

HAWKINS ADVISORY

SEC'S REPORT AND ORDER REGARDING HARRISBURG

Introduction

On May 6, 2013, the Securities and Exchange Commission (the "SEC"), in an administrative proceeding,¹ accepted a settlement offer made by the City of Harrisburg, Pennsylvania (the "City") and entered a cease-and-desist order (the "Order") against the City. The SEC found that the City had acted in a reckless manner in violation of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder. In the Order, no action was taken against City officials. The proceeding was accompanied, however, by a report of investigation (the "Report") issued by the SEC pursuant to Section 21(a) of the Exchange Act in which the SEC addressed the obligations of public officials relating to their secondary market disclosures (i.e., disclosures made outside the context of an offering of municipal securities).

The SEC's press release that accompanied the Order and Report states that the SEC's investigation found that "misleading statements were made in the city's budget report, annual and mid-year financial statements, and a State of the City address." The SEC noted that this "marks the first time that the SEC has charged a municipality for misleading statements made outside of its securities disclosure documents." The SEC has previously brought enforcement actions against municipalities for materially misleading statements or omissions in disclosure documents such as financial statements,² the transmittal letters by which such financial statements were posted on third-party websites,³ continuing disclosure filings,⁴ and rating agency presentations.⁵ But in each case, the SEC had also found materially misleading misstatements or omissions in Preliminary and final Official Statements that were prepared contemporaneously with such documents.

SEC Order and Report

[The SEC Order](#). During the period January 2009 through March 2011 (defined in the Order as the "relevant time period"), the City had approximately \$43 million in outstanding

general obligation debt and constituted an "obligated person" (within the meaning of Rule 15c2-12⁶) for approximately \$455 million of outstanding debt that it guaranteed for several of its component units. The City had entered into six separate continuing disclosure agreements⁷ in connection with such debt in which it had agreed to provide, commencing in July 2009, annual financial information and, for the general obligation debt, notices of material events under Rule 15c2-12. During the relevant time period, in violation of these continuing disclosure obligations, the City did not submit annual financial information, audited financial statements, or notices of material events (or notices of failures to file any such information).

In light of such failures to file, and the resulting lack of financial information in the market, the SEC concluded that investors would "seek out" other public statements made by City officials:

As a result of Harrisburg's multi-year failure to provide financial information and notices as Harrisburg had agreed pursuant to its Continuing Disclosure Certificates, investors and the trading markets did not have certain information regarding the City's financial condition and had to seek out other public statements made by Harrisburg for current information on the City's finances.

The SEC determined that the City had made materially misleading statements or omissions in the following documents, which had been posted on the City's website: its 2007 Comprehensive Annual Financial Report ("CAFR"); its 2008 CAFR; the Management's Discussion and Analysis in the 2008 CAFR; its adopted 2009 budget; the Mayor's 2009 annual State of the City address; and its 2009 mid-year fiscal report, which compared budget-to-actual numbers. The material misstatements or omissions that were cited in the Order included: the omission of \$4 million in guarantee payments the City had to make on debt related to a municipal resource recovery facility;

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

² *In re* City of Miami, Florida, SEC Rel. No. 33-8213 (Mar. 21, 2003).

³ *Id.*

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

⁵ *Id.*

⁶ SEC Rule 15c2-12 under the Exchange Act (17 CFR § 240.15c2-12) defines "obligated person" to mean "any person . . . committed by contract or other arrangement to support payment of all, or part of the obligations on the municipal securities to be sold in the Offering."

⁷ SEC Rule 15c2-12 provides that a broker-dealer cannot underwrite municipal securities unless it has reasonably determined that the issuer or an obligated person has executed a continuing disclosure agreement, which requires the issuer or obligated person to provide annual financial information and notices of certain specified events.

the omission of a rating downgrade; and the failure to disclose that the City had been using its surplus revenues to make guarantee payments.

