

**MEMORANDUM**

TO: File No. 4-610

FROM: Alicia F. Goldin  
Division of Trading and Markets

DATE: June 21, 2011

RE: Telephone Call with Gerard J. Lian

On May 24, 2011, Alicia Goldin spoke with Gerard J. Lian, Senior Analyst at Invesco Fixed Income. The topic of discussion was the Commission's review of the municipal securities market. Mr. Lian expressed his support for the Commission's initiative, and offered to be a resource to Commissioner Walter and the Commission staff on issues related to the municipal securities market. Mr. Lian followed up on the telephone call by sending the attached documents.

Confidential information redacted. [Author cites ]“Presentation regarding Build America Bonds by Gerard J. Lian at the NFMA 2010 Annual Conference, May 7, 2010.

# NFMA Disclosure Committee

**To:** Members of the NFMA Disclosure Committee

**From:** Gerry Lian

**Re:** Survey of Rule 15c2-12 Annual Financial Information Reports

**Date:** March 26, 2002

## Introduction

At the January 16, 2002 meeting of the NFMA Board of Governors, in preliminary discussion regarding secondary market disclosure for municipal securities, it was suggested that increased attention should be directed to the quality of financial disclosure being filed in conjunction with the annual reporting requirements set forth under SEC Rule 15c2-12 (the "Rule"). The purpose of this memorandum is twofold: (i) to highlight the importance of operating data in evaluating credit quality and to discuss the scope of the reporting requirements prescribed by Rule 15c2-12; and (ii) to propose that the NFMA Disclosure Committee identify and evaluate a sample of Rule 15c2-12 annual financial information reports to determine the extent to which operating data is being included in conformance with the letter and spirit of the Rule.

Although Rule 15c2-12 requires municipal issuers to include operating data within annual financial information reports, neither regulators nor industry groups have evaluated the scope and quality of information being filed. The SEC and DPC Data have each recently performed informal surveys of a select sample of municipal issuers to determine to what extent, if any, obligated persons are filing reports at all. For those issuers who are routinely filing Rule 15c2-12 reports, however, little, if any, attempt has yet been made to evaluate: (a) whether the substantive content of Rule 15c2-12 reports conform to the reporting requirements set forth under the Rule; and (b) whether the scope and quality of operating data contained in these annual reports contains adequate material information to facilitate rigorous credit surveillance and analysis.

## The Importance of Operating Data

Provision of operating data is of profound importance to the credit analysis of all types of municipal securities. Although financial audits enable analysts to scrutinize balance sheets, income statements, and statements of cash flow, provision of financial audits alone restricts the scope of credit surveillance to a review of financial performance.

Memorandum

Municipal analysts recognize that in order to perform a careful, in-depth review of the credit quality of municipal issuers, it is also necessary to probe and to evaluate very closely the operating performance of governmental borrowers. While financial performance bears a strong correlation to credit rating, operating performance is what shapes and determines financial results. Operating data measures the efficiency and effectiveness of service provision, illuminates performance trends over time and facilitates comparative assessment of the relative performance and competitive position of all types of government instrumentalities. No matter what credit sector is considered, operating data provides a crucial tool that enables analysts to analyze operating efficiency and performance, assess management skill and develop an informed opinion on credit quality. In short, operating data provides a vital analytical reference point that brings financial results into sharper focus and amplifies our understanding of overall credit quality.

### **The Reporting Requirements Under SEC Rule 15c2-12**

SEC Rule 15c2-12 provides that in order for municipal securities to be eligible for underwriting or trading, each issuer of municipal securities or other obligated persons must undertake to file an annual information report with designated NRMSIRs. In general, the Rule does not specify what information per se is required to be included in annual financial reports but instead enumerates categories of information to be disclosed. These categories of information include:

- Annual financial information
- Audited financial statements
- Notices of material events
- Notice of failure to make Rule 15c2-12 filings

In summarizing the substance of the directive governing annual reporting requirements, the following discussion will make reference to two sources: (i) specific provisions contained within the Rule itself; and (ii) the explanative commentary prepared by the Commission that accompanied original release of the Rule. For ease of reference, Appendix A provides a copy of Rule 15c2-12 while Appendix B presents important excerpts from the SEC Commentary that accompanied release of the Rule.

#### **(i) A Look at the Text of Rule 15c2-12**

The text of Rule 15c2-12 provides limited guidance on what information is to be included in “annual financial information” reports. Subparagraph (b) of the Rule directs

municipal issuers to file annual financial information with NRMSIRs and state information depositories, if applicable, but leaves the precise meaning of this term largely undefined. The term “annual financial information” is later defined in subparagraph (f) (9) to mean “financial information or operating data, provided at least annually, of the type included in the final official statement”. This language is significant in two somewhat incongruous respects. First, by defining “annual financial information” in the disjunctive as financial information *or* operating data, the Rule seems to suggest, in direct contradiction to the SEC Commentary hereafter considered, that annual financial information may include either type of information and need not include both. Second, by linking the kind of information to be incorporated within annual financial information reports to the type of information included in a final official statement, it implies that a materiality standard governs the scope of information to be included in secondary market disclosure. This latter observation has given rise to the so-called mirror concept, a notion further discussed in the SEC Commentary which posits that in accordance with the structure of Rule 15c2-12, secondary market reports are supposed to contain information that mirrors the original information contained in the official statement.

