MONEY MATTERS

Courtesy of the CSDA Finance Corporation

Tax-Exempt Debt and Continuing Disclosure Requirements Part 1

Many special districts that issue tax-exempt debt are required to provide annual continuing disclosure. This article is part of a series on this important topic.

History of Continuing Disclosure

Beginning in July of 1995, the Securities Exchange Commission (the "SEC") began requiring the issuers of more that $1 million of tax-exempt debt to provide annual information to investors. Private placements of tax-exempt debt, such as those to banks, were excluded from continuing disclosure. Prior to this time, issuers provided information to investors only through the initial Official Statement for the obligation. The SEC believed that issuers should inform investors throughout the life of the financing issue, similar to what is required by the private sector. The ongoing information is formalized in the Continuing Disclosure Agreement (the "Disclosure Agreement") executed by the issuer at the time the obligation is sold, the form of which can generally be found in the appendices of the Official Statement.

The information required in the Disclosure Agreement is annually sent to the Nationally Recognized Municipal Securities Information Repositories (the "Municipal Repositories"). There are currently four Municipal Repositories. As the Municipal Repositories can change, issuers should check the SEC Web Site for current information.

Information in the Disclosure Agreement

The form of Disclosure Agreement used by various issuers is not fully standardized, as different information is required for different types of issues. The required information is usually dependant upon the source of repayment for the issue. For example, if the issue was a property tax-based financing, such as a general obligation bond, the Disclosure Agreement might require information such as tax delinquencies, assessed values and the top tax payers of the tax area. If the source of payment was the general fund or enterprise fund of the issuer, then the Disclosure Agreement might require the issuer's budgets and annual revenues and expenditures.

Transactions secured by enterprise funds, such as water or sewer revenues, generally require information on the utility rates, largest customers, and levels of service. In almost all cases the most recent audit financial statements of the issuer are required; however, if appropriate, the Official Statement should clearly note that the general fund might not be pledged or available for payment of debt service.

Reporting of 'Significant Events'

In addition to providing the required ongoing annual information, the Disclosure Agreement also requires issuers to immediately report certain "Significant Events" determined by the SEC. These Significant Events include: delinquencies or defaults on payments of principal or interest, unscheduled draws on the debt service reserve fund, rating agency downgrades of the rating or ratings for the issue, and adverse tax opinions affecting the tax-exempt status of the issue. The Disclosure Agreement requires that the issuer immediately inform the Municipal Repositories if these or the other events set forth in the Disclosure Agreement occur.

Repercussions for Failure to Comply

The initial repercussion for failure to submit annual reports to the Municipal Repositories is that the issuer must disclose such failure in any subsequent borrowing for up to 5 years. This could result in certain investors avoiding the obligations of problem issuers, which could then increase future borrowing costs. In addition, other ramifications for not complying with the Disclosure Agreement are starting to occur.

Bond Counsel, Underwriters and Disclosure Counsel often now require issuers to bring current any delinquent Disclosure Agreement obligations before an issuer can issue new debt or refund existing debt. Investors are increasingly aware that an issuer cannot in good faith commit that it will comply with a Disclosure Agreement on a new issue when it has not complied with such agreements in the past. For an issuer, trying to gather information for delinquent Disclosure Agreements could cause delays in the financing of a new project, or the issuer could lose the ability to refinance existing debt at favorable interest rates. It is also often difficult for an issuer to gather information for prior years that may no longer be readily available.

Being Proactive in Writing the Disclosure Agreement

If a public agency is in the process of issuing more than $1 million in tax-exempt debt, it should be proactive in writing and understanding the proposed Disclosure Agreement. Prior to committing to provide information, the issuer should thoroughly understand its obligations to gather and keep current the required information. Because information is often gathered by members of the financing team during the financing process, the issuer may not realize the time or expense necessary to continue to annually gather that information over the life of the issue.

