

SEC and the Municipal Market: A CPA Firm Perspective

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Objectives

- Discuss recent studies conducted by the SEC and GAO on municipal securities.
- Consider recent trends in municipal securities and impact on market participants.
- Understand published best practices related to municipal securities issuers.
- Provide a vision of the future in municipal securities.
- Suggest possible action plans.



Report on the Municipal Securities Market



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About the Report

- Prepared by the SEC using
 - Field hearings
 - Comment letters
 - Academic studies
 - Publicly available materials
 - Staff generated statistics
 - Other testimony given during meetings and conference calls on the topic

Structure and Objectives of the Report

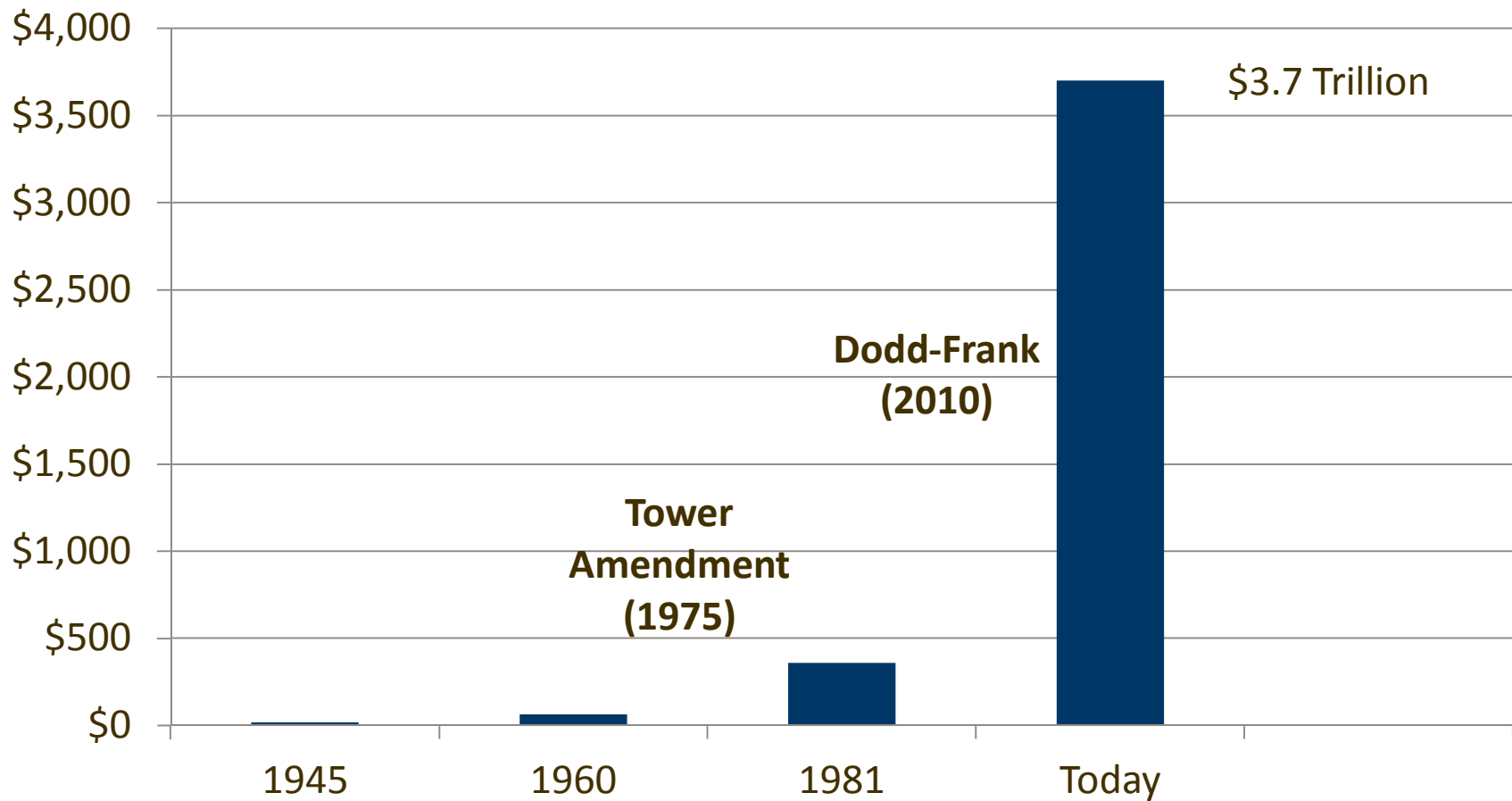
- Provide context and overview of the municipal securities market
- Provide information on the regulatory structure and roles of key market participants
- Discuss areas of concern in the municipal securities market
- Provide recommendations to improve the municipal securities market