What is unambiguous, however, is that the Rule contemplates that annual financial information should include more than audited financial statements. This can be inferred by reading section (b) (5) (i) (A) of the Rule in conjunction with section (b) (5) (i) (B). Whereas section (b) (5) (i) (A) posits that municipal issuers must file “annual financial information” for each obligated person for whom financial information or operating data is included in the final official statement, section (b) (5) (i) (B) stipulates that “annual financial information” should include audited financial statements, when and if available, if not already included as *part* of section (b) (5) (i) (A) submissions. The same conclusion is reached by a different route. In prescribing what is to be included within the text of a written undertaking, section (d) (ii) (A) of the Rule directs municipal issuers to provide, in reasonable detail, the type of financial information *and* operating data to be provided as part of annual financial information (italics added).

### **(ii) SEC Commentary to Rule 15c2-12**

The best explanation of the reporting requirements is provided in the SEC’s Commentary to Rule 15c2-12. The Commission directly addresses and further expounds upon the definition of “annual financial information”, then goes on to clarify what type of information ought to be included with respect to “operating data”. The SEC’s explanation of “annual financial information” is easily summarized by reference to a direct quote:

The definition of *annual financial information* specifies both the timing of the information - that is, once a year - and, by referring to the final official statement, the type of financial information *and*

operating data that is to be provided to the repositories. If financial information or operating data concerning an obligated person ... is included in the final official statement, then annual financial information would consist of the same type of financial information or operating data. (Italics added).

The significance of the foregoing language is twofold. First, the Commission reiterates that the definition of the term annual financial information is to be made by reference to the type of information included in the final official statement. The implication of this linkage back to the Official Statement is potentially far reaching because it suggests, rather unmistakably, that ongoing disclosure should include information beyond audited financial statements. Second, the text uses the word “and” to refer to financial information and operating data in the conjunctive, again implying that annual financial information should include *both* financial audits as well as operating data.

To dispel any doubt as to either the importance of operating data as a distinct reporting component or the Commission’s expectation that operating data should be routinely included as a part of annual financial information, the SEC’s Commentary includes the following additional discussion about operating data:

Operating data is included as a subset of annual financial information, and the operating data to be provided annually also is determined by reference to the type of operating data presented in the final official statement. Thus, the parties will determine at the outset, presumably with the assistance of applicable industry guidelines, what operating data will be provided, both initially and on an ongoing basis.

To illustrate in greater detail what is meant with respect to operating data, the Commission cites a concrete example with reference to health care financing. In noting that under current industry practice, an official statement typically provides information that includes operating statistics such as bed utilization, admissions and type, patient days, and payor utilization, the Commission points out that this information is the type operating data to be provided annually.

### **(iii) Conclusions**

A careful reading of Rule 15c2-12 in conjunction with the SEC’s Commentary yields a number of important conclusions regarding the nature and scope of annual reporting requirements. These conclusions may be summarized as follows:

- ◆ Rule 15c2-12 does not specify the form or content of information that should be provided either as part of annual financial information reports or with respect to material event notices;
- ◆ In refraining from setting forth a specific definition per se of the term “annual financial information”, the Rule allows the parties to a transaction to establish the scope of the disclosure undertaking based largely upon self-defined notions of materiality;
- ◆ The Rule does not establish a standardized format for presentation of financial information, or any specification of the content of the information, other than by reference to the final official statement.
- ◆ The Rule contemplates that specific categories of information will be included within secondary market reports. These include: (i) annual financial information reports; (ii) audited financial statements; (iii) notice of prescribed material events; and (iv) notice of failure to make Rule 15c2-12 filings.
- ◆ A fair reading of the letter and spirit of the Rule strongly suggests that operating data should be included as a distinct component of the annual financial information to be reported each year. This conclusion is supported by several considerations: (a) repeated reference is made to the term operating data within the actual text of the Rule, with the clear implication that operating data is expected to be included as a separate and distinct component to annual financial information; (b) the directive within the Rule for issuers to define the scope of information to be included in annual financial information reports in a manner consistent with materiality standards governing the preparation of final official statements; and (c) assertions set forth in the SEC Commentary that operating data included in final official statements is expected to be routinely included within annual financial information reports if it is of ongoing material importance to investors.

### **Actual Reporting Practices Under Rule 15c2-12**

Since operating data is an essential element to rigorous credit analysis, as the municipal bond industry embarks upon a review of reporting and dissemination practices under SEC Rule 15c2-12, it is highly important to determine not only whether municipal issuers are filing secondary market reports but also to consider the quality of information being provided. Consistent with the letter and spirit of Rule 15c2-12, in order to evaluate actual reporting practices it is necessary to determine two things: (i) the extent to which operating data is being included as a component of annual financial information; and (ii) the quality and completeness of operating data being provided.

