



Metropolitan Water District of Southern California Board of Directors

Disclosure Responsibilities under the Federal Securities Laws

Presented by:
Brian Forbath

Stradling Yocca Carlson & Rauth,
a Professional Corporation
660 Newport Center Drive, Suite 1600
Newport Beach, CA 92660

949.725.4000 P
949.725.4100 F

www.stradlinglaw.com



Introduction

This presentation will cover:

- The standards under the federal securities laws that apply when approving Appendix A in connection with a bond sale or otherwise making public statements;
- The duties and responsibilities of Board members in approving Appendix A in connection with a bond sale;
- SEC enforcement and why disclosure compliance is important; and
- Disclosure controls to mitigate exposure.

Securities Laws - Indirect Regulation by the SEC

- Municipal issuers are **subject to the SEC's antifraud rules** even though they do not have to register securities and are exempt from the SEC's periodic reporting requirements.
- “When a municipal issuer releases information to the public that is reasonably expected to reach investors and the trading markets, such disclosure is subject to the antifraud provisions.” (SEC 2012 Report on Municipal Issuers)
- “The fact that [statements] are not published for purposes of informing the securities markets does not alter the mandate that they not violate antifraud proscriptions.” (March 1994 Statement of the Commission Regarding Disclosure Obligations of Municipal Securities and Others)

Types of Disclosures to which Rules Apply

- Public statements: When a municipality elects to “speak to the market,” it must be accurate and complete.
- Generally, no requirement to speak.
- Examples of public statements:
 - Preliminary official statements and official statements – “Appendix A” is where information about Metropolitan and its finances is contained (primary focus of this presentation);
 - Continuing disclosure filings/financial statements;
 - Other contexts, including speeches and presentations made by officers and officials such as Board members.

Disclosure Standard: Rule 10b-5

- **Rule 10b-5:** It shall be unlawful for any person . . . to make any untrue statement of a material fact or to omit 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.
- Under **Section 10(b)** of the Securities Exchange Act, an intentional or reckless act is required.
- Under **Section 17(a)** of the Securities Act, the SEC can charge securities fraud under a negligence standard (“knew or should have known”).

The Question of Materiality

- The materiality standard remains opaque, guidance comes primarily from court decisions, SEC enforcement cases and SEC staff legal bulletins.
- Materiality is defined as:
 - a **substantial likelihood** that a **reasonable bond investor** or prospective investor **would consider it important** in making an investment decision; or
 - **viewed by a reasonable investor** as having **significantly altered the “total mix”** of available information.
- When information pertains to a possible future event, “materiality will depend at any given time upon a balancing of both the **indicated probability that the event will occur and the anticipated magnitude of the event.**”
- In practice, SEC staff takes a subjective, hindsight view of materiality.

Duties and Responsibilities

Guidance from SEC 1996 Orange County Report –

- “a public official may not authorize disclosure that the official knows to be false;”
- “nor may a public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading.”
- Exercise proper care and supervision not to make a material misstatement or omission and to prevent material misstatements and omissions in disclosure prepared by staff

Discharging Responsibilities (cont.)

- Per Orange County report, steps “appropriate to the circumstances” to prevent the dissemination of materially false or misleading information “could have included becoming familiar with the disclosure documents and questioning the issuer’s officials, employees or other agents about the disclosure of those facts.”
 - Importance of Board review – Board members are uniquely positioned to have material information regarding all aspects of the organization and be informed of the significance of developments from a broader perspective
 - If you have questions or concerns, raise the issue with Finance staff and legal office so it may be vetted prior to dissemination of the disclosure document

Reliance on Professional Services

- Issuers and principals are ultimately accountable for the accuracy of statements of fact about the issuer and cannot delegate this responsibility.
- In the event of a misstatement, reliance on advice of professionals will only serve as a defense under limited circumstances.
- *Presence of counsel* does not equate to *advice of counsel* (a defense requiring a privilege waiver): SEC generally requires a direct request for advice on a particular disclosure topic.

SEC Enforcement Actions

- Municipalities Securities and Public Pensions Unit
- SEC applies nearly strict liability for compliance
- Recent cases have sought:
 - Financial penalties;
 - Individual accountability (control person liability);
 - Parallel criminal charges;
 - Admission of wrongdoing;
 - Public statements outside of offering materials or continuing disclosures.

Consequences of Bad Disclosure

- SEC Investigation – fees for lawyers and consultants
- Adverse publicity
- Personal Fines
- Reduced market access
- May have to impose new procedures and oversight to settle SEC actions
- Rating Downgrades (could trigger increased credit/liquidity provider fees, higher borrowing costs)

Disclosure Controls: Best Practices

Mitigate exposure through steps advocated by the SEC:

- Written Disclosure Policies and Procedures
- Regular Disclosure Training
- Establishment of Disclosure Working Group
- Seeking expert advice as warranted
- Regularly updating disclosure practices