HAWKINS ADVISORY

SEC SETTLES ILLINOIS ENFORCEMENT ACTION; CITES IMPORTANCE OF DISCLOSURE CONTROLS AND PROCEDURES

General. On March 11, 2013, the Securities and Exchange Commission (the "SEC"), in an administrative proceeding,[1] accepted a settlement offer made by the State of Illinois (the "State") and entered a cease-and-desist order (the "Order") against the State. The SEC concluded that the State had acted negligently, in violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 (the "Securities Act").[2] The Order concerned disclosures relating to the State's pension liabilities in official statements and preliminary official statements used for numerous bond offerings in the 2005-2009 period. The bonds being offered were general obligation bonds, backed by the full faith and credit of the State. The Order stated that "the State omitted to disclose . . . material information regarding the structural underfunding of its pension systems and the resulting risks to the State's financial condition." The Order further cautioned that the "resulting systematic underfunding imposed significant stress on the pension systems and on the State's ability to meet its competing obligations."[3]

Significantly, the Order advised that the misleading disclosures resulted in part from "various institutional failures." In determining to settle the proceeding against the State on a charge of negligent conduct, the SEC noted that the State had implemented a series of remedial measures. In the Order, the SEC stated that:

> The State retained disclosure counsel, significantly enhanced disclosures in the pension section of its bond offering documents, developed training materials, and added formal disclosure controls regarding pension disclosures. The State also designated a disclosure committee responsible for collecting information from relevant sources, evaluating the State's disclosure obligations, and approving bond offering disclosures.

Prior Enforcement Actions. The SEC had settled two prior enforcement actions against governmental issuers relating principally to their pension disclosures - the City of San Diego[4] and the State of New Jersey.[5] In doing so, the SEC cited in each instance, in the context of ameliorated penalties, remedial actions that had been undertaken by the issuers.

The SEC found that the City of San Diego had made materially misleading disclosures regarding its pension and retiree health care systems in preliminary official statements, official statements, continuing disclosures, and presentations to rating agencies. Unlike Illinois, in which the SEC attributed the misleading disclosures "largely to institutional failures," the SEC concluded in the San Diego enforcement action that "the City, through its officials, acted with scienter. City officials who participated in drafting the misleading disclosure were well aware of the City's pension and retiree health care issues and the magnitude of the City's future liabilities." As a result of the finding of scienter, the SEC concluded that the City had violated Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (the "Exchange Act").

The SEC cited the following remedial measures that the City had undertaken: (i) the hiring of "new disclosure counsel [Hawkins] for all of its future offerings, who will have better and more continuous knowledge on the City's financial affairs," (ii) "seminars for City employees on their responsibilities under the federal securities laws," conducted by outside disclosure counsel, (iii) the formation of a Disclosure Practices Working Group "comprised of senior City officials from across City government," to review "the form and content of all the City's documents and materials prepared, issued, or distributed in connection with the City's disclosure obligations."

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[1] The SEC has two options for civil enforcement actions: (i) an administrative proceeding before an administrative law judge or (ii) an action in federal district court before a federal judge. Potential criminal proceedings are referred by the SEC to the Department of Justice.

[2] If the SEC had determined that the State had acted with scienter (either recklessness or intentional deceit), it could have charged a violation of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.

[3] The analytic construct of "competing obligations" was also suggested in "Considerations in Preparing Disclosure in Official Statements Regarding an Issuer's Pension Funding Obligations," a joint project of various municipal market participants, which advised that "Disclosure about an issuer's pension obligations that is included in the [Official Statement] should reflect the degree to which such obligations could affect the issuer's ability to make bond payments to investors, or place pressures on the basic functions of government that would affect the creditworthiness of the bonds."

[4] *In re City of San Diego*, SEC Rel. Nos. 33-8751 and 34-54745 (Nov. 14, 2006).

[5] *In re State of New Jersey*, SEC Rel. No. 33-9135 (Aug. 18, 2010).

In December 2007, the then-SEC Director of Enforcement delivered a speech entitled "Lessons Learned from San Diego," in which she advised that the San Diego enforcement action had lessons for all issuers, including "(1) adopt written disclosure policies and procedures; [and] (2) provide appropriate training to city officials and employees." She explained that such policies and procedures should "at a minimum clearly identify who is responsible for what; clearly state the process by which the disclosure is drafted and reviewed; and provide checks and balances so there is adequate supervision and reasonable disbursement of responsibilities so that too much power and information is not placed with just one person." With respect to training, she advised that it was "essential," and should encompass "training for everyone involved in the disclosure process - from the city council members to the staff members who are involved in the initial drafting of the disclosure documents."

The New Jersey enforcement action concluded that there was negligent conduct in violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act. The order stated that in "79 municipal bond offerings, the State misrepresented and failed to disclose material information regarding its under funding of New Jersey's two largest pension plans." Interestingly, in this enforcement action the SEC went beyond recommending enhanced disclosure procedures and training, and offered a cause-and-effect relationship between such actions and the avoidance of misrepresentations and material omissions:

> The State was aware of the under funding of [the State's two pension systems] and the potential effects of the under funding. However, due to a lack of disclosure training and inadequate procedures relating to the drafting and review of bond disclosure documents, the State made material [mis]representations and failed to disclose material information regarding [such pension systems] in bond offering documents.

