Federal Securities Law

Paul S. Maco, Bracewell LLP, Washington, D.C.

The Senate Committee on Banking, Housing, & Urban Affairs has scheduled a hearing for Jay Clayton, the nominee for Chairman of the SEC, on March 23. Pay close attention to his testimony, for as has been the case with prior Chairs, his testimony will indicate his agenda. The SEC continues to operate under two Commissioners, Acting Chairman Michael Piwowar and Commissioner Kara Stein, as permitted by 17 CFR 200.41 Quorum of the Commission. Indeed, the Commission unanimously approved release of proposed amendments to Rule 15c2-12[1] at an open meeting of the Commission on the morning of March 1, 2017. More on this below. First, an update on notable enforcement developments.

"Bold and Unrelenting Enforcement Policy" Continued

On January 10, 2017, the SEC announced acceptance of an offer of settlement and entry of a cease and desist order in the proceeding In the matter of *The Port Authority of New York and New Jersey* (the "Order").[2] The Order is noteworthy for several reasons, among them, according to the Order, that the Authority has approximately $20 billion in total debt outstanding, the Authority agrees to pay a civil monetary penalty of $400,000, and, as stated in the Order, the Authority "admits the facts set forth in Sections III. A, B., C., and D.[3] " and "acknowledges that its conduct violated the federal securities laws," while also admitting Commission jurisdiction and consenting to entry of the Order. The quoted language is a sharp break from the standard "without admitting or denying the findings herein" contained in prior settled administrative proceedings, and it appears to be another first for the municipal market under the "bold and unrelenting enforcement agenda" of former SEC Chair White.[4]

The SEC's press release states "[t]he Port Authority is the first municipal issuer to admit wrongdoing in an SEC enforcement action." The phrase "admit wrongdoing" however does not occur in the Order. As reported by The Bond Buyer, counsel for the Authority contended in a letter sent to the SEC "that the SEC's [earlier] March 2016 settlement with California's Westlands Water District[5] required a similar admission from the issuer that its actions had violated securities laws."[6] The order in Westlands Water District contains the standard "without admitting or denying the findings herein, except as to the Commission's jurisdiction…" but deviates from that standard by the addition of "and except as provided herein in Section V, …" Section V states:

> It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S. C. §523, that the findings in the Order are true and admitted by Respondents Birmingham and Ciapponi, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondents Birmingham and Ciapponi under the Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondents Birmingham and Ciapponi of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

In other words, the individual respondents, Thomas W. Birmingham and Louie David Ciapponi, penalized $50,000 and $20,000 respectively, cannot avoid payment of their ordered penalties through discharge in bankruptcy.

---

1 *Available at*: https://www.sec.gov/rules/proposed/2017/34-80130.pdf

2 Sec. Act Rel. No. 10278, Admin. Proc. File No. 3-17763, *available at*: https://www.sec.gov/litigation/admin/2017/33-10278.pdf

3 Sections III. A, B., C., and D. consist of enumerated paragraphs 1 through 41 of the Order and provide a summary of the facts. Section IV Violations, consisting of paragraphs 42 and 43, is not "admitted," however

4 See *Federal Securities Law*, The Bond Lawyer, Vol. 40, No. 4 (Fall 2016) for more on this and "broken windows" enforcement.

5 *Available at*: https://www.sec.gov/litigation/admin/2016/33-10053.pdf

6 Casey, Port Authority to Pay $400K, Admit Wrongdoing to Settle SEC Charges The Bond Buyer (Jan. 10, 2017).

Context for the Port Authority Order is provided by three paragraphs in the Summary:[7]

> In response to requests by the State of New Jersey for funding of certain roadway projects ("Roadway Projects"), the Port Authority approved $1.8 billion in non-revenue generating projects, and initially allocated bond proceeds towards funding such projects, without disclosing known material risks surrounding the potential lack of legal authority to fund those projects. In financial terms, at an estimated final cost of $1.8 billion, the Roadway Projects have been one of the most significant Port Authority capital projects during the last five years.
>
> Port Authority lawyers explicitly identified "the risk of a successful challenge by the bondholders and investors" in connection with the funding of the Roadway Projects. On multiple occasions, Port Authority lawyers cautioned that "projects that fall outside the scope of the Port Authority's mandate would be ultra vires, and cannot, therefore, be undertaken by the Port Authority as a Port Authority project or funded by the Port Authority, in partnership with another governmental agency…." Yet, the Port Authority omitted disclosures in its relevant Official Statements concerning any risks surrounding the Port Authority's legal authority to fund the Roadway Projects that were "necessary in order to make [certain statements in the Official Statements], in light of the circumstances under which they were made, not misleading.2 15 U.S.C. § 77q. Further, the Port Authority's lax governance then-in-place allowed the Roadway Projects to be approved without any disclosure to the Port Authority's Board of Commissioners concerning any legal risks surrounding the projects.
>
> As a result of the conduct described herein, the Port Authority violated Sections 17(a)(2) and (3) of the Securities Act in connection with the offer and sale of over $2.3 billion of its bonds between January 2012 and June 2014.