Because information required in the Disclosure Agreement is not standard, this information is negotiable and should be discussed by the issuer with the financing team <u>prior</u> to inclusion in the Official Statement. A complete review and understanding of the proposed Disclosure Agreement can avoid the costs and trouble of an issuer having to provide information that is not readily available or possibly not even available at all. The costs for gathering certain information for the Official Statement should be multiplied by the number of years for the maturity of the issuer, and budgeted for appropriately. The review of the proposed Disclosure Agreement can also prepare the issuer to initiate a system for collecting the required information well in advance of when it is due to the Municipal Repositories.

The Disclosure Agreement requires that information be sent to the Municipal Repositories by a certain date. This deadline is typically 6-9 months after the close of the fiscal year, but is subject to negotiation prior to issuance of the debt. Establishing an appropriate deadline is particularly beneficial when the audited financial statements of the issuer are required as part of the Disclosure Agreement, as the audit may not be completed until March or April of the following year. This was especially beneficial for issuers who had audits delayed due to the recent accounting reporting requirements. Issuers that are required to submit their audits by December or January are particularly vulnerable to having to send out preliminary information, followed by final material, if their audits have been delayed.

Over Reliance on Dissemination Agents

Many issuers select a Dissemination Agent prior to the financing, although some issuers serve as the Dissemination Agent themselves. The Dissemination Agent is often the Trustee for the issue. The Dissemination Agent is generally not obligated to review the content of the annual report to ensure compliance with the Disclosure Agreement, but only to send the information provided by the issuer to the Municipal Repositories. Unfortunately, if the annual report does not fulfill all of the requirements of the Disclosure Agreement, then the issuer is in violation. Sending out partial information, such as only the audited financial statements, does not satisfy compliance with the Disclosure Agreement.

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To locate the SEC Web Site for current Municipal Repositories or for more information please go to:
www.PecheAssociates.com

Tax-Exempt Debt and Continuing Disclosure Requirements Part 2

In the May 2005 issue of the CSDA Money Matters we discussed the importance of tax-exempt issuers providing continuing disclosure in the form of annual reports. This article discusses some additional important topics on continuing disclosure.

Setting Up a Disclosure Information System

As previously discussed, it is highly recommended that an issuer be proactively involved in drafting and understanding the Continuing Disclosure Agreement (the "Disclosure Agreement") during its financing. The issuer should thoroughly understand the costs (and staff time) involved with annually gathering and keeping current the required information. Such costs can then be regularly budgeted to ensure that funding will be available to complete future annual reports.

Ideally, the issuer should begin establishing a disclosure information system shortly after the financing closes, or at least three to four months before the annual report is due. The obvious benefit to beginning the disclosure system early is that information from the Official Statement can be used to begin developing an annual report format. With some planning, other required information of a financial nature, such as debt coverage tables, can also be included in an issuer's audited financial statements.

Because the Disclosure Agreement covers the life of the transaction, whether or not it is tax-exempt, it is critical to ensure that the issuer's Bond Counsel or Disclosure Counsel review the format and drafts of the first annual report. This "testing" of the information in the draft first annual report will help ensure that the issuer is complying with the Disclosure Agreement requirements. Thereafter, the issuer can update the annual reports with confidence.

Presenting the Disclosure Information

The Disclosure Agreements generally do not require a specific format in presenting the information for the annual reports. Some issuers simply gather the information and send it in various pieces of paper along with their audited financial statement to the Nationally Recognized Municipal Securities Information Repositories (the "Municipal Repositories").

In addition, some Disclosure Agreements allow for the Official Statement to be filed for the first annual report. This is not considered an ideal practice for two reasons: a) information on the issuer has possibly changed since the Official Statement was prepared, and b) the issuer is delaying, by possibly as much as two years, establishing a disclosure system and format. This could likely make it more difficult to gather and organize the required information once a significant amount of time has passed since it was originally prepared for the Official Statement.

