

HAWKINS ADVISORY

Municipal Market — Federal Securities Law Update (2022)

This Hawkins Advisory provides an update on the municipal securities market and related federal securities law regulation. In particular, this Advisory reviews (i) the current composition of the Securities and Exchange Commission (the “SEC”) and its regulatory priorities; (ii) the SEC’s proposed rules on climate change disclosure and other environmental, social, and governance (“ESG”) initiatives; (iii) developments in cybersecurity disclosure; and (iv) recent SEC enforcement actions in the municipal securities market.

Composition of the SEC and its Regulatory Priorities

SEC Commissioners. The SEC has five Commissioners who are appointed by the President of the United States with the advice and consent of the Senate.¹ Not more than three Commissioners may be members of the same political party, and in making appointments members of different political parties are required to be appointed alternately as nearly as may be practicable.² The President also designates one of the Commissioners as Chairman, the SEC’s top executive.³ Presently, there is a Democratic Chair (Gary Gensler), two additional Democratic Commissioners (Caroline A. Crenshaw and Jaime Lizárraga), and two Republican Commissioners (Hester M. Peirce and Mark T. Uyeda).

Director of the Office of Municipal Securities (“OMS”). On March 16, 2022, the SEC announced a new Director for OMS, Dave A. Sanchez. Mr. Sanchez succeeds Rebecca Olsen, who led OMS from 2017 to 2021, and is now the Deputy Chief for the Division of Enforcement’s Public Finance Abuse Unit.

SEC Regulatory Priorities. Since becoming SEC Chair in April 2021, Mr. Gensler has noted that the SEC’s regulatory agenda will focus on, among other things, (i) market structure (including the Treasury market, non-Treasury fixed income markets, equity markets, security-based swaps, and cryptocurrency asset markets), (ii) predictive data analytics (including establishing rules to protect investors as the capital markets are modernized), (iii) issuers and issuer disclosure (including disclosure regimes related to climate risk, human capital, and cybersecurity, among others), and (iv) investment fund management (including focusing on funds that market themselves as green, social, or sustainable investment choices and cybersecurity risk and incident disclosure). This Advisory discusses several recent SEC regulatory and enforcement

actions addressing the disclosure and fund management themes.

Proposed Rules on Climate Change Disclosure and ESG Initiatives

General. Interest in ESG aspects of investment has exploded across the capital markets in recent years. In the municipal market, this has resulted in notable developments for ESG risk factor disclosure and ESG-designated/labeled bonds. As municipal market practices in these areas evolve, it is important to (i) identify ESG risk factors that may be relevant to each bond issue based upon its specific factual context; (ii) review proposed regulatory actions regarding ESG disclosure and ESG-related practices; and (iii) understand the significance of ESG-designated/labeled bonds, including matters related to self-designation, third party provider verification, and reporting requirements for ESG-designated/labeled bonds.

SEC Rule Proposal for Public Companies. The SEC has released a number of recent climate change-related initiatives to enhance and standardize climate-related disclosures, seeking to mandate such disclosures for public companies. On March 21, 2022, the SEC proposed mandated climate-risk disclosures by public companies that are subject to the reporting requirements of the Securities Exchange Act of 1934 (the “Climate Proposing Release”).⁴ The proposed rules would require certain climate-related information to be included in registration statements and periodic reports, including, among other things, (i) climate-related risks and their actual or likely material impacts on business, strategy, and outlook, (ii) governance of climate-related risks and relevant risk management processes, (iii) greenhouse gas emissions, (iv) certain climate-related financial statement metrics and related disclosures in a note to audited financial statements, and (v) information about climate-related targets and goals, and transition plans, if any. Although the Climate Proposing Release applies to public companies, the rules will likely be informative by analogy to municipal issuers and their disclosure documents.

Several hundred comment letters have been submitted to the SEC regarding the Climate Proposing Release and it is clear that some aspects of the proposed rules have sparked controversy. The comment period for the proposed rules was initially set to end on May 20, 2022 and was extended until

¹ Section 4(a) of the Securities Exchange Act of 1934.

² *Id.*

³ *Id.*

⁴ SEC Rel. Nos. 33-11042; 34-94478, *The Enhancement and Standardization of Climate-Related Disclosures for Investors* (Mar. 21, 2022).

June 17, 2022 (with additional comments being submitted after the deadline). It remains to be seen whether the proposed rules as set forth in the Climate Proposing Release will be modified prior to adoption.