Since an industry review of Rule 15c2-12 is well underway, in order to facilitate consideration of the quality of annual disclosure being provided by municipal issuers as a discrete and important element of the review process, it is important that the NFMA Disclosure Committee proceed to develop a careful, well-focused review of a representative sample of Rule 15c2-12 filings and do so in a timely and expeditious manner. The scope of the survey will be threefold: (i) to develop a reliable sample of municipal issuers that currently file Rule 15c2-12 reports with NRMSIRs; (ii) to carefully evaluate the quality of information being filed both in terms of fulfillment of written undertakings and in terms of meeting the materiality standard embedded within the Rule; and (iii) to compile and report results report back to the NFMA Board in time for the May 7, 2002 Board meeting.

Attached please find a final copy of the Rule 15c2-12 Sample and Survey Form to be used in performing this study. Note that the sector weightings that have been assigned to individual credit sectors within the NFMA sample closely approximate overall percentage distributions within the municipal marketplace at large. The close correlation can be seen by comparing: (a) NFMA sector weightings with (b) market issuance statistics for each credit sector compiled by *The Bond Buyer*. Although the NFMA sector weightings do not mirror actual market experience with mathematical precision, the weightings provide a very close proxy ensuring that the sample drawn is extremely well-distributed and diversified. The integrity of the sample is further protected by the use of randomly generated CUSIP numbers for nearly all credit sectors. This safeguard ensures that issuers were selected with no advance knowledge of actual reporting practice.

The sample design calls for surveying the quality of operating data provided in connection with annual information reports filed by 120 municipal issuers in compliance with Rule 15c2-12. The focus of the survey centers exclusively on studying the reporting practices of issuers found to be actually filing information mandated by the Rule. Since the Rule requires municipal issuers or obligated person to file annual financial information with each designated NRMSIR, in identifying issuers who filed such reports only one NRMSIR is being used and no attempt will be made to determine if reports filed at one pre-selected NRMSIR were cross-filed and consistent with reports filed by the same issuer at other NRMSIRs. While that additional step could conceivably show differences in what was filed, the likelihood that an issuer would file different reports with different NRMSIRs seems to be highly remote and statistically insignificant. The results of the survey will be compiled and reported upon to the entire NFMA Board upon final completion.

## Appendix A

### Text of SEC Rule 15c2-12

#### 240.15c2-12 Municipal securities disclosure.

**Preliminary Note:** For a discussion of disclosure obligations relating to municipal securities, issuers, brokers, dealers, and municipal securities dealers should refer to Securities Act Release No. 7049, Securities Exchange Act Release No. 33741, FR-42 (March 9, 1994). For a discussion of the obligations of underwriters to have a reasonable basis for recommending municipal securities, brokers, dealers, and municipal securities dealers should refer to Securities Exchange Act Release No. 26100 (Sept. 22, 1988) and Securities Exchange Act Release No. 26985 (June 28, 1989).

(a) General. As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any broker, dealer, or municipal securities dealer (a "Participating Underwriter" when used in connection with an Offering) to act as an underwriter in a primary offering of municipal securities with an aggregate principal amount of \$1,000,000 or more (an "Offering") unless the Participating Underwriter complies with the requirements of this section or is exempted from the provisions of this section.

\* \* \* \*

(b) **Requirements.** \* \* \*

(5)(i) A Participating Underwriter shall not purchase or sell municipal securities in connection with an Offering unless the Participating Underwriter has reasonably determined that an issuer of municipal securities, or an obligated person for whom financial or operating data is presented in the final official statement has undertaken, either individually or in combination with other issuers of such municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such securities, to provide, either directly or indirectly through an indenture trustee or a designated agent:

(A) To each nationally recognized municipal securities information repository and to the appropriate state information depository, if any, annual financial information [GJL1]for each obligated person for whom financial information or operating data is presented in the final official statement, or, for each obligated person meeting the objective criteria specified in the undertaking and used to select the obligated persons for whom financial information or operating data is presented in the final official statement, except that, in the case of pooled obligations, the undertaking shall specify such objective criteria;

(B) If not submitted as part of the annual financial information, then when and if available, to each nationally recognized municipal securities information repository and to the appropriate state information depository, audited financial statement for each obligated person covered by paragraph (b)(5)(i)(A) of this section;

(C) In a timely manner, to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of any of the following events with respect to the securities being offered in the Offering, if material:

- (1) Principal and interest payment delinquencies;
- (2) Non-payment related defaults;
- (3) Unscheduled draws on debt service reserves reflecting financial difficulties;
- (4) Unscheduled draws on credit enhancements reflecting financial difficulties;
- (5) Substitution of credit or liquidity providers, or their failure to perform;
- (6) Adverse tax opinions or events affecting the tax-exempt status of the security;
- (7) Modifications to rights of security holders;
- (8) Bond calls;
- (9) Defeasances;
- (10) Release, substitution, or sale of property securing repayment of the securities;
- (11) Rating changes; and

(D) In a timely manner, to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of a failure of any person specified in paragraph (b)(5)(i)(A) of this section to provide required annual financial information, on or before the date specified in the written agreement or contract.

