HAWKINS ADVISORY

Securities Liability for Tax Certification - Analysis of SEC Order regarding South Miami, Florida

Introduction

On May 22, 2013, the Securities and Exchange Commission (the "SEC"), in an administrative proceeding,[1] accepted a settlement offer made by the City of South Miami, Florida (the "City") and entered a cease-and-desist order (the "Order") against the City.[2] The SEC found that the City had acted in a negligent manner in violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 (the "Securities Act"). No enforcement action was taken against City officials.

The City was a borrower in pooled conduit municipal bond offerings in 2002 and 2006 of the Florida Municipal Loan Council. The project financed by proceeds of the City's borrowings began as a municipal parking garage but evolved into a mixed-use retail and public parking structure developed by a for-profit developer. In connection with the 2002 bond issue, bond counsel had advised City officials that none of the proceeds of such bond issue that were to be loaned to the City could be used to fund the retail portion of the building. Without regard to such advice, less than one month after the closing of the 2002 bond issue the City loaned a significant portion of the proceeds of the 2002 borrowing to the developer, and in 2005 negotiated a revised lease agreement that leased to the developer the entire structure of the project, including the retail space and the parking garage. The City failed to disclose such 2002 and 2005 actions at the time undertaken to either the conduit issuer and bond counsel or to the market as a whole. In addition, the City did not inform the conduit issuer or the bond counsel of these actions when it applied to participate in the 2006 pooled financing.

The loan and the lease revisions resulted in an impermissible "private business use" that jeopardized the tax-exempt status of both the 2002 bonds and the 2006 bonds of the Florida Municipal Loan Council. On July 22, 2010, the City filed a material event notice stating that on July 19, 2010, it had commenced discussions with the IRS under the Voluntary Closing Agreement Program ("VCAP") to preserve the tax-exempt status of the 2002 bonds and the 2006 bonds, and further stating that on July 19, 2010, the SEC had issued a formal order of investigation. Another material event notice was filed on August 18, 2011, stating that a closing agreement under VCAP had been entered into on August 17, 2011, which agreement preserved the tax-exempt status of the 2002 and 2006 bond issues.

Order

The Order concluded that the City had violated Sections 17(a)(2) and 17(a)(3) of the Securities Act because of the material misrepresentations and omissions in the 2006 Tax Certificate and in the 2006 Loan Agreement by which it borrowed money from the conduit issuer. Section 17(a) provides, in pertinent part (emphasis added):

> (a) It shall be unlawful for any person ***in the offer or sale of any securities*** . . .
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> (2) ***to obtain money*** . . . by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
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> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

The City agreed in the Order to retain an independent third-party consultant for a period of three years to advise it regarding disclosure policies and training. The scope of this engagement is substantially identical to that undertaken by the City of San Diego in its settlement with the SEC.[3] The Order provides:

> The City agrees to retain, at the City's expense and within 120 days of this Order, an independent third-party consultant, not unacceptable to the staff, for a period of three years, to conduct annual reviews of the City's policies, procedures, and internal controls regarding: its disclosures for municipal securities offerings, including: (i) disclosures made in financial statements; (ii) disclosures made pursuant to continuing disclosure agreements and disclosures regarding credit ratings; (iii) the hiring of internal personnel

[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 South Miami, Florida, SEC Rel. No. 33-9404 (May 22, 2013).

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

and external experts for disclosure functions; (iv) the designation of an individual at the City responsible for ensuring compliance by the City of such policies, procedures, and internal controls; and (v) the implementation of active and ongoing training programs for, among others, the City Attorney(s), the City Manager, the Mayor, the City Finance Director, and the City Commissioners regarding compliance with disclosure obligations.

Analysis

In the *South Miami* Order, the SEC concluded that material misrepresentations in documents that were not provided to investors, but which were part of the basis for a bond counsel opinion that a bond issue was tax-exempt, could subject the municipality making such representations to federal securities law liability.[4]

The SEC advised in the *Ira Weiss* enforcement action[5] of the interplay between the tax exemption of a bond issue and the general antifraud provisions of the federal securities laws. In that enforcement action, bond counsel was found to have violated Sections 17(a)(2) and 17(a)(3) by negligently rendering an unqualified opinion that interest on the notes in question was exempt from federal taxation, which opinions was described in the official statement. The SEC concluded that "Weiss was responsible for misrepresentations and omissions in the Official Statement and in his legal opinions which were made available to investors." Thus, the SEC focused on documents that were directly provided to investors.

The SEC advised in the recent *Harrisburg* enforcement action[6] that an issuer's misleading disclosure can occur outside the context of a primary offering of securities. As we noted in our recent Hawkins Advisory:

> The SEC has previously brought enforcement actions against municipalities for materially misleading statements or omissions in disclosure documents such as financial statements, the transmittal letters by which such financial statements were posted on third-party websites, continuing disclosure filings, and rating agency presentations. 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.

But in *Harrisburg*, the SEC argued that the budgetary and other documents, in the unique circumstances at issue there, were "reasonably expected to reach investors."[7]

The SEC advised in the *Massachusetts Turnpike* enforcement action[8] that the federal securities laws could be violated by a governmental entity that provided false or misleading information to another governmental entity that issued securities, if that issuer were to use such information in preparing its offering materials:

> Section 17(a) is to be interpreted broadly, and an individual who provides false or misleading information included in offering materials may be liable under this section even if that individual does not have direct contact with investors or editorial control of the offering materials.

