



PUBLIC FINANCE –
2013 IN REVIEW AND THE
OUTLOOK FOR 2014

2013 was another active year for regulation of the municipal market, particularly for matters relating to federal securities laws and federal tax laws. The most notable are summarized below.

FEDERAL SECURITIES LAWS

SEC Enforcement Activities in Overdrive

2013 was a banner year for [SEC enforcement in the municipal market](#) with several high profile actions being announced. A common theme running through all of the SEC's orders in these actions is the importance of a municipal issuer implementing disclosure policies and procedures. The SEC has mentioned repeatedly over the years that municipal issuers should do this in order to provide better disclosure in primary offerings and to enhance secondary market disclosure practices. A summary of the actions announced by the SEC in 2013 follows.

City of Harrisburg

The SEC issued a cease and desist order against the City of Harrisburg, PA, charging the City with fraud on the basis of misrepresentations and/or omissions in public statements and financial information available on the City's website during a long period of failure by the City to fully comply with its continuing disclosure obligations. This order marks the first time the SEC has instituted enforcement proceedings against a municipality other than in connection with alleged fraud and negligence in official statements or related disclosure documents prepared for a bond issue. Although the Harrisburg facts are unique, the SEC's legal analysis contained in both the order and the report of the investigation that accompanied the order underscore the SEC's decades long admonitions to municipal issuers and municipal officials to provide ongoing timely and accurate information to the secondary market.

According to the SEC: "Municipal issuers have an obligation to make sure that information that is released to the public that is reasonably expected to reach investors and the trading markets, even if not specifically published for that purpose, does not violate the antifraud provisions."

While there are limited circumstances under which municipal issuers are required to speak to the market other than in connection with the issuance of its securities, if a municipal issuer chooses to make statements that are "reasonably expected to reach the market" those statements are subject to the antifraud provisions of federal securities laws. The SEC's legal conclusion in the Harrisburg case was that the City's statements and information available on its website could be "reasonably expected to reach the market," regardless of the City's intentions, in large part because the City failed to comply with its continuing disclosure undertakings.

Although the SEC did not proceed against any individuals, the accompanying report specifically addresses public officials' obligations with respect to secondary market disclosures. As stated in the report: "Public officials should be mindful that their public statements, whether written or oral, may affect the total mix of information available to investors, and should understand that these public statements, if they are materially misleading or omit material information, can lead to potential liability under the antifraud provisions of the federal securities laws." The report then strongly suggests that public officials should, at a minimum, consider "adopting policies and procedures that are reasonably designed to result in accurate, timely, and complete public disclosures." For purposes of the report, the SEC defines "public officials" to include elected and appointed officials, as well as employees of state and local government entities and instrumentalities.

The SEC did not impose any monetary penalty against the City or any City official and the City, which consented to the entry of the order, neither admitted nor denied the SEC's findings.

The City of South Miami

In May 2013, the SEC settled with the City of South Miami, Florida over possible securities law violations resulting from the City's failure to comply with federal tax requirements for two loans from a tax-exempt loan pool. Although no financial penalty was required, the City agreed to engage a consultant for three years to implement and conduct an annual review of the city's policies, procedures, and practices related to its disclosures for municipal securities offerings. The City had previously settled with the Internal Revenue Service (IRS) concerning the same loans and related bonds.

This double barreled federal regulatory episode for South Miami serves to underscore the importance of understanding the restrictions involved with respect to tax-exempt financing and the great value of having in place post-issuance compliance procedures for both tax and disclosure matters, particularly in the case of personnel transitions.

West Clark Community Schools

The SEC found that West Clark Community Schools misled investors in a 2007 offering document by falsely stating it had complied with prior continuing disclosure obligations.

In its settlement with the SEC, the school district agreed to bring all required filings current, adopt enhanced policies and procedures regarding its contractual continuing disclosure obligations, implement annual training for personnel involved in the bond disclosure process, and establish policies and procedures to ensure all required notices and filings are made electronically through the Municipal Securities Rulemaking Board (MSRB).

State of Illinois

The SEC instituted action against the State of Illinois for failing to provide adequate disclosure regarding its pension obligations. According to the SEC: "The State failed to adopt or implement sufficient controls, policies, or procedures designed to ensure that material information was assembled and communicated to individuals responsible for disclosure determinations, to train personnel involved in the disclosure process adequately, or to retain disclosure counsel. As a result, the State lacked proper mechanisms to identify and incorporate into its official statements relevant information held by the pension systems and other bodies within the State."

The State instituted remedial measures prior to the 2012 order in the SEC's investigation of the State of New Jersey for similar pension disclosure failures but stepped up those remedial measures up after the SEC's order in New Jersey, which was cited favorably by the SEC.