Climate Proposing Release and the Municipal Securities Market. Various municipal market participants have submitted comment letters to the SEC regarding the Climate Proposing Release. Such letters, among other things, highlight certain key differences between the public company and municipal securities markets and note how current federal securities laws already adequately require disclosure of climate-related risks in the municipal securities market. Utilizing a principles-based approach to the antifraud provisions of the federal securities laws, municipal issuers disclose in their primary offering documents information regarding risks that are material to their securities, which include climate-related risks, as applicable. The municipal securities market continues to develop ESG best practices, with such entities as Government Finance Officers Association (“GFOA”) providing guidance and white papers on climate-related disclosure.⁵

The environmental factors that an issuer should consider disclosing will vary depending on the specific facts relating to the issuer and the issuer’s programs and responsibilities. Generally, the issuer should consider the materiality of any potential operational and financial impacts of climate change risks and highlight what steps the issuer is taking (if any) to address the risks.

In contrast to “environmental” impacts on a governmental entity, there is less consensus about the materiality for disclosure purposes of “social” and “governance” factors and how to describe such factors in a disclosure document. Social factors may be material for certain projects, like affordable housing projects, public school projects to support equitable quality education, and projects supporting affordable access to essential services and basic infrastructure. Governance factors include government management, operations, and finances, and information on organizational structure, management, decision-making, policies, and budget and financial management and reporting. Governance factors may also illustrate how such structural items could impact an issuer’s ability to comply with its bond covenants and other representations.

MSRB Request for Information (the “MSRB RFI”). On December 8, 2021, the MSRB issued a request for information on ESG market practices in the municipal securities market as part of its broader engagement on ESG trends and to enhance issuer and investor protections related to these matters.⁶ Among other topics, the MSRB requested comments on the disclosure of information regarding ESG-related risk factors and ESG-related practices and the labeling and marketing of municipal securities with ESG designations. The information collected by the MSRB is expected to be summarized in a report to be released later this year.

In connection with the MSRB RFI, several municipal securities market participants submitted comments and practical insights on ESG practices. Some market participants, including the Securities Industry and Financial Markets Association (SIFMA) and the National Association of Bond Lawyers (NABL), expressed concern that the MSRB is not the appropriate regulatory authority to engage in rulemaking regarding the content of issuer disclosure or to determine the materiality of such content. Other comments highlighted concerns about regulating an evolving market, such as the ESG market, and raised questions about whether such regulation could impede its growth.

ESG-Designated or Labeled Bonds. In addition to general ESG disclosure and risk factor considerations, the market for ESG-designated and labeled bonds – such as green, social, and sustainability bonds – is growing exponentially.

Disclosure documents for ESG-designated and labeled bonds typically include (i) a description of the basis on which such designation is made (*i.e.*, self-designated by the issuer or verified by a third party provider), (ii) the mission or goal of the issuer as it relates to such designation, (iii) whether the designation is related to the particular project being financed or a specific program, and (iv) a framework that describes the program and use of proceeds generally and certain related reporting requirements. Such disclosure is designed to highlight aspects of the particular program or project for investors who may be seeking investments that align with their own ESG funds and may require specific reporting metrics as part of the bond offering.

There are several industry participants that established ESG standards for designation, such as the International Capital Market Association (“ICMA”). ICMA’s standards are aligned with certain United Nations sustainable development goals, such as (i) combatting poverty and hunger, (ii) clean water and sanitation efforts, (iii) providing access to quality education and affordable and clean energy, and (iv) infrastructure and climate action projects, among others. In describing the ESG-designated and labeled bonds in offering documents, issuers will often tie such description to one or more of these ICMA standards.

ESG-designated and labeled bonds may be either self-designated by the issuer or verified by a third party. Self-designation is generally an internal process whereby the issuer determines whether a designation is desirable and appropriate, and agrees to provide some ongoing disclosure to investors to support the designation. For ESG-designated and labeled bonds that are verified by a third party, the offering document will include a description of the verifier and the standards it uses (*i.e.*, what they are evaluating, what reports or opinions are provided, and any limitations on its opinion). Such disclosure may also describe whether the report or opinion can be revoked or rescinded if certain ongoing reporting obligations or other standards are not met.

⁵ See GFOA ESG Best Practices – “E” Environmental - <https://www.gfoa.org/materials/esg-disclosure>; “S” Social – <https://www.gfoa.org/materials/esg-best-practice-s-social>; and “G” Governance – <https://www.gfoa.org/materials/esg-best-practice-g-governance>.

⁶ MSRB Notice 2021-17, *Request for Information on Environmental, Social and Governance (ESG) Practices in the Municipal Securities Market* (Dec. 8, 2021).