Overview of the Market

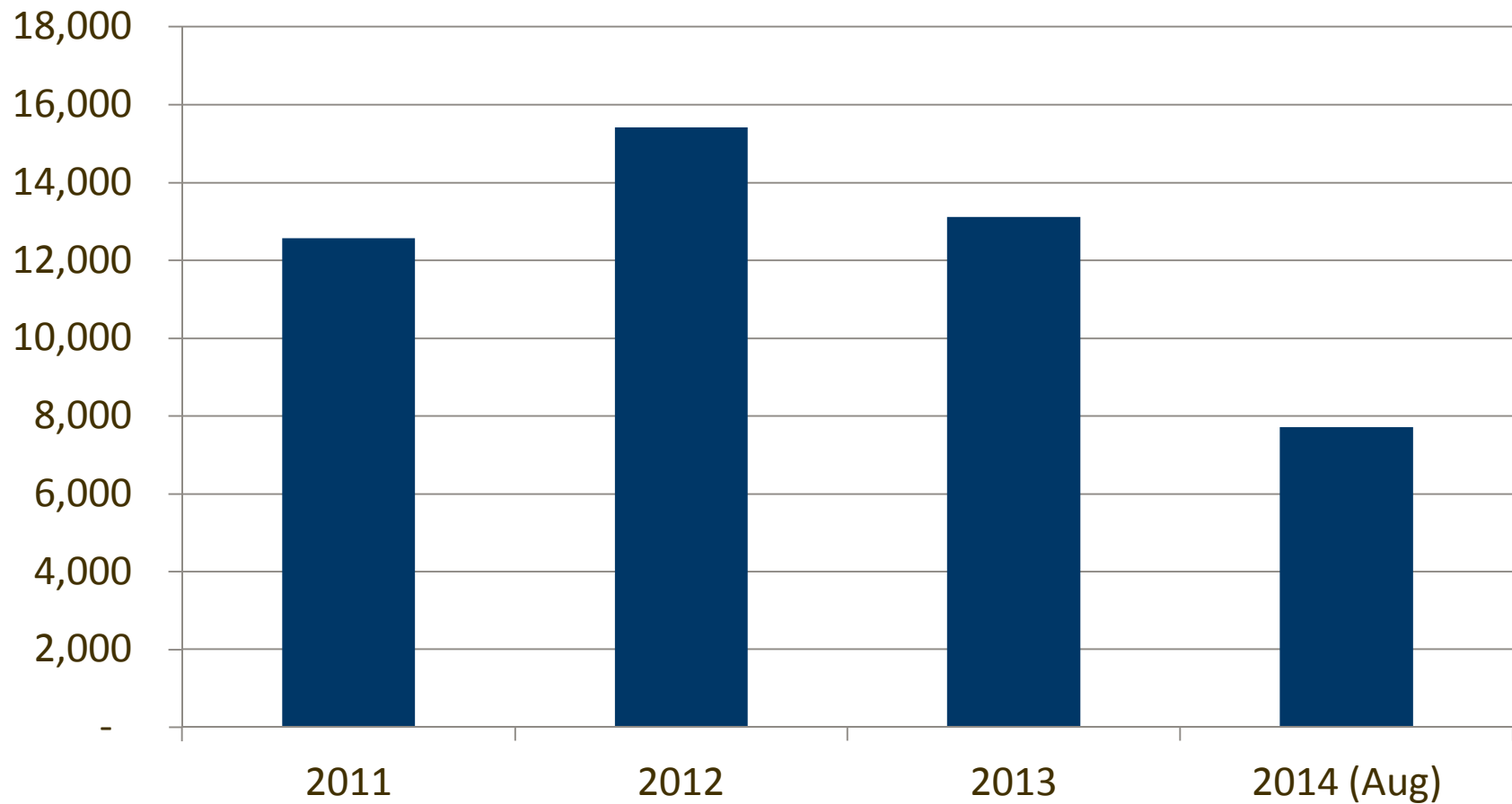
Muni Market Then and Now

Outstanding in Billions

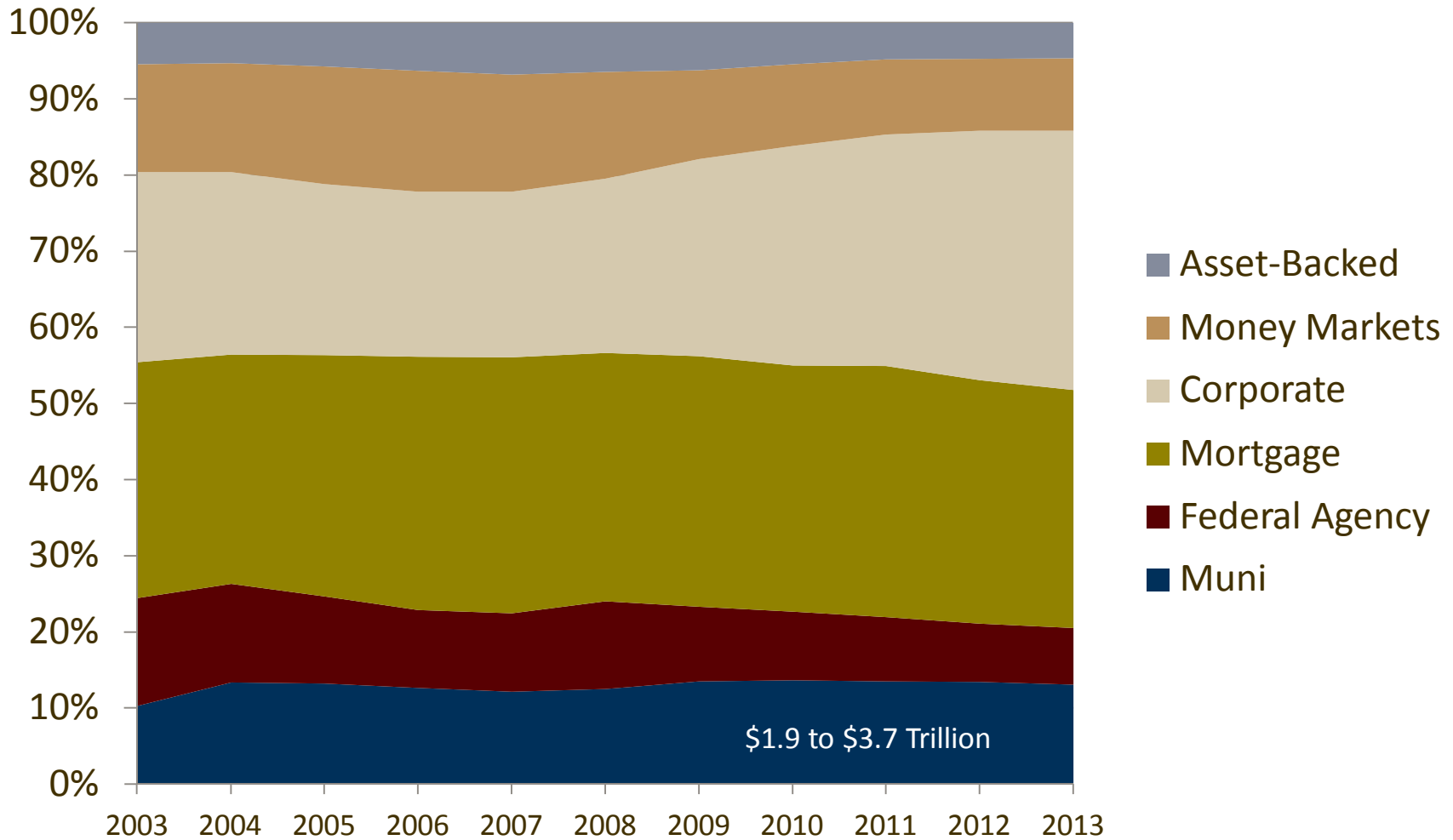


New Municipal Issuance By Year

Number of Issuances



U.S. Bond Market 2003-2013 w/o Treasury Bonds



Regulatory History (Quick Refresher)

