Municipal Bond Disclosure: Disclosing COVID-19 Impacts

State and local governments are bearing significant costs responding to the COVID-19 public health emergency. Meanwhile, state and local government revenues have been affected by the sudden halt in business activity mandated by the public health emergency. Sales and excise taxes have been particularly hard hit. In Washington State, strict limitations on annual property tax increases have, over the past decades, led to reliance on the sales and excise tax revenues that are hardest hit.

As state and municipal bond issuers navigate this time of increased community need, budget pressure and uncertainty, issuers should be mindful of how best to communicate with bond investors while complying with the federal securities laws that apply when "speaking to the market." A broadly-worded SEC Staff Legal Bulletin released on February 9, 2020,[1] cautioned that *any* statement that may reasonably be expected to reach investors may be subject to the antifraud requirements, highlighting the need for care in any communications.

Some communications are required even in this time of uncertainty – for example, if one of the required Rule 15c2-12 notice events occurs, such as a ratings change, an unscheduled draw on a debt service reserve or credit enhancement, or incurrence of a new material financial obligation. Further voluntary disclosures may be helpful. The following provides considerations in filing required and voluntary disclosures.

Required Disclosures

State and municipal bond issuers provide annual financial information as well as notice of certain events to bondholders pursuant to Continuing Disclosure Undertakings ("CDUs"). Bond underwriters are required under SEC Rule 15c2-12 to reasonably determine that an issuer of municipal securities has undertaken to provide this required continuing disclosure via EMMA.[2] CDUs specify the annual financial information to be provided, including audited financial statements, and the (currently 16) events that require notice within 10 business days of the occurrence of the event. Among others, the required 16 events include material covenant defaults, unscheduled draws on debt service reserves or credit enhancement reflecting financial difficulties, and ratings changes. The newest two events, added in 2019, require notices regarding financial obligations, including notice of the incurrence of material financial obligations such as liquidity lines of credit.

Any required EMMA filing will certainly constitute speaking to the market, and will be subject to the antifraud requirements. Rule 10b-5 under Section 10(b) of the Securities Exchange Act applies to secondary market disclosures and prohibits making any untrue statement of material fact or omitting to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. Accordingly, any required EMMA notice must be reviewed with this standard in mind. Any required filing could note that it is being filed pursuant to a CDU obligation to provide specific notice that a listed event has occurred and not to provide a general update of financial

[1] Available at https://www.sec.gov/municipal/application-antifraud-provisions-staff-legal-bulletin-21.
[2] Located at http://www.emma.msrb.org/.

and operating conditions. Cautionary language added to the notice also could state that the information is subject to change, and is provided only as of its date. Given the level of uncertainty associated with the COVID-19 pandemic and changing economic conditions, readers should be cautioned to expect material changes.

Disclosure procedures are helpful to issuers in complying with CDU notice obligations and with the antifraud requirements of Rule 10b-5. Procedures identify responsible persons for monitoring the required notice events, and provide a process for reviewing the filing for material accuracy and completeness and completing the filing within 10 business days of the event.

Voluntary Disclosures

State and local governments are subject to sunshine laws, generally embrace transparency as a principle of accountable good government, and work hard to provide robust information to constituents. Providing voluntary disclosure to investors can be consistent with this overall approach. Voluntary disclosure also can be helpful in sharing information broadly, in the event the issuer is asked to provide information in response to particular investor questions. Even though Regulation FD, which prohibits selective disclosure by public companies, is not applicable to state and municipal issuers, issuers also strive to avoid selective disclosure in the interests of fairness and transparency.

As state and municipal bond issuers navigate the challenges posed by the COVID-19 public health emergency, however, the uncertainty associated with the pandemic as well as the evolving economic consequences make it difficult for issuers to speak to the market with confidence. State and municipal bond issuers are beginning to file voluntary disclosures regarding COVID-19 impacts,[3] but many are in the process of understanding these impacts sufficiently to be able to share this understanding with investors.

Although the recent SEC Staff Legal Bulletin cautioned that any public statement (at least by officials who may be viewed as having knowledge regarding the financial condition and operation of an issuer) may be reasonably expected to reach investors and therefore be subject to the antifraud requirements, the bulletin also includes a reminder that "scienter" is a required element of a 10b-5 fraud violation in connection with secondary market disclosures. In this context, scienter means willful fraud or reckless disregard, but not mere negligence.[4] Accordingly, any secondary market disclosures, including voluntary disclosures and other public statements, are subject to this scienter-based standard, which should provide room for issuers to provide good faith voluntary disclosure even in challenging circumstances. [5]

Disclosure procedures are helpful in setting forth a process for reviewing and approving voluntary disclosures, including information posted to investor relations websites and to EMMA.

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[3] A helpful collection of COVID-19 disclosures is available at https://lumesis.com/.

[4] In contrast, the SEC has settled antifraud charges in connection with primary offering disclosures under Section 17 of the Securities Act based on a negligence standard.

[5] Voluntary disclosure can add to the total mix of information made available to investors, potentially lessening the materiality of a particular disclosure. The recent SEC Staff Legal Bulletin noted that because "statements are evaluated for antifraud purposes in light of the circumstances in which they are made, the extent to which the municipal issuer has made other statements may increase or decrease the risk that the statements may significantly alter the total mix of information."

Any voluntary filing should provide contextual information in the form of cautionary language, particularly in the current environment. SEC Chair Clayton recently released a statement "The Importance of Disclosure – For Investors, Markets and Our Fight Against COVID-19,"[6] encouraging fulsome public company disclosure regarding COVID-19 impacts. The statement encourages public companies to provide as much information as is practicable regarding current financial and operating status as well as future financial and operating plans, notwithstanding the uncertainty inherent in the current public health and economic environment. To encourage such disclosure, the statement offers a few observations and provides the following assurance: "We encourage companies that respond to our call for forward-looking disclosure to avail themselves of the safe-harbors for such statements and also note that we would not expect good faith attempts to provide appropriately framed forward-looking information to be second guessed by the SEC." Although there is no statutory safe harbor for forward-looking statements by state and municipal issuers (as there is for public companies), state and municipal issuers should include cautionary language regarding any forward-looking statements to provide appropriate context for the statements.

Any voluntary filing regarding financial and operating status and plans in response to COVID-19 could include cautionary language noting that the disclosure is a voluntary filing that is not required under a CDU, the issuer is not undertaking to update the voluntary filing, the information is not an offer to sell, the information is subject to change, and the filing provides specific information and does not purport to include all relevant information. In addition, any information should be clearly dated as of its date. As noted above, any forward-looking statements should note the risks associated with forward-looking statements and any key assumptions. Again, given the level of uncertainty associated with the COVID-19 pandemic and changing economic conditions, readers should be cautioned to expect material changes.

Conclusion

As state and municipal issuers navigate the current public health and economic conditions, it is important to be mindful of CDU event notice requirements. In addition, it may be helpful to review the voluntary disclosures being filed by similarly situated entities, consider whether developing information regarding COVID-19 impacts can be shared with investors, and prepare any filing with cautionary language that helps readers understand the limitations associated with providing information during an evolving situation.

If you have any questions regarding this information, please contact us. Additional COVID-19 resources are available on our website at https://www.pacificalawgroup.com/covid-19-resources/.

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Dated: April 16, 2020

[6] https://www.sec.gov/news/public-statement/statement-clayton-hinman

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