Five recent actions brought by the Securities and Exchange Commission (SEC) against state and municipal borrowers highlight the SEC’s increased focus on disclosure relating to municipal securities and, in particular, the importance to borrowers of publicly issued debt of establishing good disclosure practices and procedures. Although the SEC’s actions were targeted at state and municipal issuers, the lessons that can be drawn from these actions are equally applicable to healthcare borrowers.

Recent SEC Enforcement Actions
Federal securities laws are designed to protect investors that purchase securities by, among other things, ensuring that borrowers provide investors with information that does not misstate or omit to state a material fact. In short, disclosure must be accurate and complete. Although borrowers of municipal bonds are not subject to much of the federal regulatory regime applicable to issuers of corporate securities, the antifraud provisions of federal law apply equally to municipal and corporate securities. Thus, a failure to provide an investor with disclosure regarding the borrower that is accurate and complete can lead to liability under federal law for fraud, and that liability can arise from negligence, rather than intentional acts of the borrower.

The recent line of cases provides insight into what the SEC appears to believe constitutes best practices for municipal borrowers. Notwithstanding that the SEC lacks regulatory authority to directly require municipal borrowers to adopt these practices, the commission appears to be sending a clear signal that it believes that these practices should be considered and adopted by municipal market participants.
State of Illinois. The first of the SEC recent enforcement actions focused on the state of Illinois’ disclosure regarding its statutory plan to fund its pension obligations. On March 11, 2013, the SEC charged the state with securities fraud for allegedly misleading municipal bond investors about its approach to funding pension obligations and issued a cease-and-desist order against the state. Illinois, which had begun in 2009 to implement a series of measures to improve its disclosure regarding its pension obligations, without admitting or denying the SEC’s findings, agreed to a settlement and consented to the SEC’s order.

Illinois, like many public employers, has provided its employees with a variety of pension benefits. Although the state’s disclosure has consistently included statistics regarding the Illinois pension system’s assets and liabilities, the SEC alleged that Illinois did not disclose that statutorily required contributions underfunded Illinois’ pension obligations and deferred pension funding into the future. The result, according to the SEC, was that the underfunding of the pension plans created risk that, in the future, the shortfall in required pension payments would have to be covered from Illinois’ operating budget, potentially straining the state’s ability to meet its other obligations—a fact that the SEC found would be material to a reasonable investor.

City of Harrisburg. The SEC’s next enforcement action, filed on May 6, 2013, focused on the failure of the city of Harrisburg, Pa., to provide required continuing disclosure and the alleged effect on the secondary market of other publicly available information that arguably failed to describe Harrisburg’s financial condition adequately. According to the SEC, for more than two years, Harrisburg failed to submit information and event notices required under the city’s continuing disclosure agreements. During this two-year period, on finding itself in dire financial condition, the city sought to restructure its financial position through state receivership or federal bankruptcy. The SEC found that Harrisburg made other public statements in these two years, however, including posting certain materials on its website that the SEC alleged did not accurately and completely describe the city’s precarious financial position. The SEC stated that investors were forced to make investment decisions without having the benefit of material information regarding Harrisburg’s financial condition. Based on the findings of its investigation, the SEC instituted a cease-and-desist proceeding against Harrisburg.

City of South Miami. The SEC’s enforcement action, instituted against the city of South Miami, Fla., on May 22, involved the failure of a borrower to disclose a change in the use of a bond-funded project that had significant tax law implications and which, according to the SEC, also resulted in violations of the federal securities laws because of the borrower’s failure to disclose this material information to the market.

City of Miami. The SEC filed a complaint on July 19 against the city of Miami and its former budget director alleging that by making improper interfund transfers, the city and its budget director had caused Miami’s general fund balance to be shown as higher than warranted in the city’s audited financial statement. Because these financial statements were filed as part of Miami’s continuing disclosure and were also included in official statements for subsequent bond issues, the SEC alleged that Miami’s disclosure was misleading and inaccurate. Miami had been the subject of a cease-and-desist order entered in 2003 alleging that the city had violated federal securities laws. The SEC’s 2013 complaint seeks both an injunction against further violations of these laws by the city as well as civil monetary penalties.

West Clark Community Schools. On July 29, the SEC issued a cease-and-desist order against West Clark Community Schools, an Indiana school system, alleging that the school system had materially misstated in its official statement that it had met all of its continuing disclosure obligations over the previous five years when it had not done so. The SEC also brought a similar action against the underwriter of the subsequent bond issues.
alleging, among other offenses, that the underwriter conducted inadequate due diligence and, as a result, failed to form a reasonable basis for confirming the truthfulness of the issuer’s official statement.

Lessons Learned from the SEC’s Actions
The SEC’s recent enforcement actions offer healthcare organizations several important lessons regarding making good disclosure.

First, and perhaps most important, the SEC has focused on borrowers implementing formal disclosure practices and procedures. Where borrowers improved them, the SEC cited the improved practices and procedures as a significant mitigating factor. In those cases where the borrower had not instituted such improvements, the SEC required the borrower to undertake improved disclosure practices. Formalizing processes and instituting written procedures allows borrowers to develop clearer and more detailed disclosure.

