May 7, 2013

Caution - Statements by Public Officials May Result in Securities Law Violations

Yesterday, the Securities and Exchange Commission issued a Report of Investigation (Report) that included a warning to public officials to "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 accompanied an order instituting a settled cease-and-desist proceeding against the city of Harrisburg, PA, for violating Securities and Exchange Act (Exchange Act) antifraud rules. [1]

Antifraud Provisions

Issuers of municipal bonds and others are subject to the antifraud provisions of the federal securities laws, including Section 10(b) of the Exchange Act, which "prohibits the making of any untrue statement of material fact or omitting to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading in connection with the purchase or sale of securities." A fact is material if there is a substantial likelihood that the information would have been viewed by the reasonable investor as significantly altering the total mix of information upon which an investment decision would be made.

Harrisburg

While Harrisburg's distress is now well-publicized, the SEC found that over a period of years the city failed to provide the information or notices required by its continuing disclosure undertakings to EMMA (the Municipal Securities Rulemaking Board's Electronic Municipal Market Access system). According to the SEC, this left bond investors in the secondary market reliant on public statements made by government officials, notwithstanding that these communications were made outside of the disclosure documents related to either a primary offering or continuing disclosure. In addition, the SEC found that the financial information that was made publicly available was misleading and omitted material information.

Much of the city's distress relates to its guarantee of bonds issued by The Harrisburg Authority (Authority) to finance upgrades and repairs to a Resource Recovery Facility (RRF). The city became obligated to make payments on the Authority's RRF bonds when the Authority did not have sufficient revenue.

Some of the public statements cited in the SEC's order were:

- The city's administration provided a 2009 budget proposal to the City Council that was posted on the city's website. The budget proposal did not include any funds for debt guarantee payments even though the administration knew that the Authority was unlikely to have revenues to meet its debt service obligations, which meant that the city would be obligated to pay. The budget also misstated the city's credit rating.
- The mayor's 2009 "State of the City Address" described the RRF situation as merely "an additional challenge" and an "issue that could be resolved." The SEC found that this ignored the extent of the financial burden that the guarantee put on the city's general fund and the impact that burden was already having on the city's finances.

- The city posted a midyear report to its website that did not reference any of the guarantee payments the city had made on the RRF bonds, which guarantee payments already amounted to 7 percent of the city's general fund expenditures at that time.

The SEC has long made clear that when information about a municipal issuer (or obligated person) is "reasonably expected to reach investors and the trading markets, those disclosures are subject to the antifraud provisions." [2] However, this enforcement represents the first time that the SEC has charged a municipality for misleading statements made outside of its securities disclosure documents. The SEC states in the Report that

> [u]nlike many primary offering disclosure documents, statements by public officials that reach the secondary market may not be subject to the same comprehensive review with respect to the disclosure standards of the federal securities laws. Nevertheless, public officials may have liability under the antifraud provisions of the federal securities laws for such statements. Therefore, the statements of those public officials who may be viewed as having knowledge regarding the financial condition and operations of a municipal issuer should be carefully evaluated to assure that they are not materially false or misleading.

The SEC noted in the Report that "[b]ecause statements are evaluated for antifraud purposes in light of the circumstances in which they are made, the lack of other disclosures by the municipal entity may increase the risk that municipal officials' public statements may be misleading or may omit material information." Finally, while such a finding of fraud requires a showing that the defendant acted with scienter, such requirement could be satisfied by showing that the defendant acted with recklessness. The SEC found the city acted recklessly, its actions being an "extreme departure from the standards of ordinary care, and which represents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."

Practical Guidance

The Report states that issuers should consider taking the following steps to reduce the risk of misleading investors:

- Adopt policies and procedures to prescribe a practice for ensuring accurate, complete and timely disclosure is provided to the market.
- Identify those persons involved in the disclosure process.
- Evaluate public disclosures including financial information and other statements prior to public dissemination.
- Ensure that responsible individuals receive training about their obligations under the federal securities laws.

Day Pitney often serves as disclosure counsel to assist issuers in navigating these complicated demands. If you have any questions about the above, please feel free to contact any of the attorneys listed on this alert.

[1] See Report of Investigation in the Matter of the City of Harrisburg, Pennsylvania Concerning the Potential Liability of Public Officials with Regard to Disclosure Obligations in the Secondary Market, May 6, 2013, available at http://www.sec.gov/litigation/investreport/34-69516.htm. See also Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21c of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, Release No. 69515, May 6, 2013, available at http://www.sec.gov/litigation/admin/2013/34-69515.pdf.

[2] See Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Exchange Act Release No. 34-33741, March 9, 1994, at 12-13.