to Staff, whether an issuer’s statements to the market have been uneven or consistent may increase or decrease the risk that the statements significantly alter the total mix of information and create antifraud liability.

In addition, SEC Staff takes a broad view of information reasonably expected to reach investors: in addition to EMMA disclosures, public announcements, press releases, interviews with media representatives, discussions with interest groups and municipal issuer information disseminated by other state and local governmental bodies are sources of information that reasonably can be expected to reach investors and the trading markets. These statements are part of the “total mix” and can lead to exposure to antifraud liability, depending on the level of issuer information otherwise available in the market. Even if not published for purposes of informing the securities markets, such oral or written statements may not violate the antifraud provisions

## **Examples of Statements (Other than EMMA Disclosures) Covered by Antifraud Provisions**

To emphasize that the antifraud provisions apply to *all* issuer statements reasonably expected to reach investors and trading markets, regardless of the intended primary audience or medium of delivery, the Staff Guidance provides examples of issuer statements other than EMMA disclosures that could be subject to antifraud liability:

*Information on Municipal Issuer Websites.* To avoid misleading investors, information previously posted on an issuer’s website should be separately identified as **historical** and located in a separate section of the website. The Staff Guidance encourages municipal issuers to follow public reporting company guidance regarding **hyperlinked** information, including disclosing the reason for the hyperlink, using disclaimers and use of exit screens or intermediate screens to minimize antifraud liability. **Summary information** posted on issuer websites should be displayed in a manner designed to avoid confusing or misleading investors. On each of the foregoing areas of website disclosure concerns, the Staff Guidance directs municipal issuers to follow Commission guidance regarding how antifraud provisions apply to public reporting companies.

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<sup>2</sup> SEC 21(a) Report, “Report of Investigation in the Matter of the City of Harrisburg,” SEC Rel. No. 34-69516 (May 6, 2013) (the “Harrisburg Report”).

*Municipal Issuer Reports Delivered to Other Governmental Bodies.* The Staff Guidance states that CAFRs, budgets and mid-year financial reports are information reasonably expected to reach investors and trading market even if not posted on EMMA, and are subject to the antifraud provisions. The Staff Guidance states that additional types of reports may be covered by the antifraud provisions, depending on facts and circumstances, including reports submitted by a municipality to a state agency, reports by a state or local official to a city council or state legislature and other publicly available reports. Again, while this Staff Guidance is consistent with past SEC principle-based guidance, it is expansive in its present detail of what sources may be viewed as significant, current information reasonably expected to reach investors and markets.

*Statements Made By Municipal Issuer Officials.* The Staff Guidance re-emphasizes past SEC guidance that statements by municipal issuer officials reasonably expected to reach investors or securities markets are subject to the antifraud provisions. The current Staff Guidance broadly defines the term “municipal issuer official” to include elected officials, appointed officials and employees or their functional equivalents. In addition, the current Staff Guidance broadly describes the types of statements, depending on facts and circumstances, that may be actionable under the antifraud provisions: verbal statements, speeches, public announcements, interviews with media as well as *other avenues such as social media*. The Staff Guidance, in bringing past guidance current, is expansive in its views of municipal issuer statements subject to antifraud provisions.

## **Key Importance of Disclosure Policies and Procedures**

The Staff Guidance emphasizes that “reasonably designed” and “consistently implemented” disclosure policies and procedures will help a municipal issuer comply with the antifraud provisions. Given the current, broad views of Staff on what constitutes actionable statements and what public information is reasonably expected to reach investors and trading markets, the Staff’s renewed emphasis on adopting and implementing disclosure policies and procedures is of key importance for municipal issuers. The Staff Guidance recommends that municipal issuers “follow and further develop initiatives to enhance disclosure policies and procedures for both primary offering and ongoing disclosures”, including adoption of disclosure committees and training programs. Specifically, the Staff Guidance recommends that disclosure policies and procedures:

- Designate a responsible individual;
- Conduct periodic training for staff and officials;
- Identify the documents and reports that customarily contain current financial and operational information and establish a process for disseminating the documents and reports to investors; and
- Identify the places, such as EMMA or an investor-relations website, where such documents and reports are regularly available to the public.

## **Conclusions and Recommendations**

The new Staff Guidance provides views consistent with past SEC guidance on municipal issuer secondary market disclosure and states that it does not create new or additional obligations for municipal issuers. At the same time, in offering its current views on how the antifraud provisions apply to secondary market disclosures, the Staff Guidance offers broad, even expansive, views of current municipal issuer obligations: the antifraud provisions apply to all statements, broadly defined from EMMA disclosures to social media, that are reasonably expected to reach investors and the trading markets, whoever the intended primary audience, whatever the medium of delivery and regardless of the extent to which an issuer has fulfilled its continuing disclosure undertakings. The scope of application of the antifraud provisions is broad, notwithstanding changes or improvements in municipal issuer disclosure practices, changes in technology, investor expectations and changes in regulatory framework. While the Staff Legal

Bulletin addresses municipal issuers who have outstanding issues in the public market subject to the continuing disclosure rules, the Staff views on application of the antifraud provisions to issuer statements are also relevant to primary offerings and issuer statements made in an offering process before an issue is closed.

According to the Staff Guidance, the broad potential for antifraud liability of municipal issuers and their officials for secondary market disclosures and public statements underscores the need for adopting, and regularly carrying out, thorough disclosure policies and procedures. Municipal issuers can expect to see continued focus by their counsel on adequacy and regular implementation of disclosure policies and procedures. Specifically, municipal issuers will want to ensure that their disclosure policies and procedures appropriately identify the financial and operating information that will regularly be made available to investors and the trading markets by EMMA filings or through other means such as an issuer website, and consider separating and/or disclaiming information not intended for investors or the market. Issuers may look to disclosure counsel increasingly to advise not just on primary disclosure in connection with initial bond issuances, but on ongoing EMMA disclosures and other publicly available issuer statements. The Staff Guidance makes clear that OMS and SEC Staff, including Enforcement, view the application of the antifraud provisions broadly with respect to municipal issuer statements. Disclosure policies and procedures are a critical line of defense against fraud claims and Enforcement review.

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