Greater Wenatchee Regional Events Center Public Facilities District

The Greater Wenatchee Regional Events Center Public Facilities District became the first municipal issuer to be assessed a financial penalty by the SEC in an enforcement action. Although a relatively small penalty (\$20,000), the financial penalty is likely a harbinger for future enforcement settlements. According to the SEC, among other noted disclosure deficiencies, the district's official statement used in the offering and sale of bond anticipation notes in 2008 stated there had been no independent reviews of financial projections for the events center being financed even though an independent consultant twice examined the projections and raised questions about the center's economic viability. The underwriter was also charged as well as the developer and the district's executive services director who signed off on the disclosure document.

As part of the settlement with the SEC, the district agreed to "establish policies, procedures, and internal controls relating to disclosures in the offering of municipal securities and continuing disclosures pursuant to Rule 15c2-12 of the Securities Exchange Act of 1934 to ensure compliance with the federal securities laws, including the designation of an individual within the District responsible for ensuring compliance by the District of such policies, procedures, and internal controls."

City of Miami, Florida and Victorville, California Enforcement Actions

Unlike the settled actions described above, the cities of Miami, Florida and Victorville, California are fighting the SEC in federal district court proceedings in Florida and California, respectively. The SEC charged Miami with violating a previous cease and desist order by failing to adequately disclose matters relating to certain fiscal year end interfund transfers that, according to the SEC, hid a declining financial condition and thereby misled investors in the City's 2009 bond offerings. Victorville was charged by the SEC with defrauding investors by including what the SEC alleges are inflated valuation figures for certain property in connection with a tax increment financing for airport improvements in 2008. In December a federal judge rejected Miami's motion to dismiss the case. A similar motion filed by Victorville in California is still under consideration.

Long Awaited Municipal Advisor Regulations

In September 2013, the SEC unanimously approved the regulatory regime for municipal advisors and allayed concerns raised in the proposed rule regarding the treatment of appointed issuer officials. After considering more than 1,000 comment letters, the SEC exempted from the rule "all members of a municipal entity's governing body, its advisory boards and its committees, as well as persons serving in a similar official capacity with respect to the municipal entity, to the extent they are acting within the scope of their official capacity, regardless of whether such members or officials are employees of the municipal entity."

Although the SEC clearly reviewed and understood the concerns raised in the comment letters submitted following release of the proposed rule in late 2010, there remains uncertainty regarding the extent of the rule and its application to certain activities commonly performed by attorneys and underwriters, including the following:

- Unsolicited pitches by underwriters to municipal issuers may be limited (or eliminated), which may impede the ability of municipal issuers to receive, review and respond to refunding and/or restructuring opportunities.
- Frank analysis and discussion by attorneys regarding financial aspects of a transaction may be chilled, thereby denying municipal issuers the opinions and observations of their counsel, who already has a fiduciary duty to the municipal issuer.

These and other questions raised may only be resolved through additional guidance from the SEC and/or the MSRB.

FEDERAL TAX LAWS

Several trends in the treatment of tax-favored bonds continued throughout 2013. The IRS continued to focus on post-issuance compliance and arbitrage matters, with a special emphasis on the issue price of tax-favored bonds. Although making little progress, Congress continued discussing tax reform that may result in the elimination or reduction of federal subsidies for state and local bonds. The following are a few of the highlights from 2013.

Sequestration Cuts Direct Pay Bond Payments and Other State and Local Government Funding

On March 1, sweeping sequestration cuts to the federal budget, mandated by the Budget Control Act of 2011, were ordered, some of which directly affect a portion of the municipal bond market. Among the reductions are interest subsidy payments the federal government makes to issuers of “direct pay bonds” (i.e., build America bonds, recovery zone economic development bonds, and most qualified school construction bonds, qualified zone academy bonds, new clean renewable energy bonds, and qualified energy conservation bonds). **These interest payments are reduced by 7.2% through September 30, 2014, the end of the current federal fiscal year, and by a percentage yet to be announced thereafter.** Sequestration also slashes federal funding for a number of state and local transportation, education, and healthcare programs, potentially threatening the budgets of state and local governments.

IRS Issues Final Report of its Colleges and Universities Compliance Project

On April 25, the IRS [issued a final report](#) (Report) on its “Tax-Exempt Colleges and Universities Compliance Project.” The Report includes IRS findings and conclusions drawn from responses to questionnaires distributed to 400 public and private colleges and universities, and from the results of examinations of 34 of the colleges and universities that completed a questionnaire, in order to gain a better understanding of practices involving unrelated business income (UBI) and executive compensation.