(ii) The written agreement or contract for the benefit of holders of such securities also shall identify each person for whom annual financial information and notices of material events will be provided, either by name or by the objective criteria used to select such persons, and, for each such person shall:

(A) Specify, in reasonable detail, the type of financial information and operating data to be provided as part of annual financial information;

(B) Specify, in reasonable detail, the accounting principles pursuant to which financial statements will be prepared, and whether the financial statements will be audited; and

(C) Specify the date on which the annual financial information for the preceding fiscal year will be provided, and

to whom it will be provided.

(iii) Such written agreement or contract for the benefit of holders of such securities also may provide that the continuing obligation to provide annual financial information and notices of events may be terminated with respect to any obligated person, if and when such obligated person no longer remains an obligated person with respect to such municipal securities.

(c) **Recommendations.** As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any broker, dealer, or municipal securities dealer to recommend the purchase or sale of a municipal security unless such broker, dealer, or municipal securities dealer has procedures in place that provide reasonable assurance that it will receive prompt notice of any event disclosed pursuant to paragraph (b)(5)(i)(C), paragraph (b)(5)(i)(D), and paragraph (d)(2)(ii)(B) of this section with respect to that security.

(d) **Exemptions.** (1) This section shall not apply to a primary offering of municipal securities in authorized denominations of \$100,000 or more, if such securities:

(i) Are sold to no more than thirty-five persons each of whom the Participating Underwriter reasonably believes:

(A) Has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the prospective investment; and

(B) Is not purchasing for more than one account or with a view to distributing the securities; or

(ii) Have a maturity of nine months or less; or

(iii) At the option of the holder thereof may be tendered to an issuer of such securities or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months until maturity, earlier redemption, or purchase by an issuer or its designated agent.

(2) Paragraph (b)(5) of this section shall not apply to an Offering of municipal securities if, at such time as an issuer of such municipal securities delivers the securities to the Participating Underwriters:

(i) No obligated person will be an obligated person with respect to more than \$10,000,000 in aggregate amount of outstanding municipal securities, including the offered securities and excluding municipal securities that were offered in a transaction exempt from this section pursuant to paragraph (d)(1) of this section;

(ii) An issuer of municipal securities or obligated person has undertaken, either individually or in combination with other issuers of municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such municipal securities, to provide:

(A) Upon request to any person or at least annually to the appropriate state information depository, if any, financial information or operating data regarding each obligated person for which financial information or operating data is presented in the final official statement, as specified in the undertaking, which financial information and operating data shall include, at a minimum, that financial information and operating data which is customarily prepared by such obligated person and is publicly available; and

(B) In a timely manner, to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of events specified in paragraph (b)(5)(i)(C) of this section with respect to the securities that are the subject of the Offering, if material; and

(iii) the final official statement identifies by name, address, and telephone number the persons from which the foregoing information, data, and notices can be obtained.

(3) The provisions of paragraph (b)(5) of this section, other than paragraph (b)(5)(i)(C) of this section, shall not apply to an Offering of municipal securities, if such municipal securities have a stated maturity of 18 months or less.

(4) The provisions of paragraph (c) of this section shall not apply to municipal securities:

(i) Sold in an Offering to which paragraph (b)(5) of this section did not apply, other than Offerings exempt under paragraph (d)(2)(ii) of this section; or

(ii) Sold in an Offering exempt from this section under paragraph (d)(1) of this section.

(e) Exemptive Authority. The Commission, upon written request, or upon its own motion, may exempt any broker, dealer, or municipal securities dealer, whether acting in the capacity of a Participating Underwriter or otherwise, that is a participant in a transaction or class of transactions from any requirement of this section, either unconditionally or on specified terms and conditions, if the Commission determines that such an exemption is consistent with the public interest and the protection of investors.

(f) **Definitions.** \* \* \*

(3) The term final official statement means a document or set of documents prepared by an issuer of municipal securities or its representatives that is complete as of the date delivered to the Participating Underwriter(s) and 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 pursuant to paragraph (b)(5)(i), paragraph (d)(2)(ii), and paragraph (d)(2)(iii) of this section, if applicable, and of any instances in the previous five years in which each person specified pursuant to paragraph (b)(5)(ii) of this section failed to comply, in all material respects, with any previous undertakings in a written contract or agreement specified in paragraph (b)(5)(i) of this section. Financial information or operating data may be set forth in the document or set of documents, or may be included by specific reference to documents previously provided to each nationally recognized municipal securities information repository, and to a state information depository, if any, or filed with the Commission. If the document is a final official statement, it must be available from the Municipal Securities Rulemaking Board.

\* \* \* \* \*

(9) The term annual financial information means financial information or operating data, provided at least annually, of the type included in the final official statement with respect to an obligated person, or in the case where no financial information or operating data was provided in the final official statement with respect to such obligated person, of the type included in the final official statement with respect to those obligated persons that meet the objective criteria applied to select the persons for which financial information or operating data will be provided on an annual basis. Financial information or operating data may be set forth in the document or set of documents, or may be included by specific reference to documents previously provided to each nationally recognized municipal securities information repository, and to a state information depository, if any, or filed with the Commission. If the document is a final official statement, it must be available from the Municipal Securities Rulemaking Board.