This order illustrates the Commission's "bold and unrelenting" enforcement agenda.[8] It includes (in addition to the Authority's admissions) negligence-based violations, a $400,000 civil penalty, and undertakings to engage an Independent Consultant, to adopt written policies and procedures (as well as training), including "a policy requiring that the Port Authority's Law Department certify in writing to the Port Authority's Board of Commissioners that any proposed expenditure of the Port Authority's funds presented to the Board for approval is legally authorized and, with respect to any expenditure of Port Authority funds exceeding Fifty Million Dollars provide the Board with a legal opinion that such expenditure is legally authorized." Part of the bold and unrelenting enforcement agenda includes the SEC's admissions policy, which former SEC Chair White described in a November 2016 speech as "a first for a civil financial regulator."[9] In her words: "we announced in June 2013 that the SEC would begin to require admissions as a condition for settlement in certain types of cases, including cases with harm to large numbers of investors or significant risk of harm to the market, where the settling party engaged in egregious conduct or obstructed Commission investigations, or where admissions would significantly enhance the deterrent message of the action."[10] As to those who do not settle, in the same speech she notes:

> When we introduced our new admissions policy, I acknowledged that some firms and individuals might opt to litigate rather than settle on our terms. And that has happened, but it has not deterred us. Our very significant and recent trial win against the City of Miami (for misstatements in connection with bond offerings) was a trial that occurred primarily because the City would not accept admissions; we have now resolved the case with the City with a $1 million penalty.

---

7 Within Section III of the Order. See n.3, *supra*.

8 See *Federal Securities Law,* n.4, *supra*.

9 Mary Jo White, A New Model for SEC Enforcement: Producing Bold and Unrelenting Results (Nov. 18, 2016. *Available at*: https://www.sec.gov/news/speech/chair-white-speech-new-york-university-111816.html.

10 Id.

Proposed Amendments to Rule 15c2-12

On March 1, 2017, the Securities Exchange Commission voted in open meeting to propose amendments to Rule 15c2-12, adopted under the Securities Exchange Act of 1934.[11] The amendments would add two event notices to the current 14 required in continuing disclosure agreements. The Commission vote was unanimous, 2-0, as noted by Acting Chairman Piwowar. Specifically, the proposal would add new events (15) and (16):

> (15) Incurrence of a financial obligation of the obligated person,[12] if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the issuer or obligated person, any of which affect security holders, if material; and
>
> (16) Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of the financial obligation of the obligated person, any of which reflect financial difficulties.

The proposal would also amend Rule 15c2-12(f) to define "financial obligation:"

> (11) The term financial obligation means a (i) debt obligation, (ii) lease, (iii) guarantee, (iv) derivative instrument, or (v) monetary obligation resulting from a judicial, administrative, or arbitration proceeding. The term financial obligation shall not include municipal securities as to which a final official statement has been provided to the Municipal Securities Rulemaking Board consistent with this rule.

In the meeting, Acting Chairman Michael S. Piwowar said the proposed changes aim to reduce the "information asymmetry among market participants and to increase transparency to the municipal securities market by improving investor and market participant access to timely information relating to a municipal issuer's financial obligations." Commissioner Kara M. Stein said that this proposal represents a step toward increased transparency and will create efficiency for issuers and investors alike. Commission staff noted that the incurrence of material obligations could substantially impact the credit of the person or persons obligated to pay a security and thus the riskiness of its security. Accordingly, investors should be informed of these financial obligations. Commission staff also stated that, under the current disclosure requirements of Rule 15c2-12, investors have limited or substantially delayed access to information about the non-public financing agreements of issuers and other obligated persons and that this lack of information disadvantages investors.

If the proposed amendments are adopted as proposed, event reporting under the first proposed event would hinge upon whether the event is material and affects security holders and under the second proposed event would hinge upon whether the event reflects financial difficulties. To comply with post-adoption continuing disclosure agreements, issuers and obligated persons would need to judge whether a new financial obligation is material and which of its terms, if any, affect securities holders and are material. They would likewise need to assess whether specified events under the terms of financial obligations "reflect financial difficulties" and therefore trigger event reporting. The absence of transparency regarding new financial instruments and related financial difficulties, a motivating factor behind the proposed amendments, may pose challenges to underwriters when forming a reasonable basis for belief in the accuracy of statements in issuer or obligated person offering documents as to compliance with disclosure undertakings.