Although the *South Miami* Order has elements of the *Ira Weiss*, *Harrisburg*, and *Massachusetts Turnpike* enforcement actions, it provides new guidance to the market as to the SEC's view of the scope of a non-issuer governmental entity's disclosure obligations. The key elements of the *South Miami* Order are:

- material misrepresentations and omissions are not limited to preliminary and final official statements or documents "reasonably expected to reach investors,"
- material misrepresentations and omissions can occur in tax documentation and underlying contractual obligations that are not provided to investors, but are relied upon by bond counsel in its analysis of tax-exemption,
- such material misrepresentations and omissions may be determined to have resulted from an undisclosed failure to act in compliance with such tax documentation and obligations, even if the failure does not ultimately (through VCAP or otherwise) affect the tax status of the bonds,

[4] In the context of a private cause of action under Rule 10b-5, for which reliance is a requisite [it is not a requisite for a SEC enforcement action under either Rule 10b-5 or Section 17(a)], it is not necessary for the investor to have been directly provided materially misleading disclosure. In the case of a materially misleading omission, there is a rebuttable presumption of reliance, known as the "fraud-on-the-market theory," that, on the premise of an efficient market, assumes that the omitted fact would have impacted the market price of the security. That principle was established in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), which is cited by the SEC in the *South Miami* Order.

[5] *In re* Ira Weiss, SEC Rel. Nos. 33-8641, 34-52875 (Dec. 2, 2005) and SEC Rel. Nos. 33-8459, 34-50235 (Aug. 24, 2004).

[6] *In re* The City of Harrisburg, Pennsylvania, SEC Rel. No. 34-69515 (May 6, 2013) and Report of Investigation in the Matter of the City of Harrisburg, Pennsylvania, SEC Rel. No. 34-69516 (May 6, 2013). These were the subject of a Hawkins Advisory dated May 10, 2013.

[7] *Id*. In making such reference in *Harrisburg*, the SEC cited its 1994 Interpretive Release (SEC Rel. Nos. 33-7049, 34-33741, Mar. 9, 1994), in which it stated "A municipal issuer may not be subject to the mandated continuous reporting requirements of the Exchange Act, but 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."

[8] *In re* The Massachusetts Turnpike Authority, SEC Rel. No. 33-8260 (July 31, 2003).

- a Section 17(a) violation can occur if one is seeking to "obtain money" [Section 17(a)(2)] and does so by means of a material misrepresentation or omission, and
- although Section 17(a) requires that the misleading disclosure occur "in the offer or sale of any securities," this requirement can be satisfied by secondary market trading. As the *South Miami* Order states, "numerous investors traded the 2002 and 2006 Bonds at prices that assumed those bonds were tax-exempt. Information regarding the bonds' tax-exempt status was important to investors in evaluating whether to purchase bonds through this municipal bond offering."[9]

It is worth noting that the SEC, in its "Report on the Municipal Securities Market,"[10] stated that it was considering seeking, as part of its legislative agenda, authority to receive information from the IRS that is currently protected by federal law:

> Section 6103 of the Code does not permit the IRS to disclose return information to the Commission and Commission staff in connection with civil enforcement of the securities laws. Were the IRS able to share with the Commission in appropriate instances information it obtains from returns, audits, and examinations, Commission enforcement actions relating to municipal securities would be more consistent, comprehensive, and timely.

Another notable lesson of the *South Miami* enforcement action is the imposition of the requirement to hire a third-party consultant with the responsibilities summarized above. Such a requirement was imposed in the *San Diego* enforcement action after a finding that "[t]he City, through its officials, acted with scienter . . . the City officials acted recklessly in failing to disclose material information regarding [pension] liabilities." But in the *South Miami* enforcement action, the SEC imposed this significant undertaking even though the finding was based only on negligent conduct. The highlighting of remedial actions undertaken or to be undertaken, particularly written disclosure controls and procedures and disclosure training, has become a key element of recent SEC settlements, commencing with the *San Diego* enforcement action, and continuing with the *New Jersey*,[11] *Illinois*,[12] and *Harrisburg* enforcement actions. In our Hawkins Advisory analyzing the *Harrisburg* enforcement action, we provided a template of the core features of written disclosure controls and procedures and disclosure training. Based on the *South Miami* Order, such procedures, controls, and training should address not only documents being provided to investors or documents reasonably expected to reach investors, but should also include the disclosure ramifications of compliance with any tax documentation or certifications upon which bond counsel bases its analysis of tax-exemption.

[9] The SEC had provided a comparable analysis in the *Harrisburg* enforcement action in the context of Rule 10b-5, concluding that the "in connection with the purchase or sale of any security" element of that Rule was satisfied by secondary market trades occurring during the period misleading disclosure was in effect.

[10] Report dated July 31, 2012, which was the subject of a Hawkins Advisory dated August 2, 2012.

[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). See Hawkins Advisory, "SEC Settles Illinois Enforcement Action; Cites Importance of Disclosure Controls and Procedures," dated March 22, 2013.

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