(10) The term obligated person means any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such 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 (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities).

\* \* \* \* \*

(g) Transitional Provision. \* \* \* Paragraph (b)(5) of this section shall not apply to a Participating Underwriter that has contractually committed to act as an underwriter in an Offering of municipal securities before July 3, 1995; except that paragraph (b)(5)(i)(A) and paragraph (b)(5)(i)(B) shall not apply with respect to fiscal years ending prior to January 1, 1996.

Paragraph (c) shall become effective on January 1, 1996.  
Paragraph (d)(2)(ii) and paragraph (d)(2)(iii) of this section shall not apply to an Offering of municipal securities commencing prior to January 1, 1996.

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## Appendix B

### Select SEC Commentary on Rule 15c2-12<sup>1</sup>

#### c. Scope of Financial Information and Operating Data to be Provided Annually

##### (1) Definition of Financial Information

The amendments provide a definition of the term "annual financial information,"-[91]- a concept that was used, without definition, in the Proposed Amendments. The definition of annual financial information specifies both the timing of the information -- that is, once a year -- and, by referring to the final official statement, the type of financial information and operating data that is to be provided to the repositories. If financial information or operating data concerning an obligated person (or category of obligated persons in the case of financings using the objective criteria approach) is included in the final official statement, then annual financial information would consist of the same type of financial information or operating data. For example, if anticipated cash flow information is provided in the final official statement for a revenue bond financing, cash flow data reflecting actual operations must continue to be provided on an annual basis. Only the annual financial information called for by the undertakings need be sent to the repositories; other types of financial information and reports that may be prepared by the issuer or obligated persons are not subject to the rule's dissemination provisions.

Many commentators addressed the issue of whether the rule should specify form and content of the information that should be provided on an annual basis, as well as for event specific information.-[92]- Some commentators argued that the rule should include specified formats for information to be provided, including financial statements and certain industry reporting formats,-[93]- while other commentators contended that no form or content should be specified and that the parties should be permitted to make determinations based on materiality alone.-[94]- As discussed below, the flexibility afforded by the concept of annual financial information addresses these concerns by providing a minimum standard for ongoing disclosure, but allowing the parties to define that standard with respect to each offering of municipal securities.

<sup>1</sup> Taken from 17 CFR Part 240, Release No. 34-34961

## (2) Financial Information

The proposal to mandate audited financial statements produced considerable comment. As with the proposed definition of final official statement, commentators expressed concern with the availability of audited financial statements on an annual basis, as well as the relevance of financial statements for certain types of financings.

Some commentators indicated that some municipalities were not required by law to have independently audited financial statements, and any such requirement would impose a significant new expense.-[95]- A number of commentators also expressed doubt as to whether audited financial information could be delivered on an annual basis, because audits may not be completed for a number of years following the close of the fiscal year.-[96]- Commentators noted that in some cases, financial statements for certain types of entities were audited every year, and in other cases every 2-3 years.-[97]- Therefore, some of these commentators argued that the requirement for annual audited financial statements would have an adverse impact on an issuer's ability to access the public securities markets or increase its costs of financing.-[98]-

A number of commentators also raised concerns regarding the availability of full financial statements for certain issuers, whether or not audited.-[99]- As examples, commentators noted that some issuing entities do not have their own financial statements and may be included in the financial statements of a larger issuer or entity.-[100]- Commentators from two states indicated that governmental units of the states may be encompassed in the state's comprehensive annual financial report and that there may be only supplemental schedules that described the governmental units.-[101]-

Some commentators raised the point that financial statements of a general governmental unit may not necessarily be relevant in certain project and structured financings.-[102]- As an example, one commenter noted that in some asset backed financings, information about the governmental issuer may be relevant only with respect to its experience in managing programs of loan pools.-[103]-

Commentators proposed a number of alternatives to the requirement to provide annual audited financial statements. Among the alternatives was a suggestion that financial statements be required in the form customarily prepared by the issuer promptly upon becoming available and that audited financial statements be provided to the extent available.-[104]- Other suggestions included limiting the requirement to those entities required by state or federal law to have audited financial statements.-[105]-

In view of the comments received, the amendments do not adopt the proposal to mandate audited financial statements on an annual basis with respect to each issuer and significant obligor.

Instead, the amendments continue to require annual financial information, which may be unaudited, and may, where appropriate and consistent with the presentation in the final official statement, be other than full financial statements. While it is anticipated that full financial statements will be provided for entities with ongoing revenues and operating expenses, it is possible that in the case of dedicated revenue streams and certain types of structured financings, other types of special purpose financial statements, project operating statements or reports may be used to reflect the financial position of the credit source for the financing. However, if audited financial statements are prepared, then when and if available, such audited financial statements will be subject to the undertaking and must be submitted to the repositories.-[106]- Thus, as suggested by a number of commentators, the undertaking must include audited financial statements only in those cases where they otherwise are prepared.