The second lesson is that the SEC remains focused on borrowers making accurate and complete disclosure regarding pension obligations. The future pension obligations of many entities, including some healthcare institutions, are significant and, if not adequately addressed, could impair a borrower’s ability to satisfy other future obligations, including debt service payments, as the current Chapter 9 bankruptcy filing by the City of Detroit has demonstrated. The SEC has made clear that it regards failure to provide accurate and complete notice that the tax-exempt status of the bonds was in jeopardy, which the SEC characterized as the omission of a material fact. The South Miami enforcement action marks the first time the SEC has taken the position that a borrower’s failure to disclose actions jeopardizing the tax-exempt status of bonds is a violation of federal securities law.

South Miami’s alleged materially misleading statements were apparently due to a lack of processes and procedures to ensure that appropriate city staff were familiar with the city’s tax and disclosure responsibilities, leading to a failure of South Miami’s staff to determine whether the city was in compliance with its covenants. The shortcomings led South Miami’s staff to falsely certify each year that the city was in compliance with its contractual obligations while failing to provide notice that the tax-exempt status of the bonds was in jeopardy, which the SEC characterized as the omission of a material fact. The South Miami enforcement action marks the first time the SEC has taken the position that a borrower’s failure to disclose actions jeopardizing the tax-exempt status of bonds is a violation of federal securities law.

The SEC has noted in the past that the failure by some issuers of municipal securities to comply with their continuing disclosure obligations is a problem that must be corrected, and the SEC has sought legislation that would authorize it to sanction municipal issuers that fail to meet these obligations. In the West Clark case, the SEC appears to take the position that an issuer’s inaccurate statement of compliance with its continuing disclosure obligations in a disclosure document constitutes a material misstatement reflecting a violation of the securities laws.

The complaint against Miami and its former finance director may be a harbinger of a new “get tough” approach by the SEC against persons and entities that it believes have violated federal securities laws. This case also demonstrates the necessity of diligence in accounting. The SEC claims that many of the allegedly improper interfund transfers lacked appropriate back-up documentation and were not in compliance with state and local law. Further, the SEC cited to the Governmental
Recent Marketplace Developments Related to Municipal Disclosure

In addition to the SEC’s recent enforcement actions, three other developments relating to municipal disclosure are worthy of note.

The current popularity of direct loans with banks. Since 2009, governmental issuers and conduit borrowers have increasingly used private bank loans as an alternative to publicly offered bonds. However, borrowers are not required to provide disclosure regarding additional debt, including bank loans. Thus, information regarding such loans often is not available to bondholders and analysts. The Municipal Securities Rulemaking Board (MSRB) took note of this issue and in 2012 issued a notice encouraging borrowers to make information about bank loans available voluntarily. On May 1, 2013, a task force of market participants issued a white paper entitled Considerations Regarding Voluntary Secondary Market Disclosure About Bank Loans (www.sifma.org; search on “considerations”).

The whitepaper presents recommendations regarding the disclosure that a borrower having outstanding bonds may wish to make when it enters into a bank loan. Although it does not go so far as to recommend that a borrower make such disclosure, the whitepaper provides a useful guide of the types of information that borrowers electing to provide disclosure should provide.

The white paper does include a recommendation that disclosure be provided within 10 days of the bank loan. Because the information that is disclosed should reasonably be expected to reach the market, borrowers are reminded that the antifraud provisions of the federal securities laws are applicable to such disclosure. The whitepaper also notes that borrowers making such disclosure may wish to include disclaimers in any such voluntary filing.

The Securities and Exchange Commission (SEC) issuance of a report on the municipal securities market. On July 31, 2012, the SEC issued its Report on the Municipal Securities Market, which contains recommendations relating to disclosure. The SEC’s authority to regulate the municipal market is limited under current federal law. The SEC’s report focuses on several discrete disclosure topics that the SEC finds to be of special interest and importance, including financial statements and financial information, disclosure regarding pension and other postemployment benefits, exposure to derivatives, the use and import of disclaimers, and disclosure of conflicts of interest or other relationships.

The report provides a clear view of the issues that the SEC believes require further attention to improve disclosure in the municipal market. Healthcare borrowers and their counsel should read the report and consider whether their current disclosure practices are consistent with the SEC’s recommended positions. The report presages many of the issues that have been the focus of recent SEC enforcement actions, and it seems likely that other issues it addresses will be the focus of SEC attention in the future.

The impact of healthcare reform on disclosure. Healthcare reform and new payment and financial penalty approaches are likely to alter significantly the types of information that municipal buy-side analysts will be seeking from healthcare borrowers, both in official statements and in continuing disclosure.

For example, the shift in emphasis and funding incentives from inpatient to outpatient treatment means that statistics that account only for inpatient market share and net patient revenue have become less accurate as indicators of a healthcare institution’s standing than they were in the past. Of increasing importance to analysts are outpatient market share, allocation of revenues between outpatients and inpatients, total case mix by categories of payers, percentage of revenues from various sources such as the Medicare Shared Savings Program and capitation arrangements, and readmission rates and other quality scores.