ESG Disclosure for Investment Advisers and Investment Companies

Further highlighting the SEC's focus on ESG, on May 25, 2022, the SEC issued two proposing releases that address the ESG labeling and disclosure practices of investment companies and investment advisers.⁷ The comment period for each of these proposals runs through August 16, 2022. Proposals of this sort, if implemented, could lead to significant changes in market practice, effectively obligating the issuer to make new primary offering and secondary market disclosures in order to accommodate investment company and/or investment adviser labeling requirements, even when SEC disclosure content regulations do not directly require the issuer to do so.⁸

Cybersecurity Disclosure for Public Companies

A Hawkins Advisory on cybersecurity dated May 29, 2018, focused on developments regarding disclosure of cybersecurity risks and incidents and their import for municipal disclosure.⁹ The Advisory examined the SEC's 2018 guidance for public companies in preparing disclosures about cybersecurity risks and incidents (the "SEC's 2018 Guidance")¹⁰ and the Yahoo Enforcement Action from April 2018.¹¹ It also provided guidance for disclosure by municipal issuers of cybersecurity risks and incidents, reiterating the fact that such disclosure is governed by the same guidelines and standards that apply to municipal disclosure generally – namely, what is material to an investor regarding the particular securities being offered. The Advisory also included sample due diligence questions regarding cybersecurity risks and incidents. The themes covered in such Advisory remain applicable today.

On March 9, 2022, the SEC proposed rules for registered companies to enhance and standardize disclosures regarding cybersecurity risk management, strategy, governance, and cybersecurity incident reporting by public companies that are subject to the reporting requirements of the Securities Exchange Act of 1934 (the "Cyber Proposing Release").¹² Such rules would require (i) current reporting about material cybersecurity incidents, (ii) periodic disclosures about a registrant's policies and procedures to identify and manage cybersecurity risks, management's role in implementing cybersecurity policies and procedures, and the board of directors' cybersecurity expertise, if any, and its oversight of cybersecurity risk, and (iii) registrants to provide updates about previously reported cybersecurity incidents in their periodic reports.

In the Cyber Proposing Release, the SEC notes that the proposed rules are intended to better inform investors about risk management, strategies, and governance and provide

timely notification of material cybersecurity incidents. The Cyber Proposing Release builds on the guidance provided in the SEC's 2018 Guidance on cybersecurity and seeks to make much of that guidance part of a new reporting requirement for public companies. While the Cyber Proposing Release applies to public companies, the rules will likely be informative by analogy to municipal issuers and their disclosure documents. The comment period for the proposed rules in the Cyber Proposing Release ended on May 9, 2022.

Recent Municipal Enforcement Actions

The following is a review of select SEC municipal securities enforcement actions from calendar years 2021 and 2022 to date. Several of these actions remain pending. References to facts alleged in these cases are made for purposes of discussion only and are not intended to express a view on the merits.

Sweetwater Union High School District (Sept. 16, 2021)¹³

- The SEC settled with a School District and its former CFO for including misleading budget projections and interim financial reports in offering documents for the School District's 2018 bonds; such misleading information was also provided to the rating agency
- The disclosure failed to take into account current projected expenses and were based on lower prior year expenditures; figures showed a surplus when in fact there was a deficit
- The School District's budget monitoring reports consistently showed that actual expenses were trending significantly higher than budgeted
- The School District continued to use stale budget projections in its interim budget reports; financial concerns were easier to conceal in the interim reports; when the audit came out so did the deficit
- The settlement was based on Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 (the "Securities Act") (which requires the SEC to establish that the School District and its former CFO were negligent in preparing the disclosure; rather than establishing fraudulent intent or recklessness that is required for violations of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder, as well as Section 17(a)(1) of the Securities Act)
- The CFO agreed to settle with the SEC and to be enjoined from future violations of the federal securities laws as well

⁷ SEC Rel. Nos. IA-6034; IC-34594, *Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices* (May 25, 2022) and SEC Rel. Nos. 33-11067; 34-94981; IC-34593, *Investment Company Names* (May 25, 2022).

⁸ More information on the SEC's ESG proposing releases for investment companies and investment advisers can be found in the respective SEC Fact Sheets at <https://www.sec.gov/files/ia-6034-fact-sheet.pdf> and <https://www.sec.gov/files/ic-34593-fact-sheet.pdf>.

⁹ Available at <https://www.hawkins.com/about/publications/2018-05-29-cybersecurity-municipal-disclosure>.