The amendments adopt the proposed requirement that the undertaking specify the accounting principles pursuant to which the financial information provided as part of the annual financial information will be prepared.-[107]- As discussed in the Proposing Release, it is important that financial information be prepared on a consistent basis to enable market participants to evaluate results and perform year to year comparisons.-[108]- The undertaking also must specify whether audited financial statements will be provided as part of the annual financial information.-[109]-

The amendments do not establish a standardized format for presentation of financial information, or any specification of the content of the information, other than by reference to the final official statement. The annual financial information may be presented through any disclosure document or set of documents, whatever their form or principal purpose, that include the necessary information. The amendments, as adopted, contemplate that sequential final official statements prepared by frequent issuers may meet the standards of the rule. As in the case of final official statements, annual financial information submitted to a repository also may reference other information already submitted to repositories or the MSRB, or filed with the Commission.-[110]-

## (2) Operating Data

The Proposed Amendments [111] would have required that the undertaking call for pertinent operating information, and that the parties specify the pertinent operating information to be provided on an annual basis. The basic concern of commentators regarding this provision, in addition to issues of specification of form and content discussed above, was that the use of the term "pertinent" did not provide sufficient guidance as to who would determine what was pertinent and what independent obligations Participating Underwriters would have with respect to such evaluation.-[112]-

The amendments have been modified to respond to these comments. The phrase "pertinent" has been deleted from the reference to operating information and the word "data" is used to emphasize the intended quantitative nature of the information. Operating data is included as a subset of annual financial information, and the operating data to be provided annually also is determined by reference to the type of operating data presented in the final official statement. Thus, the parties will determine at the outset, presumably with the assistance of applicable industry guidelines, what operating data will be provided both initially and on an ongoing basis. For example, in a conduit health care financing, under current industry practice, an official statement typically provides information relating to the obligated party -- the hospital -- in an appendix. In addition to a discussion describing the hospital, its administration and management, economic base and service area, and capital plan, operating statistics such as bed utilization, admissions and type, patient days, and payor utilization often is provided.[GJL3] Under the amendments, in this type of transaction, parties at the outset of a transaction will determine which operating data will be included in the hospital appendix; such information, in turn, will be the type of "operating data" to be provided annually.

## Endnotes

- [89]- See, e.g., Letter of Bond Investors Association; Letter of PSA; Letter of Texas Public Finance Authority.
- [90]- See, e.g., Letter of Bank One Corporation; Letter of Reliance Trust Company; Letter of State Street Bank and Trust Company.
- [91]- Rule 15c2-12(f)(9).
- [92]- See, e.g., Letter of Dean Witter Reynolds, Inc. ("Dean Witter"); Letter of National League of Cities; Letter of NFMA; Joint Response; Letter of PSA; Letter of Tillinghast, Collins & Graham; Letter of the Treasurer of the State of Connecticut.
- [93]- See, e.g., Letter of Dain Bosworth, Inc.; Letter of First Albany Corporation; Letter of MSRB; Letter of NFMA; Letter of Standish, Ayer & Wood, Inc.
- [94]- See, e.g., Letter of CDFR; Letter of Chapman and Cutler; Letter of CIFA; Joint Response; Letter of H.M. Quackenbush; Letter of NABL.
- [95]- See, e.g. Letter of Texas Water Development Board; Letter of State of Washington, Office of the Treasurer.
- [96]- See, e.g., Letter of City of Barling; Letter of Dain Bosworth, Inc.; Letter of Friday, Eldridge & Clark.
- [97]- See, e.g., Letter of AMP -- Ohio; Letter of State of Indiana, State Board of Accounts; Letter of State of Montana, Department of Natural Resources and Conservation; Letter of Washington Finance Officers Association.
- [98]- See, e.g., Letter of AMP -- Ohio; Letter of Washington Finance Officers Association.
- [99]- See, e.g., Letter of ABA Business Law Section; Letter of Florida Division of Bond Finance; Letter of Gust & Rosenfeld; Letter of Office of the State Auditor, Texas ("Texas Office of the State Auditor").
- [100]- See, e.g., Letter of Treasurer of the State of North Carolina; Letter of Texas Office of the State Auditor.
- [101]- See, e.g., Letter of the Treasurer of the State of North Carolina; Letter of Texas Office of the State Auditor.
- [102]- See, e.g., Letter of ABA Urban Law Section; Letter of APPA; Letter of Goldman Sachs; Letter of Gust & Rosenfeld; Letter of The Hospital & Higher Education Facilities Authority of Philadelphia; Letter of Morgan

Stanley; Letter of NABL; Letter of New York State Housing Finance Agency.

- [103]- See Letter of ABA Urban Law Section.
- [104]- See, e.g., Letter of ABA Business Law Section; Letter of Association of Bay Area Governments; Letter of North East Independent School District; Letter of PSA; Letter of Washington Finance Officers Association.
- [105]- See, e.g., Letter of the Treasurer of the State of North Carolina; Letter of Washington Finance Officers Association.
- [106]- See Rule 15c2-12(b)(5)(i)(B).
- [107]- See Rule 15c2-12(b)(5)(ii)(B).
- [108]- See Proposing Release. A number of commentators responded to the request for comment on specification of the use of generally accepted accounting principles ("GAAP") and generally accepted auditing standards ("GAAS"). See, e.g., Letter of Comptroller of the State of California; Letter of Government Accounting Standards Board ("GASB"); Letter of NAST; Letter of National State Auditors Association; Letter of Prudential Investment Corp. The amendments as adopted do not mandate the use of either GAAP or GAAS.
- [109]- See Rule 15c2-12(b)(5)(ii)(B).
- [110]- Of course, any required information must be the subject of an undertaking, and if the information cross referenced has not been submitted to a repository or the MSRB, or filed with the Commission, the undertaking will not have been complied with.
- [111]- Paragraph (b)(5)(i)(A) of the Proposed Amendments.