- Securities Act of 1933 and Securities Exchange Act of 1934 were regulations covering U.S. capital markets, however, broad exemption for municipal securities from all provisions except for the antifraud provisions.
- Tower Amendment (1975) create a limited regulatory arrangement for municipal securities market in response to:
 - Growth in market
 - Market abuses
 - Increasing participation of individual investors

Tower Amendment

- Required firms transacting business in municipal securities to registers with the SEC as broker-dealers.
- Required banks dealing in municipal securities to register as municipal securities dealers.
- SEC became the enforcement authority over broker-dealers and municipal securities dealers.



- Created the Municipal Securities Rulemaking Board (MSRB)
 - Authority to promulgate rules governing the sale of municipal securities by broker-dealers and municipal securities dealers

Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)

- Signed into law in 2010
- GAO Study on Muni Disclosure
 - Required a study and review by GAO of municipal securities disclosure, possible recommendation for municipal issuer disclosure requirement and advisability of the repeal or retention of the Tower Amendment.
- Municipal Advisors
 - Required the registration of municipal advisors with the SEC and provided for their regulation by the MSRB.
- GASB Funded
 - SEC ordered FINRA to establish and collect fees.



Conclusions

- The dollars in the municipal securities market have increased in proportion to their corporate counterparts.
 - Materially, we are in the same situation as the last ten years as far as market share.
- After the financial meltdowns of the *Great Recession*
 - Our elected officials are evaluating all U.S capital markets including the municipal securities market.
 - Actions were taken in the municipal securities market
 - ◇ Municipal advisor regulation
 - ◇ GASB funded as a government standards setter
 - ◇ SEC enforcement on the up swing

Risk on Municipal Bonds - Default

- News of bankruptcy is not equivalent to bond defaults.
 - Some government declaring bankruptcy have been paying their debt.
- Defaults happen when management is poor –
 - Fixed costs are not controlled or adjusted based revenue base
 - ◇ Salaries, pensions, medical benefits, etc.
 - Large capital projects fail and/or controls are not adequate to control project costs
 - Not raising revenues on revenue bonds when needed
 - Poor fraud controls and existence of major frauds

Rate of Default by Rating (Moody's)

Rating	After 1 Year	After 3 Years	After 10 Years
AAA	0.0% / 0.0%	0.0% / 0.01%	0.0% / 0.0%
AA	0.0% / 0.02%	0.0% / 0.14%	0.01% / 0.92%
A	0.0% / 0.06%	0.01% / 0.41%	0.05% / 2.48%
BBB	0.01% / 0.18%	0.06% / 0.90%	0.3% / 4.74%

Municipal Default Rate / Corporate Default Rate

Defaults by Sector (Moody's)

Sector	Percentage
Housing	39.7%
Hospitals & Health Care	30.1%
General Obligation	6.8%
Infrastructure	5.5%
Utilities including Water and Sewer	5.4%
Education	4.1%
Cities (non-general obligation)	4.1%
Counties	2.7%
Other	1.6%

Chapter 9 Filings

Period	Chapter 9 Filings	Annual Average
1980 – 1989	71	7.1
1990-1999	95	9.5
2000-2009	69	6.9
2010-2012	31	10.3

It is anticipated the decade of 2010-2019 will be similar to 1990-1999.

Summary

- Low risk
- Playing the same role in the overall market
- Dollars are getting more significant
- Regulation is fairly limited compared to other investments in the U.S. capital markets
- Transparency in the market place is limited



Overall Disclosure Practices

Market Participants and Investors

- Interested in greater and timelier disclosures in
 - Primary offerings
 - ◇ Particular with respect to smaller less sophisticated issues and conduit borrowers.
 - Continuing disclosure
 - ◇ Missing
 - ◇ Inconsistent and incomplete
 - ◇ Not understandable