¹⁰ SEC Rel. Nos. 33-10459, 34-82746 (Feb. 21, 2018), which provided updates to CF Disclosure Guidance: Topic No. 2, Cybersecurity (Oct. 13, 2011).

¹¹ *In re Altaba Inc. f/d/b/a Yahoo! Inc.*, SEC Rel. Nos. 33-10485, 34-83096 (Apr. 24, 2018) (the "Yahoo Enforcement Action").

¹² SEC Rel. Nos. 33-11038; 34-94382, *Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure* (Mar. 9, 2022).

¹³ See [SEC.gov | SEC Charges School District and Former Executive with Misleading Investors in Bond Offering](https://www.sec.gov/SECCharges/SchoolDistrictandFormerExecutivewithMisleadingInvestorsinBondOffering).

as from participating in any future municipal securities offerings; also agreed to pay a \$28,000 penalty

- The School District agreed to settle with the SEC and engage an independent consultant to evaluate its policies and procedures related to its municipal securities disclosures

Crosby Independent School District (Mar. 16, 2022)¹⁴

- The School District failed to report payroll and construction liabilities in offering document for 2018 bond offering
- The School District's 2017 audited financial statements falsely reported general fund reserves and were included in the offering document
- When these misstatements were discovered, the School District declared a financial emergency, the bonds were downgraded, and the audited financial statements were restated
- This matter involved violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Section 17(a) of the Securities Act
- The School District agreed to the entry of an order finding violations of the antifraud provisions; no further action taken against the School District as a result of self-imposed remedial actions and cooperation with the SEC in its investigation
- The CFO agreed to the entry of an order finding violations of the antifraud provisions; agreed to pay a \$30,000 penalty and not participate in any future municipal securities offerings
- The auditor was charged with violating certain accounting standards and agreed to be suspended from appearing or practicing before the SEC as an accountant with the right to apply for reinstatement after 3 years; further agreed to not serve as the engagement manager, engagement partner, or engagement quality control reviewer in connection with any audit expected to be posted in the MSRB's Electronic Municipal Market Access ("EMMA") system until reinstated by the SEC

Town of Sterlington, Louisiana (June 2, 2022)¹⁵

- This matter involved misconduct in the issuance of municipal bonds by the Town in 2017 and 2018, which were sold in private placements to investors and were intended to finance the development of a water system for the Town and improvements to its existing sewer system
- The Town applied to a local bond commission for approval of the bond offerings and included in the applicable applications false financial projections about the anticipated revenue of the Town's sewer system; there was an overstatement of sewer customer and revenue projections so that the Town could meet the minimum

debt service coverage ratio required for bond commission approval

- The false projections were created by the Town's municipal advisor with the participation and approval of the Town's then-Mayor and misled the bond commission as to the Town's ability to cover its debt service for the proposed bonds
- There were no offering documents prepared for the applicable bond issuances; bond investors were provided with copies of the bond commission applications and related approvals
- Bond investors were not informed that the Town had obtained approval of the bonds based on false projections, and were not informed of the associated risk that the bonds may not have been duly authorized; the Town also did not disclose to investors that it had misused over \$3 million from earlier bond offerings
- This matter involved violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder
- The SEC considered remedial acts undertaken by the Town relating to improvements to its internal controls and establishment of a financial oversight committee charged with, among other things, overseeing and approving any borrowing or applications for funds, and approving disbursements; no further action taken against the Town
- The municipal advisors (principal and firm) were charged with failing to register as municipal advisors and with violating fiduciary duty and fair dealing rules; they consented to the entry of judgments enjoining them from future violations and agreed to pay disgorgement, prejudgment interest, and civil penalties in amounts to be determined
- The Mayor is contesting the allegations against him

SEC v. City of Rochester, New York, et al. (June 14, 2022)¹⁶

- The SEC charged the City, its Director of Finance, the School District's former CFO, and its municipal advisor (principals and firm) in connection with a 2019 bond issuance, where the City sold approximately \$119 million in bonds to investors on behalf of the School District
- The School District is the largest component of the City's budget
- Investors were told that \$50 million of the bond proceeds would be loaned to the School District to offset the effects of timing differences between cash receipts and disbursements, as the School District awaited anticipated funding from the State; the School District was expected to repay the \$50 million loan
- The remaining \$69 million was to provide financing for the School District, as well as other City projects

¹⁴ See [SEC.gov | SEC Charges Texas School District and its Former CFO with Fraud in \\$20 Million Bond Sale](#).

¹⁵ See [SEC.gov | SEC Charges Louisiana Town and Former Mayor with Fraud in Two Municipal Bond Deals](#).