The Report is the latest example of the IRS’ increased emphasis on compliance matters of tax-exempt institutions and follows on the heels of the final report released in 2011 of its “Tax-Exempt Bond Compliance Questionnaire Project.” The IRS’ demonstrated interest in 501(c)(3) compliance emphasizes that the issues addressed in the Report are significant not only to a 501(c)(3) college or university’s tax exemption, but also to the tax-exempt bonds issued for the benefit of 501(c)(3) colleges and universities, including post-issuance compliance, bond audits by the IRS, and fulfillment of various bond covenants.

Proposed Arbitrage Regulations

The Treasury Department [issued long-awaited proposed arbitrage regulations on September 16, 2013](#). Published in Bloomberg BNA Daily Tax Report, the editorial “[Treasury Issues Long-Awaited Issue Price, Other Arbitrage Proposed Regulations: What You Need to Know and a Call to Action](#)” by Squire Sanders lawyers John W. Hutchinson, Michael A. Cullers and Robert J. Eidnier provides a detailed summary of the regulations. While issuers are not required to apply the new regulations until they are finalized by Treasury, issuers generally may choose to apply some or all of them to transactions occurring after September 16 (and undoubtedly will choose to apply some of them).

The new regulations propose a number of changes to the arbitrage rules, some issuer-friendly and some not. For example, an unfavorable change would base “issue price” on actual sales rather than the current “reasonable expectations,” and would generally require 25% of the bonds to be sold rather than the current 10% to establish issue price. In addition, an even broader and more ambiguous “anti-abuse” arbitrage rule than currently exists would be imposed. On the other hand, generally favorable changes are included for grant financings, “qualified hedges” and working capital financings.

WHAT TO LOOK FOR IN 2014

Federal Securities Laws

Implementation of the municipal advisor rule is likely to dominate the municipal market in 2014, including continued debate concerning the effect of the rule on long-standing practices of underwriters concerning issuer client communication and the issuance of final implementation and complimentary rules by the Municipal Securities Rulemaking Board. Already this month, the SEC issued a set of “FAQ’s” regarding the application of the rule and pushed the compliance date back from January 13, 2014 to July 1, 2014.

It is also anticipated that the stepped up enforcement activities of the SEC in the municipal market will continue, perhaps with a sharper focus on secondary market activity and underwriters’ diligence responsibilities. The ongoing court proceedings for both the City of Miami and the City of Victorville will stay on the municipal market’s radar for the potential judicial blessing or curtailing of recent SEC enforcement activities.

Somewhat of a “sleeping issue” in 2014 may be the application of the so-called “Volcker Rule” to municipal securities in terms of the treatment of different types of municipal securities for bank reserve requirements.

The City of Detroit bankruptcy action will be something to watch in 2014 as certain key legal issues are addressed by the bankruptcy court and likely appealed. Although the Detroit legal issues are not limited to its outstanding municipal debt, the potential for judicial precedent concerning the interplay between federal bankruptcy law and state law concerning local government debt and contractual obligations is notable and highly anticipated.

Tax Legislation

Congress continues its deliberations on tax reform while making little substantive progress. The key question for issuers, conduit borrowers, and underwriters of tax-exempt bonds is how broader tax reform efforts may affect the federal subsidy of these bonds. Representative Camp (R), Chairman of the House Ways and Means Committee, issued several proposals for tax reform. Although he had initially hoped to introduce tax reform legislation in 2013, he did not. In the Senate, Finance Committee Chairman Max Baucus (D) introduced draft legislation but had little support from Republicans or the business community. At this point, it appears unlikely that tax reform legislation will be introduced in 2014, and if introduced it appears even less likely to be enacted. Although the specific details of tax reform remain unclear, many proposals focus on a broadening of the taxable income base and a reduction of tax rates. Although the introduction, let alone enactment, of tax reform appears to be a remote possibility at the moment for the current year, some commentators and policy groups have suggested that Congress consider eliminating or reducing the exemption for interest on state and local bonds as part of the broadening of the tax base. Issuers and other interested parties must continue to stress the vital role tax-exempt bonds play in addressing the nation’s urgent transportation, healthcare and education infrastructure needs.

Tax Regulations

As is true each year, Treasury and IRS have a number of priority guidance projects for 2014. The 2014 list includes regulations on arbitrage investment restrictions. It remains to be seen whether the IRS will finalize the recently proposed arbitrage regulations in their current form or instead revise the regulations in response to complaints from issuers and practitioners; it is likely that neither will occur in 2014. Other priority projects for 2014 include guidance on the definition of “political subdivision,” guidance relating to private activity bonds, guidance on bond reissuance, and finalization of proposed regulations (issued in 2008) on the public approval requirement for tax-exempt private activity bonds.