SEC Rule 15c2-12: Continuing Disclosure

- Annual Financial Information
- Event Notices
 - 10 days after the occurrence of the event*
 - ◇ Late principal and interest payments
 - ◇ Non-payment related defaults
 - ◇ Unscheduled draws on debt service reserves
 - ◇ Unscheduled draws on credit enhancements
 - ◇ Substitution of credit or liquidity providers or their failure to perform
 - ◇ Adverse tax opinions or events affecting tax-exempt status
 - ◇ Modification to rights of the security holders
 - ◇ Bond calls and tenders offers
 - ◇ Defeasances
 - ◇ Release, substitution or sale of property securing security
 - ◇ Bankruptcy, insolvency or receivership
 - ◇ Merger, acquisition or sale of all issuer assets
 - ◇ Appointment of successor trustee

* = 10 days for issues after December 1, 2010

Financial Statement and Financial Information

- Timeliness of Primary Offerings
 - Too slow
 - Diminished usefulness or lost relevance
- Comparability of Financial Information
 - No established standard for financial information
 - GAAP vs. non-GAAP
 - Standardization of disclosure

Disclosures by Conduit Borrowers

- Disclosure requirement should be the same for conduit borrowers
 - A concern for SEC
- SEC would like to conduit borrowers that are not municipal organization subject to the same regulation as corporate organizations

Pension Funding Obligations and OPEB

- These obligations can significantly effect the issuer's financial health and in turn their ability to pay the debt service requirements.
- GFOA Best Practice
 - *Disclosures of Pension Obligations in Official Statements*

Market Structure

- 75% of the outstanding principal of municipal securities are either directly or indirectly held by individuals or “retail” investors.
- “Buy-and-hold” (i.e. traded infrequently)
- The market is consider illiquid and opaque.
 - Municipal securities dealers
 - Secondary market pricing is not public available
 - Pricing analysis is considerable for retail investors

SEC Desires

- Transparency on pricing
- Greater access by retail investors
- Better information available to all investors
 - Timeliness
 - Content

Recommendations From SEC

- Approaches
 - Legislative
 - Regulatory
 - Industry-based initiatives

Legislative

- Authorize the Commission to:
 - Require municipal issues to prepare and disseminate official statement and disclosures during the outstanding term of the securities (include timeframes, frequency for such disseminations and minimum disclosure requirements) with the tools to enforce such requirements.
 - Establish the form and content of the financial statements including selecting a generally accepted standard setting body.
 - Require the financial statement to be audited.

Legislative (cont.)

- Eliminate the exemptions from the Securities Act and Exchange Act for conduit borrows that are not municipal entities.
- Provide a “safe harbor” from private liability for forward-looking statement for repeat issuers that are current in their disclosure obligations.
- Provide enforcement mechanisms for noncompliance with continuing disclosure agreements.

Regulatory

- SEC Annual Conference for municipal securities market
- Issue interpretive guidance regarding disclosure obligations
- Amend Exchange Act Rule 15c2-12 to further improve the disclosures
- Work with MSRB strengthen its rules and further enhance EMMA

Municipal Market Initiatives

- Encourage adherence to industry best practices
- GFOA
 - *Understanding Your Continuing Disclosure Responsibilities*
 - *Maintaining an Investor Relations Program*
 - *Using a Website for Disclosure*



Understanding Your Continuing Disclosure Responsibilities

GFOA Best Practice

Summarized Elements

- Read and understand your continuing disclosure agreement (CDA)
- Develop and document your procedures for disclosure –
 - Who is responsible to file?
 - Disclosure dates (actual goal and agreed to dates)
 - What is the annual filing?
 - What are the material events (SEC and CDA)?
- Timeliness, immediately after release (180 days, if CAFR)
- What are we going to voluntarily disclose?



Maintaining Investor Relations Program

Summarized Elements

- Develop an investor strategy
- Identify the people to carryout the strategy
- What information –
 - Required (financial info and events)
 - Budgets
 - Interim financial data
 - Fiscal policies
 - Questions and answer protocols
 - Preliminary official statements
 - Relationships with rating agencies
 - Marketing activities

Quote from Best Practice

“The municipal marketplace is changing, the need to provide additional information with greater frequency is significant. Issuers should maintain an awareness of changes in current practice in the area of investor relations. Investor Relations Programs that go beyond the legally mandated requirements of SEC Rule 15c2-12 promote the efficient sale of debt instruments in both the primary and secondary markets and improve the reception of debt offerings. Expansive disclosure practices are encouraged, especially the availability of interim financial information between your annual filings.”