¹⁶ See [SEC.gov | SEC Charges Rochester, NY, and City's Former Executives and Municipal Advisor with Misleading Investors](#).

- This matter involves violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder
- Offering documents are alleged to have been materially misleading by including outdated financial statements for the School District and failing to disclose that the School District was experiencing unusual financial distress due to overspending on teacher salaries
- The School District's former CFO is also alleged to have been aware of the financial distress and withheld such information from the rating agencies (both in meetings and in rating agency presentations) and from members of the working group
- By all indication, the School District's spending was within the budget for the fiscal year; officials are alleged to have known that was not the case
- The School District was, in fact, carrying a \$27.6 million deficit and, as a result, the City's debt rating was downgraded
- The State intervened with a \$35 million loan and appointed a monitor for the School District
- Once the financial distress came to light, the municipal advisor proposed that the financial statements be updated and a supplement to the offering documents be prepared; both of which were done
- The SEC alleges violations of the antifraud provisions of the federal securities laws in connection with the offering documents, indicating, among other things, that the City, the Director of Finance, and the municipal advisors should have been aware of the School District's financial distress or undertaken to inquire more diligently about its financial condition
- The municipal advisors are also alleged to have breached their fiduciary duty under the federal securities laws and violated MSRB Rules G-17, G-42, and G-44
- Such allegations pertain to an alleged failure to disclose to its clients (including the City) that the municipal advisor had material conflicts of interest arising from its compensation arrangements and, in many cases, falsely

stated that it had no undisclosed material conflicts of interest

- The SEC is seeking a variety of remedies, including, among other things, a finding that the defendants committed the alleged violations of the federal securities laws and regulations and enjoining further violations; disgorgement and prejudgment interest; civil penalties; and a municipal securities industry bar for the Director of Finance
- Cases against the City, the Director of Finance, and the municipal advisor are pending
- The School District's former CFO settled the case against him and agreed to pay a \$25,000 penalty and to a court order prohibiting him from future violations of the antifraud provisions and from participating in future municipal securities offerings

SEC v. Anthony Michael Holland (June 16, 2022)¹⁷

- Holland is the former Chief Administrative Officer and City Secretary for the City of Johnson City, Texas (the "City"); he is charged with creating falsified financial statements for the City's fiscal year ended September 30, 2016 and a falsified audit report for those financial statements
- Holland is alleged to have created the falsified documents to prevent discovery of his ongoing embezzlement of City funds
- Holland caused the falsified documents to be posted to the City's public website and on EMMA, where they were made publicly available to investors in the City's outstanding bonds; misleading statements in secondary market information
- Holland is charged with violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder
- The SEC is seeking a variety of remedies, including, among other things, a finding that Holland committed the alleged federal securities law violations; an order enjoining further violations; disgorgement and prejudgment interest; civil penalties; and a municipal securities industry bar
- Case is pending

¹⁷ See [Anthony Michael Holland \(Release No. LR-25426; Jun. 16, 2022\) \(sec.gov\)](#).

About Hawkins Advisory

The Hawkins Advisory is intended to provide occasional general comments on new developments in Federal and State law and regulations that we believe might be of interest to our clients. Articles in the Hawkins Advisory should not be considered opinions of Hawkins Delafield & Wood LLP. The Hawkins Advisory is not intended to provide legal advice as a substitute for seeking professional counsel; readers should not under any circumstance act upon the information in this publication without seeking specific professional counsel. Hawkins Delafield & Wood LLP will be pleased to provide additional details regarding any article upon request.

New York

7 World Trade Center
250 Greenwich Street
New York, NY 10007
Tel: (212) 820-9300

Washington, D.C.

601 Thirteenth Street, N.W.
Washington, D.C. 20005
Tel: (202) 682-1480

Newark

One Gateway Center
Newark, NJ 07102
Tel: (973) 642-8584

Hartford

20 Church Street
Hartford, CT 06103
Tel: (860) 275-6260

Ann Arbor

201 S. Main Street
Ann Arbor, MI 48104
Tel: (734) 519-5003

Sacramento

1415 L Street
Sacramento, CA 95814
Tel: (916) 326-5200

Los Angeles

333 South Grand Avenue
Los Angeles, CA 90071
(213) 236-9050

San Francisco

One Embarcadero Center
San Francisco, CA 94111
Tel: (415) 486-4200

Portland

200 SW Market Street
Portland, OR 97201
Tel: (503) 402-1320

Raleigh

4801 Glenwood Avenue
Raleigh, NC 27612
Tel: (919) 635-8294