

Preliminary Recommendation Regarding Timeliness of Financial Disclosures in the Municipal Securities Market

The Municipal Securities Transparency Subcommittee (“Subcommittee”) of the Fixed Income Market Structure Advisory Committee (“FIMSAC”) was formed to consider the impact of transparency, both pre-trade and post-trade, on the municipal securities markets. As a result of such consideration, this Subcommittee determines whether to make policy recommendations to enhance the liquidity, transparency and efficiency of the municipal bond markets.

The Subcommittee has studied and is interested in availability of financial information about municipalities. While the Subcommittee has determined that the breadth of financial related information made available to the market by municipal issuers and obligated persons (together, “municipal issuers”) is relatively comprehensive, the timeliness associated with the receipt of such information varies widely. For example, although the median municipal issuer prepared its audited financial statements for Fiscal Year 2018 within 156 days of the fiscal year end,¹ MSRB data for 2016 shows that municipal issuers that provided audited financial statements within 12 months of the end of their fiscal year made such filings within 200 calendar days after the end of the applicable fiscal period. Furthermore, MSRB data shows that the average municipal issuer provided its annual financial information within 12 months of the end of its fiscal year provided such annual information 188 days after the end of the applicable fiscal period.² If a municipal issuer does not provide interim financial disclosures and it files its annual financial disclosures within the averages referenced above, the financials available to investors could be over 500 days old as the next submission date approaches.

The Subcommittee is also aware that some municipalities, for example, are known to not have made financial statements publicly available for more than 400 days following the end of a fiscal year. Late disclosures only exacerbate the problem discussed previously.

As background, the Securities Act and the Exchange Act were enacted with broad exemptions for municipal securities from all their provisions, except the antifraud provisions of Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5. In other words, the federal securities laws do not expressly authorize the Commission to prescribe the timing and content of municipal disclosures. In the absence of a statutory scheme for municipal securities registration and reporting, the Commission’s investor protection efforts in the municipal securities market have been accomplished primarily through regulation of broker-dealers, including through Exchange Act Rule 15c2-12 (the “Rule”), regulation of municipal advisors, Commission interpretations, enforcement of the antifraud provisions of the federal securities laws, and Commission oversight of the MSRB.

The Rule was initially adopted in 1989 pursuant to the Commission’s authority to adopt rules reasonably designed to prevent fraud (Exchange Act Sections 15B(d)(2) and 15(c)(2)) and has been amended four times since. Importantly, the Rule regulates the conduct of a registered broker-dealer when acting as an underwriter in a qualifying initial offering of municipal

¹ <https://www.merritresearch.com/footnotes/chronically-late-municipal-bond-audits-further-delayed-fy-2018>

² <http://www.msrb.org/msrb1/pdfs/MSRB-CD-Timing-of-Annual-Financial-Disclosures-2016.pdf>

securities. It establishes standards for the procurement and dissemination of disclosure documents by underwriters as a means of enhancing the accuracy and timeliness of disclosure to municipal securities investors. It is also designed to assist underwriters in meeting their responsibilities under the antifraud provisions of the federal securities laws by requiring them to review municipal issuer disclosure documents before commencing sales to investors. The practical importance of this is that the regulatory obligations under Rule 15c2-12 pertain to underwriters, while municipal issuer obligations (other than the obligation not to commit fraud) exist as a matter of contract under a continuing disclosure agreement.

If a municipal issuer provides financial information in an offering document for an offering that is subject to the full scope of the Rule, such municipal issuer would then be obligated, pursuant to its continuing disclosure agreement, to provide annual financial information to the MSRB that is of the same type as those provided in the final official statement relating to the relevant municipal securities. If not part of the municipal issuer's annual financial information, the municipal issuer is only required to provide audited financial statements when and if they are available. The Rule also is flexible with respect to when municipal issuers must submit their annual information filings to the MSRB but requires each continuing disclosure agreement to specify the date on which the annual financial information for the preceding fiscal year will be provided. If the municipal issuer fails to provide its annual financial information by the specified date, it must file a "failure to file" notice with the MSRB. However, there is no effective enforcement mechanism for those municipal issuers that are not raising additional funds in the primary market.