An element of a Rule 10b-5 violation is that the misleading disclosure was made “in connection with the purchase or sale of any security.” During the relevant time period, the City was neither purchasing nor selling its securities. To establish this requisite Rule 10b-5 element, the SEC cited the secondary market trades of investors that occurred during the relevant time period:

Between December 2008 . . . and April 2009, \$28 million of bonds issued or guaranteed by Harrisburg traded without investors having the benefit of material information regarding Harrisburg’s financial condition. . . .

....

. . . . Between April 2009 . . . and August 2009 . . . another \$24 million of bonds issued or guaranteed by Harrisburg traded without investors having the benefit of material information regarding Harrisburg’s financial condition.

The SEC Report. The Order was an enforcement action against the City as an entity. In the Order, the SEC did not charge any public officials. The SEC did, however, issue the Report to provide guidance to public officials regarding their potential liability for misleading disclosures in the secondary market.⁸ The Report emphasizes that it was the lack of other contractually-required financial disclosures by the City that resulted in the SEC’s conclusion that the information that was released could be reasonably expected to influence investors:

The statements by the Harrisburg public officials were part of, and could have altered, the total mix of information available to the market . . . [T]here were no other disclosures made by the City as part of the total mix of information available to enable investors to consider other information. These public officials’ statements were the principal source of significant, current information about the issuer of the security and thus could reasonably be expected to influence investors and the secondary market. Because statements are evaluated for anti-fraud purposes in light of the circumstances in which they were made, the lack of other disclosures by the municipal entity may increase the risk that municipal officials’ public statements may be misleading or may omit material information.

The Report provides useful guidance for an issuer to minimize the risk that an investor will rely upon information that is not intended for investment purposes:

[P]ublic officials who make public statements concerning the municipal issuer should consider taking steps to reduce the risk of misleading investors. At a minimum, they should consider adopting policies and procedures that are reasonably designed to result in accurate, timely, and complete public disclosures; identifying those persons involved in the disclosure process; evaluating other public disclosures that the municipal securities issuer has made, including financial information and other statements, prior to public dissemination; and assuring that responsible individuals receive adequate training about their obligations under the federal securities laws.

Analysis

The Report and the Order provide a clarion call to municipal officials regarding the potential liability of a municipal entity (as entity) and of individual officials for materially misleading statements or omissions made in any statements or documents that are reasonably expected to reach investors.

The SEC had previously advised that secondary market disclosures will potentially be subject to antifraud liability. In 1994, the SEC advised: “A municipal issuer . . . when it releases information to the public that is *reasonably expected* to reach investors and the trading markets, those disclosures are subject to the antifraud provisions.”⁹ The issue is not whether the disclosure is *intended* to reach investors, but whether it is *reasonably expected* to reach investors. The Order and the Report state that the “reasonably expected” analysis will take into account whether there are current disclosures otherwise available to investors. The key factors noted in the Order were that during the period January 2009 through March 2011:

- the City had in the aggregate almost \$500 million of general obligation and guaranteed debt outstanding
- such debt was being actively traded in the secondary market
- there was “increased interest in its [the City’s] financial health”
- there were no new securities offerings and thus no current Official Statements or offering documents
- the City, in violation of its continuing disclosure agreements, did not submit annual financial information, audited financial statements, notices of failures to file, or notices of material events
- the City did release a series of financial and budget documents (2007 CAFR; 2008 CAFR; 2009 Budget;

⁸ In a similar fashion, in 1996 the SEC entered a cease-and-desist order against Orange County, CA (SEC Rel. Nos. 33-7260, 34-36760 (Jan. 24, 1996)), but took no action against individual members of the County Board of Supervisors. The SEC did, however, issue a 21(a) report (SEC Rel. No. 36761 (Jan. 24, 1996)) that provided guidance to members of a legislative body that authorize the issuance of securities and approve the related disclosure documents.

