

“One Size Does Not Fit All”

Municipal Securities Disclosure in Tax Incremental Financings

Lisa M. Williams, Partner

Emily P. Gordy, Partner

David Gustin, Associate

www.mcguirewoods.com

McGUIREWOODS

“We do not believe that the municipal market lends itself to a *one size fits all* approach to regulation but there should be a few basic requisites to participation in the public markets ... Beyond these basic requirements, given the differences among issuers and debt instruments offered in the municipal market, it is difficult to prescribe specifics for either the contents of official statements or financial statements.”

- Mary Colby, National Federation of Municipal
Securities Analysts Industry Practices and
Procedures Chair ¹

⁽¹⁾Letter dated October 6, 2010 from Mary Colby to The Honorable Elisse B. Walter Commissioner with the U.S. Securities Exchange Commission. The National Federation of Municipal Analysts is a not-for-profit association with “goals of promoting professionalism in municipal credit analysis and furthering the skill level of its members through educational programs and industry communication, providing an informed perspective in the formulation of legal and regulatory matters relating to the municipal finance industry, and facilitating the flow of information between investors and issuing entities.”

Federal Regulation of Municipal Securities

The Alphabet Soup of Regulatory Agencies

- **SEC:** The Securities and Exchange Commission has broad examination, inspection, and enforcement authority
- **MSRB:** The Municipal Securities Rulemaking Board was created by the Securities Exchange Act of 1934 Act to establish rules to regulate the municipal securities market; however, the MSRB does not have the authority to enforce its rules
- **FINRA:** The Financial Industry Regulatory Authority regulates broker dealers but not bank dealers, and examines for compliance with, and enforces violations of, the MSRB's rules with respect the municipal securities
- **OCC/FDIC/FRS:** The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve System are agencies that regulate bank dealers that are not regulated by FINRA

Federal Regulation of Municipal Securities

➤ The Securities Act of 1933 (the “1933 Act”)

- Governs the registration of securities with the Securities and Exchange Commission
- Provides civil liabilities for either a failure to register or materially misleading disclosure
- Municipal securities are securities under the 1933 Act; however, are exempt from registration as exempted securities under Section 3(a)(2)

➤ The Securities Exchange Act of 1934 (the “1934 Act”)

- Governs the regulation of the securities markets
- With respect to the municipal securities market, the 1934 Act:
 - Requires the registration with the SEC of brokers, dealers, municipal securities dealers, and municipal advisers (Sections 15 and 15B)
 - Created the Municipal Securities Rulemaking Board (the “MSRB”) (Section 15B)
 - Makes the violation of the rules promulgated by the MSRB a violation of federal law (Section 15B(c)(1))
 - Establishes limitations on the authority of the SEC and the MSRB regarding the filing of disclosure documents prior to the sale of the related securities (Section 15B(d)(1) and (2))
 - Sets forth antifraud provisions pursuant to which the SEC has adopted Rule 15c2-12 and Rule 10b-5

Federal Anti-fraud Provisions

Section 17(a) of the 1933 Act:

“It shall be unlawful for any person in the offer or sale of any securities ...by the use of any means or instruments or transportation or communication in interstate commerce or by use of the mails, directly or indirectly –

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make statements made, in light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.”

Federal Anti-fraud Provisions

Section 10(b) of the 1934 Act

“It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange –

...

(b) To use or employ, in connection with the purchase or sale of any security ... not so registered, ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

...”

Federal Anti-fraud Provisions

Rule 10b-5

“It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”

Federal Anti-fraud Provisions

- All participants in a municipal securities public offering have anti-fraud obligations
- HOWEVER, the *issuer* is ultimately responsible for the contents of the offering document
- While the SEC can bring actions against issuers for inadequate disclosures under the federal anti-fraud provisions, they cannot regulate what issuers put into disclosure documents

The Issuer “Owns” the Disclosure Document

- The issuer may utilize professionals and other third parties in the preparation of the disclosure document but the issuer cannot transfer the risk
- The issuer must ensure that the disclosure document is prepared and approved by the appropriate officials and/or staff

The Underwriter's Disclosure Obligations

- The underwriter has an affirmative responsibility to perform a reasonable investigation or take reasonable care that the disclosure document does not contain material misstatements or omissions and may assert a due diligence defense to legal claims
- While municipal securities are generally exempt securities under the 1933 Act and the 1934 Act, many legal concepts that are applicable to other capital market sectors are applied by analogy to the municipal securities market

The Underwriter's Disclosure Obligations: Rule 15c2-12

- “Prior to the time the Participating Underwriter bids for, purchases offers, or sells municipal securities in an Offering, the Participating Underwriter shall obtain and review an official statement that an issuer of such securities deems final as of its date ...”
- The underwriter must have a reasonable basis for believing in the truthfulness and completeness of key representations made in any disclosure document used in an offering and must review for omissions and misstatements
- “final official statement” is defined as “a document ... that sets forth information concerning the terms of the proposed issue of securities; information, including financial information or operating data, concerning such issuers of municipal securities and those other entities, enterprises, funds, accounts, and other persons material to an evaluation of the Offering; and a description of the undertakings to be provided [with respect to the continuing disclosure requirements under Rule 15c2-12].”