Regarding materiality, the proposal notes "the preliminary belief" of the Commission "that including a materiality determination would strike an appropriate balance" and provides an illustration:

> As proposed, the materiality determination applies to the incurrence of a financial obligation and each of the agreed upon terms listed (i.e., covenants, events of default, remedies, priority rights, or other similar terms). For example, an issuer or obligated person may incur a financial obligation for an amount that, absent other circum-

---

11 *Available at*: https://www.sec.gov/rules/proposed/2017/34-80130.pdf

12 The text of the proposing release alternatingly refers to "the issuer or obligated person" or "obligated person."

stances, would not raise the concerns the proposed amendments are intended to address. On the other hand, if an issuer or obligated person agrees to provide a counterparty to a financial obligation with a senior position in the debt payment priority structure, and that agreement affects existing security holders, the event likely does rise to the level of importance that it should be disclosed to investors and other market participants.

How well that balance might work in practice may depend upon how the Commission's often granular application of "materiality" in the 144 MCDC settlements will affect the behavior of issuers, obligated persons and underwriters when they decide whether to give notice of an event under the proposed amendments or to require disclosure of a failure to do so under Rule 15c2-12.[13] The proposing release provides additional examples of potential application of the proposed amendments and nine specific requests for comment regarding the proposed additional events. It also provides illustrations and explanations of the five items identified in the proposed definition of "financial obligation together with six specific requests for comments regarding the proposed definition.

Regarding use of "any of which reflects financial difficulties," the proposal notes "the preliminary belief" of the Commission that this qualifier to the event notice trigger would likewise "strike an appropriate balance" and provides an example:

> As proposed, the term "any of which reflect financial difficulties" applies to all of the events listed in the proposed event notice (i.e., a default, event of acceleration, termination event, modification of terms, or other similar events). For example, an issuer or obligated person may covenant to provide the counterparty with notice of change in its address and may not promptly comply with the covenant. A failure to comply with such a covenant may not reflect financial difficulties; therefore, absent other circumstances, this event likely does not raise the concerns the proposed amendments are intended to address. On the other hand an issuer or obligated person could agree to replenish a debt service reserve fund if draws have been made on such fund. In this example, if an issuer or obligated person fails to comply with such covenant, then such an event likely should be disclosed to investors and other market participants.

The Commission also notes "[t]he concept of "reflecting financial difficulties" has been used since the adoption of Rule 15c2-12 in paragraph (b)(5)(i)(C)(3) and in paragraph (b)(5)(i)(C)(4), and, as such, market participants should be familiar with the concept as it relates to the operation of Rule 15c2-12." Additional examples and illustrations of the potential application of the specific event notice proposed follow the expression of the Commission's preliminary belief, together with three specific requests for comment.

The Commission has not proposed an effective date for the proposed amendments, if adopted, but stated that it is preliminarily considering one that is three months after adoption of the amendments, so as to provide time for the MSRB to revise its EMMA posting operations and broker-dealers to revise their underwriting and trading procedures. If the amendments are adopted, offerings that take place after the effective date would have to be accompanied by continuing disclosure undertakings that reflect the amended Rule. The Commission has asked for comments on the effective date that it is considering.

The Commission has requested comment on all aspects of the proposed amendments, including its cost-benefit analysis, which appears to estimate that it will take underwriters about 10 additional minutes per offering to check whether (a) the issuer's continuing disclosure undertaking complies with the amended Rule and (b) its representations about compliance with the incremental provisions of prior undertakings are accurate and complete.

The requests for comment are specific to the proposed amendments. At no point does the Commission request comments regarding other amendments to or modifications of the existing rule. Municipal market participants

---

13 See *Federal Securities Law,* The Bond Lawyer, Vol. 40, No. 3 (Summer 2016) for a discussion of MCDC Commission Orders.

and other interested parties who wish to dispute the Commission's preliminary beliefs have an opportunity to do so during the comment period, which will run for 60 days following publication in the Federal Register.

It remains to be seen whether, following the addition of a new Chair and possibly other commissioners appointed by President Trump, the Commission will choose to follow his Executive Orders directing that two regulations be repealed for every new one adopted or setting forth guiding principles for financial regulations. While the Executive Orders are not binding on the Commission, it may choose to give deference to them.

March 2017