As the financial impact of healthcare reform begins to be felt, analysts will be seeking to determine which providers are successfully realigning their business models to take advantage of and benefit from the new incentives that are embedded in the legislation, and which providers are failing to keep pace with these significant changes in the market. As healthcare borrowers access the municipal market over the next several years, borrowers and their counsel will want to consider the types of data that reflect the manner in which the provider is adapting to the new healthcare market, and develop means and methods to disclose those data clearly, accurately, and thoroughly in both primary and continuing disclosure.
Accounting Standards Board (GASB) standards as controlling the disclosure that should have been included in the city’s footnotes to its financial statements. Borrowers should ensure that their accounting practices comply with applicable legal requirements and accounting standards.

**Steps to Implement a Disclosure Program**

Clearly, the lessons to be gleaned from the SEC’s enforcement actions and the developments described in the sidebar on page 4 point to a need for hospital borrowers to consider implementing a disclosure program. Here are practical steps for creation of such a program informed by meaningful disclosure policy and procedures.

*Establish procedures to meet disclosure goals—and follow them.* This critical step should begin with a review of the organization’s existing procedures (whether written or informal) regarding disclosure practices. Procedures should be structured to address the following key goals:

- Provision of accurate primary and secondary market information
- Timely release of annual and quarterly reports and material events notices
- Presentation of accurate, high-quality content without material omissions
- Adherence to efficient internal processes that must be followed before information can be publicly disseminated

Procedures also should be tailored to the specific needs and requirements of the organization. For example, the procedures developed for a stand-alone community hospital likely wouldn’t be appropriate for a large national healthcare system.

*Conduct an internal audit of current disclosure practices.* Consistent with tailoring procedures to an organization, the initiative to develop a disclosure program should begin with an inventory of what an organization currently has in place. During this “internal audit,” organization leaders should ask the following questions:

- Who ordinarily is responsible for disclosures? Who supports in that process?
- What policies and controls does the organization have in place to ensure that information about an organization is accurate and complete?
- What controls are in place to make sure that material information is assembled and communicated to the individuals responsible for disclosures to the market?
- How is information communicated to the individuals responsible for bond disclosures?
- Where may information be obtained? Does the organization post its disclosure on its company website? Is the Municipal Securities Rulemaking Board’s (MSRB’s) Electronic Municipal Market Access (EMMA®) system the sole vehicle for public disclosure?

*Designate personnel.* Responsibility for primary and secondary market disclosures should be assigned to one or more people within an organization. The most likely sources of candidates who might assume this responsibility are the treasury and financial reporting teams. Candidates should be qualified to speak on behalf of an organization at financial conferences, at bank and rating meetings, and in investor calls. Both in-house and outside counsel should be involved in disclosures and in development of the disclosure program.

*Ensure personnel involved receive appropriate training.* Once procedures are in place and roles have been established and defined, the personnel involved in the disclosure process will require training. The disclosure training process should be just like the process used for any new policy or procedure: Some departments or employees may need general training, while others may need more focused training. Disclosure problems often occur because different departments are not talking to each other, so an important focus for training should be on educating employees about when they should communicate certain information to individuals designated as responsible for disclosure.

*Reassess the organization’s historic deal pattern.* As an organization develops its disclosure procedures, it also should reconsider how it approaches...
deal-making. That is not to say each organization should reinvent the wheel; rather, it is important to consider a fresh approach to the disclosure process, looking for opportunities for improvement. When developing a deal calendar, for example, the organization should make sure that calls are planned and scheduled to allow meaningful time for reviewing documents and discussing disclosure points. And with respect to Appendix A disclosure and bondholders’ risk disclosure, management should have ample opportunity to review the disclosure and contemplate its effects. Organizations also should consider whether, in light of healthcare reform, additional information or metrics should be provided to ensure that investors have an accurate picture of the organization.

Make effective use of counsel. A quick word on disclosure counsel: Making sure that counsel understands his or her role in the disclosure process and has access to deliver the 10b-5, or due diligence, opinion at the end of the transaction is critical to ensuring high-quality primary disclosure.

Each organization will have a different approach to the use of either outside or in-house counsel after closing. It is important to think of the role of counsel, however, as it relates both to an organization’s monitoring and consideration of compliance with the SEC’s Rule 15c2-12, municipal securities disclosure, and to quarterly secondary market disclosure.

A counsel’s role (whether in-house or outside counsel) should not end with the delivery of the initial issuance opinion.

Establish clearly defined policies for website disclosure. It is important to let investors know where information can be obtained, and to use website disclosure consistently. To the extent that an organization posts information on a company-‐managed website, policies should state a clear position on website disclosure and procedures should ensure that the information is posted timely.

Never Too Late
For healthcare organizations that have not already begun to develop a disclosure program, it is never too late to start. In addition to taking into account lessons learned from several recent SEC settlements, a meaningful disclosure program can offer many benefits, the most significant of which is to provide a foundation for an effective investor relations program.

About the authors
Heidi H. Jeffery, JD, is a partner, Foley & Lardner LLP, Chicago (hjeffery@foley.com).
David Y. Bannard, JD, is a partner, Foley & Lardner LLP, Boston (dbannard@foley.com).