A better method is to start the first annual report in a booklet format (the "Summary Financial Information Statement") that is more reader friendly. This material can also include information on the location of the issuer and some general background information. A contact person with an address, phone, fax, and e-mail address should be included at the start of the Summary Financial Information Statement. Although the information required in the Disclosure Agreement is usually for the previous fiscal year, the issuer can provide previous information (since it was likely gathered in the Official Statement) to give the reader some historical comparison. The issuer can also include their web site where more information on the issuer is available.

A review of the first annual report format by Bond Counsel or Disclosure Counsel is helpful because they reviewed much of this information in connection with preparation of the Official Statement. Although some of the information can be included in the audited financial statement (which adds a tremendous amount of credibility to the annual report), it is still beneficial to have a summary of such information in the Summary Financial Information Statement.

The goal is to provide interested parties and investors with an easy to read format that provides some historical comparison, rather than searching through a package for one-time pieces of information or just another Official Statement. The Summary Financial Information Statement can then be mailed with the audited final statement to the Municipal Repositories. It can also be put in Adobe PDF format so that it can be easily e-mailed to interested parties such as rating agencies, bond insurers and investors (a PDF format will also allow the annual report to be filed electronically as discussed in a following section). The issuer has then taken positive steps towards developing better relationships with investors by putting such information in a booklet format.

Having Disclosure Help with Investor Relations

There are benefits when an issuer takes the added step of providing an easy to read Summary Financial Information Statement with some additional historical comparison information. When such an issuer goes to market with future transactions, existing investors may note that the issuer has complied with the Disclosure Agreement from a prior issue in a reader friendly format. This could lead to more interest in the issuer's financing, versus a financing of an issuer who sends the information piece meal or that has not complied with previous Disclosure Agreements.

If significant additional information is being provided in the annual report, the issuer should consider a phase like, "The intent of this Summary Financial Information Statement is not to establish additional disclosure requirements. Information not required by the Disclosure Agreement may be modified or deleted in the future." This protects the issuer in the future should they want to change the format or the information they are providing. The issuer can also include language stating that a copying and handling charge can be charged for additional copies of the Summary Financial Information Statement.

By providing a contact person in the Summary Financial Information Statement, the issuer has established a link that interested parties and investors can contact for clarification and additional information. However, the issuer must be careful not to provide pieces of information to selective interested parties that are not being provided to all investors.

Regulation FD and How it Affects Issuers

In October of 2000, the Securities and Exchange Commission (the "SEC") adopted Regulation FD (Fair Disclosure). In the language for the final rule, the SEC states:

> The regulation provides that when an issuer, or person acting on its behalf, discloses material nonpublic information to certain enumerated persons (in general, securities market professionals and holders of the issuer's securities who may well trade on the basis of the information), it must make public disclosure of that information.

Issuers of tax-exempt or taxable debt public debt are bound by Regulation FD. Although the origin of the rule was likely because of companies talking selectively to certain analysts about their stocks, public agencies as issuers must provide care to not run afoul of this rule. Issuers must provide either: a) Simultaneous Disclosure (for intentional disclosure such as an annual report), or b) Prompt Disclosure (for non-intentional disclosure such as when an issuer inadvertently provides selected parties information).

If contacted by interested parties or investors with questions, the issuer can provide information that has already been disclosed. The issuer can also point the party to the most recent disclosure filing or provide them with a copy of the most recent filing by mail, fax or e-mail (another reason to have an Summary Financial Information Statement in PDF format). If enough parties ask similar questions, the issuer can consider adding those items to an upcoming annual filing or can also consider a simultaneous secondary market filing. This way all parties can receive the same information.

This section is <u>not</u> meant as a summary for Regulation FD. Issuers should check the SEC Web site for the full ruling or ask Bond Counsel or Disclosure Counsel specifically about how Regulation FD affects them.

Filing Information by Mail or Electronically through the Central Post Office

Once the annual report is assembled in a paper format or a more reader friendly Summary Financial Information Statement booklet format, it can then be mailed to the four current Municipal Repositories. The audited financial statement, if required by the Disclosure Agreement, should also be sent if it available. If the audit is not available by the Disclosure Agreement deadline, the issuer should still file the annual report so as not to miss the deadline (the audit can then be sent separately when it becomes available). This information can then be sent to the rating agencies, bond insurers, and other interesting parties.