⁹ SEC Rel. Nos. 33-7049, 34-33741 (Mar. 9, 1994) (emphasis added).

and Mid-Year Fiscal Report for 2009), which were posted on its website

- the Mayor delivered the annual (2009) State of the City Address, which was posted on the City's website

Although the somewhat unique fact pattern presented in the Harrisburg enforcement action may suggest that the Order is of somewhat limited guidance to the market generally, it would be prudent to read the Report otherwise. The Report cautions:

Public officials should be mindful that their public statements, whether written or oral, may affect the total mix of information available to investors, and should understand that these public statements, if they are materially misleading or omit material information, can lead to potential liability under the anti-fraud provisions of the federal securities laws.¹⁰

In addition to the clear guidance provided by the SEC in the Report (quoted above) regarding disclosure policies, the SEC has provided similar advice in recent significant enforcement actions. For example, in the enforcement action against the State of New Jersey,¹¹ the SEC advised:

The State was aware of the under funding of the [State 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 misrepresentations and failed to disclose material information regarding [State pension systems] in bond offering documents.

Similarly, in its enforcement action against the State of Illinois,¹² the SEC noted the following "institutional failures":

The State failed to adopt or implement sufficient controls, policies, or procedures designed to ensure that material information was assembled and communicated to individuals responsible for disclosure determinations, to train personnel involved in the disclosure process adequately, or to retain disclosure counsel.

Disclosure Program

The Report provides guidance from the SEC regarding disclosure practices outside the context of a primary offering of securities. The New Jersey and Illinois enforcement actions provide guidance regarding disclosure practices in connection with

primary offerings. Although any disclosure program must be tailored to reflect the size and experience of, and types of financings conducted by, any particular municipal issuer, the following are key elements of a comprehensive disclosure program:

1. Written Policies and Procedures
 - a. clearly identify who is responsible for what¹³
 - b. clearly state the process by which the disclosure is drafted and reviewed
 - c. provide checks and balances so there is adequate supervision and reasonable disbursement of responsibilities
2. Disclosure Training
 - a. general training on the disclosure requirements of the federal securities laws
 - b. specific training on each particular person's role and responsibilities in the disclosure process
 - c. training for everyone involved in approving, drafting, or reviewing disclosure documents
3. Retain Disclosure Counsel
4. Designate a Disclosure Committee
 - a. responsible officials from financial, debt management, budget, in-house counsel, are to review any Preliminary or final Official Statements and other offering documents
 - b. review to include members of the financing team (e.g., bond counsel, disclosure counsel, underwriters, underwriters' counsel, financial advisor (if any))
 - c. at least one such meeting would be an in-person page-turning session
 - d. could consider having Disclosure Committee also review any document that is "reasonably expected to reach investors"
5. Use of Internet Guidelines
 - a. make clear exactly where investors should look to obtain and review financial information, whether an investor information webpage or EMMA¹⁴

¹⁰ It is interesting to note that although the Report cautions regarding both written and oral statements, the Order makes careful note that the Mayor's State of the City Address "was accessible on Harrisburg's website."

¹¹ *In re State of New Jersey*, SEC Rel. No. 33-9135 (Aug. 18, 2010).

¹² *In re State of Illinois*, SEC Rel. No. 33-9389 (Mar. 11, 2013).

¹³ The subheadings under items 1. and 2. reflect the guidance provided by Linda Chatman Thomsen, then-SEC Director of Enforcement, in a speech entitled "Lessons Learned from San Diego" (Dec. 11, 2007).

¹⁴ The Electronic Municipal Market Access system that is maintained by the Municipal Securities Rulemaking Board. EMMA initially only accepted contractually-required information. As such, many issuers established their own investor information webpages. However, EMMA now also accepts voluntarily-filed information.

- b. include a cautionary note on the issuer's homepage that the only information that is posted with the intention of reaching the investing public, including the entity's bondholders, rating analysts, financial advisors, or any other members of the investment community, is located elsewhere (whether investor information webpage or EMMA).

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