# NFMA Disclosure Committee

**To:** Board of Governors of the NFMA

**From:** NFMA Disclosure Committee

**Re:** Summary of Results of Survey and Evaluation of Reporting Practices for SEC Rule 15c2-12

**Date:** May 7, 2002

## **Rationale for the Survey**

The purpose and rationale for our survey of secondary market disclosure reports is to closely examine the content of annual information reports filed pursuant to SEC Rule 15c2-12. Although Rule 15c2-12 requires municipal issuers to include operating data within annual financial information reports, neither regulators nor industry groups have evaluated the scope and quality of information being filed. The SEC and DPC Data have each recently performed informal surveys of a select sample of municipal issuers to determine to what extent, if any, obligated persons are filing reports at all. For those issuers who are routinely filing Rule 15c2-12 reports, however, little, if any, attempt has yet been made to evaluate: (a) whether the substantive content of Rule 15c2-12 reports conform to the reporting requirements set forth under the Rule; and (b) whether the scope and quality of operating data contained in these annual reports contains adequate material information to facilitate rigorous credit surveillance and analysis.

## **Reporting Practices Under Rule 15c2-12**

Since operating data is an essential element to rigorous credit analysis, as the municipal bond industry embarks upon a comprehensive review of reporting and dissemination practices under SEC Rule 15c2-12, it is highly important to determine not only whether municipal issuers are filing secondary market reports but also to consider the quality of information being provided. Consistent with the letter and spirit of Rule 15c2-12, in order to evaluate actual reporting practices it is necessary to scrutinize two things: (i) the extent to which operating data is being included as a component of annual financial information; and (ii) the quality and completeness of the operating data being provided.

Memorandum

Since an industry review of Rule 15c2-12 is already well underway, to facilitate consideration of the quality of annual disclosure being provided by municipal issuers as a discrete and important element of the review process, the NFMA Disclosure Committee decided it was extremely important to proceed expeditiously to develop a careful, well-focused review of a representative sample of Rule 15c2-12 filings. The scope of the survey was threefold: (i) to develop a reliable sample of municipal issuers that currently file Rule 15c2-12 reports with NRMSIRs; (ii) to carefully evaluate the quality of information being filed both in terms of fulfillment of written undertakings and in terms of meeting the materiality standard embedded within the Rule; and (iii) to compile and report results report back to the NFMA Board in time for the May 7, 2002 Board meeting. Since the Disclosure Committee has completed a detailed survey and evaluation of Rule 15c2-12 reporting practices, the purpose of this memorandum is to summarize key findings obtained from this review and to make some basic recommendations derived from this study.

### **Methodology**

Attached please find a copy of detailed results derived from the Survey and Evaluation of SEC Rule 15c2-12 Reporting Practices. The underlying design structure called for surveying and evaluating annual information reports filed by a broad based sample of municipal issuers which ultimately number slightly in excess of 100. To maintain objectivity and promote accuracy, certain conventions were observed throughout this evaluative review: (a) the survey sample was structured to include a diverse mix of many credit sectors; (b) using a special search function provided by Bloomberg, CUSIP numbers were randomly selected within individualized credit sectors to insulate the results from potential bias arising from advance knowledge of issuer reporting practices; and (c) the number of issuers included within credit sectors were weighted to try to replicate actual market conditions using statistical data compiled by *The Bond Buyer* as a comparative benchmark; (d) to simplify the data retrieval process, only one NRMSIR was used as our database and no attempt was made to determine if reports filed with Bloomberg were cross-filed and consistent with reports filed with other NRMSIRs as mandated by the Rule. This shortcut in no way detracts from the validity and usefulness of the results for these reasons: (i) under Rule 15c2-12, obligors are obligated to file annual information reports with all NRMSIRs; (ii) the exclusive purpose of this study is to examine the quality of disclosure content, not the breadth of reporting compliance; and (iii) as a general rule, issuers were not included in our survey sample unless at least some information was on file.

### **Findings**

A summary of the findings from the Survey and Evaluation of SEC Rule 15c2-12 Reporting Practices is presented in the table below. Complete results derived from the Survey are presented in an accompanying attachment. The results point to three general conclusions: (i) on a very positive note, it is important to acknowledge that annual information reports filed by nearly 60% of issuers within the sample were found to contain

information deemed to be either complete or near complete; (ii) the results are positively skewed such that the highest grade categories<sup>1</sup> have received the highest scores; and (iii) despite these favorable findings, annual information reports filed by nearly 41% of the sample were found to be either somewhat inadequate or substantially inadequate.