Public Offering vs. Private Placement

- The investor base is typically limited to only sophisticated investors with respect to a private placement transaction
- In a private placement transaction the due diligence burden is in part shifted to the investor
 - Investors typically sign investor letters that they have been given an opportunity to conduct the necessary due diligence in making their investment decision
 - A disclosure document may or may not be involved
 - Information included in a disclosure document may be different in a public offering versus a private placement
 - In a disclosure document for a public offering, it is required that all information that would be necessary for an investor to make a decision be included in the disclosure document without the investor conducting any additional due diligence

Information Included in the Disclosure Document

- “One size does not fit all”
- In order to determine the credit risk of a municipal security, the information investors need depends on the type of issuer and the credit involved
 - All disclosures have a principal framework
 - Disclosure is based on the facts and circumstances of the transaction
 - Disclosure of information that may impact an investors decision to purchase
- Basic attributes of information to be included in a disclosure document:
 - Material
 - Accurate
 - No omissions
 - Not misleading
- Information must not only be reviewed in isolation but also as part of the “total mix” of information included in the disclosure document

Tax Incremental Financings

TIF Disclosure: What information to include in the disclosure document?

- Investors need sufficient information to evaluate the risks associated with purchasing the municipal security:
 - Market Risk: Value of the bond in the market
 - Credit Risk: Issuer's ability to repay debt service
 - Event Risk: Not all risks can be anticipated or accurately measured
- The assessment of these risks will impact an investor's decision to purchase the securities and at what interest rate it is willing to purchase such securities

TIF Disclosure: TIF District

- Is this a new or mature TIF District?

- What are the boundaries of the TIF District?
 - Defines the area from where revenues will be generated
 - Size of the TIF District may impact the perceived credit risk
 - Other governmental units may oppose the boundaries of the TIF District, which may create potential for litigation
 - Demographic information

TIF Disclosure: Revenues

- What is the source of repayment for the TIF?
 - Property tax increments
 - Sales tax increments
 - General Obligation
 - Double-barrel
- What is the timing of the tax-increment payments?
- If there is a surplus of tax-increment revenues, how will such surpluses be used?
- How will overlapping governmental units be impacted by the TIF?
- What limitations will be put on the governmental units ability to raise tax rates in the future?

TIF Disclosure: Other TIF Related Disclosures

- Developer Agreements
- Intergovernmental Agreements
- Tenant Leases
- Feasibility Studies
- Financial Projections

TIF Disclosure: Forecasts, Projections and Feasibility Analysis

- There are fundamental concerns with including forecasts, projections and feasibility studies in disclosure documents because by including such information in the disclosure document such information becomes subject to the scrutiny of the anti-fraud securities law
 - Unlike other information which is based on past events and can be factually sourced, forecasts, projections and feasibility studies are forward looking as based on a number of assumptions
 - Alternatively, if such analysis is done and reflects negative information about the issuer's ability to pay debt service on the TIF such information is material to an investor's decision to purchase the security
 - Forward-looking statements must be reasonable and be believed by the issuer to be reasonable statements of expected future performance
 - The parameters and factors impacting the forecasts, projections and feasibility analysis must be clearly disclosed
 - Since the completion of the analysis, have any events occurred that impact the assumptions upon which the analysis is based?

TIF Disclosure: Forecasts, Projects and Feasibility Studies

➤ “Bespeaks Doctrine”

- Statutory Safe Harbor in Section 27A of the 1933 Act and Section 21E of the 1934 Act, which is applied to municipal securities by analogy
- The common law doctrine from which these federal provisions are based is an antifraud concept and is applicable to municipal securities
- Cautionary language is included in the disclosure document to warn the investor that actual results may differ materially from the forward-looking statements included in the disclosure document

TIF Disclosure: Risks Section of the Disclosure Agreement

- Not all tax-increment financings are successful and investment in such financings involves a degree of risk
- The risks section of the disclosure agreement presents the investor with the “parade of horrors,” the list of all events and occurrences that could adversely impact the issuer’s ability to repay debt service on the TIF bonds
- The risks section provides the transaction participants a defense that an investor was put on notice of the risks associated with investing in the TIF bonds