SEC Report. The SEC issued its Report on the Municipal Securities Market on July 31, 2012 (the "Report"). In the Report, the SEC recommended that legislation be adopted to provide the SEC with "authority to establish disclosure requirements and principles," and that with such authority the SEC "could consider the appropriate disclosure policies and procedures that municipal issuers should have to assure that they will satisfy their primary and ongoing disclosure obligations." As noted above, suggested disclosure controls and procedures were also the subject of guidance provided by the prior SEC Director of Enforcement. We issued a Hawkins Advisory, dated August 2, 2012, discussing the Report. If you would like a copy of that Hawkins Advisory, please contact any Hawkins partner.

Disclosure Controls and Procedures. We now have three significant SEC enforcement actions relating to misleading pension disclosures.[6] Of common interest to all municipal issuers, regardless of their pension liability exposure, is the advice offered by the SEC and SEC staff regarding disclosure controls and procedures. In all three enforcement actions, the SEC considered the remediation efforts, including improved, formally established disclosure controls and procedures that had been undertaken by the issuers. In the New Jersey and Illinois enforcement actions, determinations that the issuer's previous disclosure practices were procedurally deficient supported findings of negligence. In the Illinois enforcement action, the SEC noted with disapproval the issuer's previous reliance upon "carry-over disclosures" and "page-turn reviews" during working group conference calls, as having been insufficient to identify and evaluate the need for new or modified disclosures in response to changes. As previously noted, disclosure controls and procedures were also the subject of guidance provided by the prior SEC Director of Enforcement and highlighted by the SEC in the Report.

The disclosure recommendations by the SEC include as core elements written disclosure controls and procedures and disclosure training, which serve to improve the quality of the disclosures being made. We note that, in this context, the application of the express remedies provided by Sections 11 and 12 of the Securities Act to the offering and sale of securities subject to SEC registration differs significantly from the application of the general antifraud provisions[7] to offerings exempt from SEC registration, such as municipal offerings. For registered corporate offerings, there is absolute liability of the issuer to investors for materially misleading misstatements or omissions, subject only to a defense that the investor knew of the materially misleading misstatement or omission at the time of purchase. In contrast, for an offering exempt from SEC registration, such as a municipal securities offering, a plaintiff must prove that the issuer acted with negligence (SEC action under Section 17(a)(2) or 17(a)(3) of the Securities Act) or with scienter (SEC or private action under Section 10(b) and Rule 10b-5 of the Exchange Act). Accordingly, in the event that a misleading misstatement or omission were to occur, written disclosure controls and procedures and disclosure training could help establish a defense to a charge of negligence or scienter (recklessness or intentional deceit).

Hawkins Experience. Hawkins has acted as disclosure counsel for state and local issuers for many years, including the following notable engagements where the firm has prepared written disclosure controls and procedures and conducted disclosure training for issuers.

[6] Pension disclosure was analyzed in detail, with accompanying recommendations and a suggested analytic framework, in the pension disclosure project referenced in footnote 3 above, which is available on the National Association of Bond Lawyers' website at www.nabl.org.

[7] Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 of the Exchange Act.

Hawkins was engaged by the City of San Diego in March 2004 as General Disclosure Counsel, and in that capacity we have prepared written disclosure controls and procedures and conduct, on a biannual basis, disclosure training both for the City Council and the City's financial staff, which were noted by the SEC in the settlement order. Hawkins was also engaged by the State of Rhode Island, and prepared for them written disclosure controls and procedures, conducted a disclosure training seminar, and served as special pension disclosure counsel on a series of bond offerings. In addition, numerous partners, while serving as either bond counsel or disclosure counsel, have conducted disclosure training for their issuer clients.

Please contact any Hawkins partner for further information regarding any of the issues in this Hawkins Advisory or if we can otherwise be of assistance.

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New York
One Chase Manhattan Plaza
New York, NY 10005
Tel: (212) 820-9300

Washington, D.C.
601 Thirteenth Street, N.W.
Suite 800 South
Washington, D.C. 20005
Tel: (202) 682-1480

Newark
One Gateway Center, 24th Floor
Newark, NJ 07102
Tel: (973) 642-8584

Hartford
20 Church Street, Suite 700
Hartford, CT 06103
Tel: (860) 275-6260

Hawkins DELAFIELD & WOOD LLP

Sacramento
1415 L Street, Suite 1180
Sacramento, CA 95814
Tel: (916) 326-5200

Los Angeles
333 South Grand Avenue
Suite 3650
Los Angeles, CA 90071
(213) 236-9050

San Francisco
One Embarcadero Center
Suite 3820
San Francisco, CA 94111
Tel: (415) 486-4200

Portland
200 SW Market Street, Suite 350
Portland, OR 97201
Tel: (503) 402-1320