Using a Website for Disclosure

Summary

- Having an area of website dedicated to the investor is a good idea, examples -

Cook County, Illinois

<http://www.cookcountyl.gov/investor-relations/>

City of Los Angeles, California

<http://cao.lacity.org/index.htm>

Disclosure Test: EMMA and Website

- Which Bond would you buy –
<http://emma.msrb.org/>
 - Village of Schaumburg, Illinois
<http://www.ci.schaumburg.il.us/Pages/home.aspx>
 - City of Delafield, Wisconsin
<http://www.cityofdelafield.com/>
 - Village of Gurnee, Illinois
<http://www.gurnee.il.us/finance>

Exercise

- Effective, January 1, 2016, MSRP create a rule the following reporting deadline for annual financial disclosures within 180 days.
 - ◇ 180 days (6 months)
 - ◇ 120 days (4 months)
- SEC amends continuing disclosures requirements to include interim data, budgets, significant financial policy changes, change in regulations, etc.
- GASB is required for annual financial disclosures.

Discussion About Timeliness

- GASB has identified timeliness of the financial reporting as “perhaps the most frequent and common concern expressed to the GASB by the users of state and local government financial reports.”
- Existing standards
 - 120 days per voluntary deadline-EMMA
 - 180 days per GFOA
 - 270 days per many continuing disclosure agreements

GASB Timeliness Study

- General purpose government take the longest
- Electric utilities and hospitals take the shortest
- Credit quality was not a overriding factor on timeliness, however, “weaker and more distressed entities” had later audit completion times.
- Within six months
 - 73% for larger governments
 - 46% for smaller governments
- City of New York – 114 days

Concerns Expressed

- If timeframe were shortened -
 - Abandon a high quality report standards and diminish the value of the information provided
 - Need more personnel and preplanning
 - Need to use auditors without governmental expertise
 - Simply unattainable
 - Financial information from component units not timely
 - Materiality is assess on the opinion unit instead of the government as a whole
 - Using estimate is less accurate than waiting for actuals

Thoughts

- Timeliness
 - Consider a process that continuously refine your financial reporting process to move the disclosure dates
 - File your disclosures as soon as they already
- Develop an investor strategy and get intentional about the strategy
- Why would I buy your bonds?



Municipal Advisors

Definition of Municipal Advisor

- A person that provides municipal financial advice or solicits business for municipal financial products on behalf of unaffiliated 3rd parties.

Advice

- Construed broadly and objectively
- Factors considered –
 - Person makes a specific recommendation
 - Whether the advice would reasonably cause someone to take action or not take action
 - How tailored is the advice.

Examples of advice

- What is advice under Rule 15Ba1-1(d)(1)(ii)
 - Recommendation of municipal financial products
 - Recommendations for the issuance of municipal securities
 - Recommendations based on the structure, timing, terms of municipal products or issuance of municipal securities
 - Recommendations particularized to the specific needs, objectives, and/or circumstances of the municipality

Not Advice

- Publicly held information
- Unspecific information
- Factual information (without viewpoints and opinions)
- Educational material

Why Does this Matter to Auditors?

- Exemption from municipal advisor rule –
 - Accountants do not have to register if they are providing accounting services that include audit or other attest services, preparation of financial statements, or issuance of letters for underwriters.



Auditor Association

When is the Auditor Associated

- The answer is simple, when they are involved
- Auditor association is different for tax-exempt offerings than corporate entities

Involved includes -

- Preparing financial information presented in the official statement
 - Not the audited financial statement
 - Other information
- Reviewing a draft of the official statement
- Manually signing the independent auditors' report for inclusion in a specific official statement

Involved includes (continued) -

- Providing a revised independent auditors' report for inclusion in a specific official statement
 - Eliminated reference to GAGAS or single audit
- Issuing a comfort letter or performing an attestation engagement
- Providing permission in response to a client request

Suggested Language for O/S when Not Associated from AICPA

“*[Name of firm]*, our independent auditor, has not been engaged to perform and has not performed, since the date of its report included herein, any procedures on the financial statements addressed in that report. *[Name of firm]* also has not performed any procedures relating to this official statement.”



Questions and Comments



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