TIF Disclosure: 10b5 Certifications

- Generally most parties involved in a financing provide some type of 10b5 certification, including the associated lawyers, with respect to the information they either provided or they have the most knowledge to know the accuracy and completeness of such information

- Third parties in which 10b5 certifications may also be obtained:
 - Developers
 - Project Managers
 - Contractors
 - Feasibility Consultants

- The 10b5 certification demonstrates participation in confirming the accuracy and completeness of the information included in the disclosure document to which the certifier has specific knowledge and an understanding of the anti-fraud obligations associated with providing information in the disclosure document

Hypotheticals

Hypo 1: New Auditor Finds Error in Prior Financial Information

- County X is in the process of issuing tax increment financing bonds for the redevelopment of an area of downtown in which two major companies are negotiating with the County to relocate their business operations to such area.
- The County has recently hired a new auditing firm to audit the financials for the current fiscal year.
- The County and the Underwriter have been discussing the timing of the financing as interest rates are rising however the final audit will not be completed for another two months.
- The new auditing firm informs the County two weeks prior to the anticipated date that the preliminary offering document is to be mailed that the auditing firm has discovered an error in the County's financials that may require the County to have the last two years of financial statements restated.

Should the financing move on as scheduled?

- Does the error have a material impact on the financials of the County?
- Does the error have an impact on the portion of the taxes being pledged as part of the proposed TIF bonds?
- What is the origination of the error? Prior auditing firm? An accounting error caused by staff?
- What are the expected going forward ramifications of the error?

Hypo 2: School Board Intends to File a Lawsuit

- The County is looking to issue TIF bonds to redevelop an area to attract Walmart to locating to a rural part of the County that has been largely undeveloped but has a major state toll-road that is about to open up in the area. The County believes that the toll-road plus a retailer like Walmart will bring residential developers to the area to develop the property and increase property taxes. The County has already spoken to one developer that is interested in building a large community if the County is able to secure Walmart.
- The local School Board is largely opposed to the County's issuance of TIF bonds. The School Board and the County have a long history of disagreeing over the School Board's budget and the County has not increased the School Board's budget in over three years.
- The School Board believes that it is already underfunded and is of the opinion that the school system would not be able to support an influx of students that could result from a new large employer and a substantial amount of residential development.
- Politically the County is not in a position to raise property tax rates for the foreseeable future.

Does the County have notice of or anticipate the School Board litigating the issuance of the TIF bonds?

- Does the County anticipate that the School Board may legally challenge the issuance of the TIF bonds?
- Does the County have a reasonable basis for the proposition that "but for" the County's subsidies to the TIF district that the redevelopment would not otherwise occur?
- Is the TIF district appropriately sized for the proposed redevelopment plan? Does it capture more increment revenues than necessary?

Hypo 3: Prior Compliance with Continuing Disclosure Obligations

- County X has never issued TIF bonds. Although it has a number of general obligation bonds and revenue bonds outstanding, due to the political climate in the County, the County has not issued bonds in over three years. The County also does not have a financial advisor.
- While conducting due diligence on an upcoming issuance of TIF bonds by County X, the Underwriter discovers that the County has not complied with its Rule 15c2-12 continuing disclosure obligations for the last three years. Although the County self-reported its continuing disclosure violations in the SEC's MCDC initiative in 2014, after bringing itself into compliance in connection with the SEC's Order with the County, the County has not been in compliance with its continuing disclosure obligations since that time.

Does the Underwriter have a reasonable basis under Rule 15c2-12 for believing that the County will comply with its continuing disclosure undertaking under Rule 15c2-12 with respect to the TIF bonds?

- Does the County have continuing disclosure policies in place? Is the staff aware of the policies?
- Has there been staffing changes over the past three years?
- Is the staff willing to correct the violations?
- What internal changes is the County staff proposing to make to prevent future compliance?

Resources

- GFOA: “An Elected Official’s Guide to Tax Increment Financing”
<https://www.gfoa.org/sites/default/files/EOGTIF.pdf>
- National Federation of Municipal Analysts: “Recommended Best Practices in Disclosure for Tax Increment Supported Debt”
https://www.nfma.org/assets/documents/DG.BP.rbp_tax_incr.doc.pdf
- Council of Development Finance Agencies: www.cdfa.net
- SEC 2012 Report on the Municipal Securities Market
<https://www.sec.gov/news/studies/2012/munireport073112.pdf>

Questions or Comments?

www.mcguirewoods.com