Since the Municipal Repositories change from time to time, it is best to check the SEC Web Site for the most recent list of where to send the annual report. The annual reports, and other secondary market filings such as for significant events, should be sent by Certified Mail with a return receipt requested. This will ensure that the issuer has proof that the annual report has been filed.

In September 2004, the SEC issued a letter and press release stating that issuers can now file their annual reports, and other secondary market filings, electronically through a "central post office". The central post office then sends the information on to the Municipal Repositories. A filing through the central post office works best if the issuer has the filing in PDF format that can then be uploaded to the central post office. The central post office will also give the filer an electronic confirmation of the filing.

The advantage to the utilizing the central post office is that the issuer will not have to mail or overnight the filings to the various Municipal Repositories. Information can be disseminated more efficiently and economically and therefore, issuers should consider the benefits of filing electronically through the central post office.

Storing Disclosure Information

Once the annual report is filed, the optimal way to store copies of the information is by creating a disclosure binder. Copies of the annual report and other secondary filings can then be placed in a readily identifiable location.

Copies of the annual report should be in paper and also ideally in electronic format (by using a computer disk). A separate three ring see-through plastic jacket should be used to store each annual report in the disclosure binder. This will allow for easy identification over the years after multiple reports are completed. Additional copies of the information can then be readily found and mailed or electronically sent to interested parties or investors. A signed copy of the Disclosure Agreement, which can be found in the transcripts for the financing, should also be included in the disclosure binder.

The disclosure binder should be clearly marked "Disclosure Binder – Do Not Discard" and placed next to the transcript binder for the issue. Other secondary filings should also be placed in the disclosure binder. In addition, the return receipt confirmation cards or electronic confirmations that the annual report has been filed should also be included.

Because Bond Counsel and Disclosure Counsel may require the issuer to disclose in the Official Statement of a new issue that they are not in compliance for filing annual reports over the last five years, the issuer should keep at least five years of previous annual reports along with confirmations that they have been filed in the disclosure binder.

Roles of Dissemination Agent and Disclosure Advisor

As previously written in Part 1 of this article, the Dissemination Agent is only responsible for sending the Municipal Repositories whatever the issuer provides them.

They are not responsible for reviewing the information to ensure that the issuer has provided all the information required by the Disclosure Agreement. Filing an incomplete annual report, or only sending an audited financial statement, means that the issuer is still in violation of their requirements under the Disclosure Agreement.

Issuers who do not have the technical expertise or staff time to develop a disclosure information system should consider working with a Disclosure Advisor. The Disclosure Advisor can thoroughly review the Disclosure Agreement and then create a format addressing the issuer's specific requirements. The Disclosure Advisor can prepare a draft of the first annual report that can then be reviewed by Bond Counsel or Disclosure Counsel to ensure it meets the Disclosure Agreement requirements. Other information that is helpful to interested parties and investors can also be included. The Disclosure Advisor should turn the annual report in to an easy to read Summary Financial Information Statement booklet that helps the issuer establish and maintain better relations with investors.

During the financing issue for which the Disclosure Agreement was originally created, the issuer can elect to disseminate the annual report for their behalf. The Disclosure Advisor can then file the information on behalf of the issuer, which could save the costs of a Dissemination Agent. Although a Disclosure Advisor does not have to be named or included in the Disclosure Agreement, they can probably make recommendations during the development of the Disclosure Agreement so the issuer is not weighed down with unnecessary requirements. The issuer has the right to add or remove Dissemination Agents and Disclosure Advisors during the life of the issue.

An issuer should consider the long-term consequences of signing a Disclosure Agreement when doing a financing. Establishing a disclosure information system and testing such a system is in the best long-term interests of the issuer. Working with a Disclosure Advisor might make sense for some issuers when compared with the possibility of not filing required information in a timely manner.

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