	<b>A</b>	<b>B</b>	<b>C</b>	<b>D</b>	<b>Total</b>
Total	34	28	27	16	105
Percent (%)	32.4%	26.7%	25.7%	15.2%	100.0 %

The practical significance of the findings is that issuers are generally adhering to the information reporting requirements mandated by Rule 15c2-12. Not only are issuers and obligors filing annual audits, they are also filing some form of operating data as required by regulation. Operating data is being included by a substantial portion of obligors, although there is a wide range of information being provided. At one level, there seems to be a diligent effort being made by a great number of obligors to provide meaningful operating data pertaining to issuer performance. For issuers found to be providing complete or near complete Rule 15c2-12 filings, there tends to be a great deal of commonality regarding the specific elements of operating data incorporated into reports. While there is room for improvement even here, it is clear that many municipal issuers are striving to live up to both the letter and spirit of the law. At another level, however, annual information reports filed by other obligors lack sufficient information and are incomplete. For these issuers, moreover, there is considerable variation in the types of operating data being included in reports. These observations are evidenced by examining the kinds of operating data provided within the sample under the column to the right.

Some important implications emerge from the survey. One is that many issuers are making a good faith effort to comply with the mandate of Rule 15c2-12. Although the Rule 15c2-12 filing and reporting system has several shortcomings, if information can be made to flow through the system more efficiently, there is reason to believe that the process can be made to work for the benefit of all market participants. A second is that to facilitate better priority ordering of data elements included with annual information reports, it would be extremely useful to identify for the market core operating data on a sector specific basis. Whether as the result of regulatory mandate or enlightened issuer initiative, many obligors are becoming conditioned to compiling annual information reports. To facilitate better secondary market disclosure, it would be of tremendous value to the market for the National

<sup>1</sup>. The definition of the grade categories are as follows: (i) A: annual financial information and operating data is complete; (ii) B: annual financial information and operating data is near complete; (iii) C: annual financial information and operating data is somewhat inadequate; and (iv) annual financial information and operating data is substantially inadequate

Federation of Municipal Analysts to begin to augment its Best Practices Guidelines with specific schedules of core operating data.

### **Recommended Action**

There are several action steps that can and should be taken to improve disclosure of operating data in the secondary market. It is the consensus of the Disclosure Committee that greater attention should be brought to bear on the importance of operating data as a crucial component of municipal disclosure. Set forth below is a general outline of specific recommended actions:

- Prepare a Press Release summarizing the results of the survey
- Draft an NFMA Position Paper highlighting the importance and value of operating data as a component of Rule 15c2-12 annual information reports
- Provide copies of each of the foregoing items to Martha Haines, Esq. and the SEC's Office of Municipal Regulation
- To facilitate greater voluntary market compliance, develop sector specific schedules of core operating data for inclusion in the NFMA's Best Practices Disclosure Guidelines

## **Market Factors**

- Improved disclosure elicits wider bidding which extends liquidity and reduces borrowing costs, particularly in a rising interest rate environment
- Good disclosure facilitates investor relations and improves market access
- Good disclosure is consistent with issuer practices in all capital markets  
accurate, timely and complete disclosure greatly lessens the need for regulation
- Good disclosure supports secondary market trading prices of related securities by broadening the underlying investor base
- Financial disclosure serves as a critical internal guide to promote effective financial management
- Reluctance to disclose erodes investor confidence in management
- Collectively, improved municipal disclosure strengthens the global competitive position of municipal bonds as an asset class
- Good disclosure serves as an effective compass to guide portfolio management which leads to improved demand for bonds and better borrowing terms
- Good disclosure promotes comparative analysis of governmental issuers which facilitates creation of peer group medians and benchmarks
- If favorable information exists, good disclosure amplifies a positive credit profile that will improve trading value and overall market access
- If unfavorable information exists, good disclosure demonstrates the full extent of management's grasp of financial problems and its ability to implement remedial action
- Good disclosure is demonstrative of management sophistication and a pro-active approach to financial administration

## **Legal Factors**

- Clear, accurate and timely disclosure promotes the efficient allocation of capital, a basic objective of our nation's securities markets
- Contrary to prior legal myth, issuers are not prevented from providing information beyond the bare minimum required by SEC Rule 15c2-1
- Clear and accurate disclosure promotes compliance with SEC Rule 10(b)(5)
- Clear and accurate disclosure promotes compliance with SEC Rule 15c2-12

## **Economic Factors**

- Used in conjunction with a FAQ file <sup>2</sup> written disclosure increases productivity
- Good disclosure is wholly consistent with the market's expectations about the increased availability of information driven by the growth of the Internet
- Good disclosure is wholly consistent with the market's expectations about the ongoing evolution of good governance standards.

### **Administrative Factors**

- Periodic disclosure is emblematic of responsible financial management
- Good disclosure promotes greater accountability and public trust in government
- Written disclosure promotes even-handed provision of information to all
- It makes considerable sense to leverage information already on tap to derive multiple benefits that attend good disclosure practices
- Good disclosure promotes a more informed citizenry which is essential to the effective management of democratic government