Under the Rule, municipal issuers with outstanding public debt subject to the Rule's provisions must provide certain ongoing (non-annual) disclosures—known as material event notices. These events are enumerated within the Rule and must be included in any continuing disclosure agreement subject to the full scope of the Rule. These notices must be filed with the MSRB within 10 business days of the occurrence of the event. Other interim (non-annual) disclosures made by municipal issuers of municipal securities are done voluntarily; over the years, the Commission has encouraged this practice.

From a historical perspective, and in the absence of explicit authority for the Commission to prescribe the timing and content of disclosures relating to municipal securities – including financial information – the Commission, in its 2012 Report on the Municipal Securities (the "SEC Report"), made a series of recommendations for possible tailored legislative approaches that could provide the Commission authority to establish improved disclosures and practices in the municipal securities market. These recommendations included authorizing the Commission to require that municipal issuers prepare and disseminate official statements and disclosure during the outstanding term of the securities, including setting timeframes, frequency for such dissemination and minimum disclosure requirements, including financial statements and other financial and operating information, and providing tools to enforce such requirements. Additionally, the SEC also recommended as part of the SEC Report, that the Commission be authorized to establish the form and content of financial statements for municipal issuers who issue municipal securities, including the authority to recognize the standards of a designated private-sector body (*e.g.*, those from the Governmental Accounting Standards Board) as

generally accepted for purposes of the federal securities laws, and provide the Commission with attendant authority over such private-sector body. A final, but important recommendation in this area, was to authorize the Commission, as it deems appropriate, to require municipal issuers to have their financial statements audited, whether by an independent auditor or a state auditor.

It is also important to recognize what the Commission did not recommend or intend. The SEC Report contains no recommendation to require pre-offering review or otherwise alter the Tower Amendment. In addition, the Commission did not recommend, and was not seeking, to replicate the corporate disclosure system or to require SEC review of municipal disclosure documents. Nor did the SEC seek to establish detailed line item disclosure requirements such as those applicable to corporate issuers.

Recommendation

As such and given this background the Subcommittee makes the following recommendations:

- That the SEC be given additional statutory authority to provide a mechanism for the SEC to enforce compliance with continuing disclosure agreements and other obligations of municipal issuers to protect municipal securities bondholders. This would give the SEC the ability to enforce compliance with continuing disclosure agreements agreed upon by the municipal issuer and the underwriter at the time of sale and provide important protections for bondholders.
- That the SEC be given additional statutory authority to provide a safe harbor from private liability for forward-looking statements for municipal issuers that satisfy certain conditions, including, but not limited to, appropriate risk disclosure relating to such forward-looking statements, and if projections are provided disclosure of significant assumptions underlying such projections and the financials are provided in good faith.
- The SEC should explore ways through which it could make disclosure deadlines for annual financial information and audited financial statements more certain and predictable. The Subcommittee is particularly concerned about language in many continuing disclosure agreements that states the municipal issuer will provide annual financial information by a specified date and audited financial statements “when and if available”. The Subcommittee believes that municipal issuers should commit to a date without the contingency language. The Subcommittee would also like the SEC to look at continuing disclosure agreements that contain language that could make the disclosure date change year to year. For example, an agreement that states the municipal issuer will provide annual financials “within one month of the September Board or Finance Committee meeting.” This recommendation is meant to give investors more certainty around when the municipal issuer has agreed to provide annual financials.
- The Subcommittee recognizes the concerns about disclosure in the municipal market by many market professionals. However, the Subcommittee also recognizes that any substantial changes to disclosure requirements could have a significant impact on municipal issuers’ ability to raise capital in the public market and could also impact investors. The Subcommittee recommends the SEC seek wide ranging public comment

about the concerns raised by market participants and the potential need for the SEC to establish a disclosure framework including timeframe obligations for municipal issuers. For example, the timeframe obligations could be tailored or tiered based on criteria such as the nature and size of the municipal issuer, the amount of its outstanding securities and the number of sub-entities that report up to the municipal issuer. After reviewing comments, the SEC can determine if it would be appropriate for the SEC to seek legislation to give the Commission additional (but still limited) authority over municipal disclosures.

- The Subcommittee is aware that there is currently not a significant differentiation in terms of yield from investors for municipal issuers that file in 120 or 170 days etc. or for those that provide robust interim financials or little to no interim financials. However, market dynamics can change, and municipal issuers should be aware that the market could demand higher yields from municipal issuers with longer disclosure time and less robust disclosures in general. Therefore, the Subcommittee recommends the SEC explore ways through which it can raise awareness of the potential consequences of providing less timely and less robust disclosure information.