

Enhanced Disclosure in the Municipal Market Benefits Borrowers

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Continuing disclosure in excess of legal minimums leads to lower borrowing costs.

The federal tax code provides that tax-exempt debt (bonds) may be issued to finance certain projects for private enterprises, including qualifying manufacturing facilities, housing facilities and facilities for non-profit (Section 501(c)(3)) organizations.

When the bonds are issued, they are often offered for sale in the public credit markets, pursuant to a disclosure document (official statement). The official statement contains, among other things, sufficient information about the project being financed, the obligor with respect to the bonds and the structure of and security for the bonds to enable an investor to evaluate and understand the terms of the financing and to make an informed decision as to whether to purchase the bonds.

Although there is less government regulation of official statements in the municipal market compared with the rules governing issuance of corporate debt, general antifraud provisions do apply, and following industry standards, the current level of disclosure available on the initial issuance of bonds in the primary market is typically regarded as good.

The quality of disclosure in the secondary market, however, has not been viewed as favorably by some market participants. The Securities and Exchange Commission adopted and amended its Rule 15c2-12 in recent years to effectively introduce requirements relating to secondary market disclosure into the municipal market. While Rule 15c2-12 has clearly improved the availability of information on an ongoing basis for many municipal financings, there remains an appetite in the market for expansion of the types of financings covered by the SEC rule as well as for additional infor-

mation to be provided during the term of a bond issue relating to projects and issuers¹ for covered financings.

Some market participants are advocating regulatory action to improve secondary market disclosure, including amendment of Rule 15c2-12 to narrow the range of offerings currently exempted from coverage by the rule. The present regulatory climate at the SEC appears to make amendments to Rule 15c2-12 or to any rule intended to impact the municipal market unlikely in the near term. For this reason, market forces should be a prime determinant of any potential changes in disclosure practices.

Current Requirements and Emerging Trends

Broadly speaking, issuers are responsible under Rule 15c2-12 for providing continuing disclosure annually to (1) update the financial information contained in the official statement for the primary offering, (2) provide audited financial statements, (3) provide notice of certain material events, and (4) provide notice of any failure to timely provide the required annual financial information. Although the provision of this information is a large improvement over the level of information available to the market before the adoption of the SEC rule, market participants, particularly those on the buy side, have been striving to receive more information, more conveniently and in a more timely manner than is currently the norm.

An example of these initiatives is found in the National Federation of Municipal Analysts' (NFMA) publication of various recommended best practices in disclosure. One of these initiatives is the *[Draft of] Recommended Best Practices in Disclosure for Long-Term Care/Senior Living Debt*.² Although perhaps to some extent a wish-list from the buy side, the practices

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described in the Best Practices are in many ways not far from current practices and actually chart a course that could benefit all market participants, including issuers.

This market sector is leading the way in providing continuing disclosure, according to industry participants in a Municipal Securities Rulemaking Board forum on this topic held in April 2002 in Washington. Investors have long been seeking enhanced disclosure, and developers of these facilities seem to be getting the message. For example, quarterly financial reporting in addition to annual audited financials, sometimes including a narrative akin to management's discussion and analysis, is fast becoming the norm.

Costs and Benefits of Increased Disclosure

The NFMA Best Practices expresses that group's desire for timely delivery of the best available data relating to a project on an ongoing basis to anyone who requests it. Providing good disclosure can help purchasers and dealers as well as the issuers themselves. Issuers have begun to hear from potential purchasers who will not buy their securities without agreement by the issuer to provide a level of continuing disclosure satisfactory to the purchaser. For example, if provision for a certain level of disclosure, which may be greater than the level mandated by Rule 15c2-12, is not contractually required for market participants, mutual funds might decline to purchase these securities in both the primary and secondary markets because they would not, in their view, be able to fulfill their obligations to price the securities on a daily basis and could not properly evaluate the securities to determine an appropriate selling price, adversely affecting the liquidity of the securities. Removal of market participants from the pool of purchasers will tend to decrease the price of the securities, increasing the cost of borrowing, or, in the primary market, simply drive up the interest rate offered on the bonds to make them saleable. Thus, more information leads to better evaluations, which in turn lead to better liquidity and to higher prices on trades.

As the market becomes increasingly attuned to the nuances of the contractual agreements requiring continuing disclosure, and buyers increasingly demand and achieve agreements that more closely reflect the level of information they wish to receive, it may become more difficult to sell debt that provides only a minimal amount of disclosure, even if the disclosure satisfies the SEC rule. But even today, issuers who agree to provide enhanced disclosure are finding more purchasers interested in their bonds and the ability to offer their bonds at lower interest rates. For example, Salomon Smith Barney has estimated that there is an interest rate penalty from lack of disclosure in the health care sector that ranges from 15 basis points for an A-rated financing to 30-50 basis points for an issue rated BBB.³ Salomon Smith Barney has further found

that a secondary market penalty caused by lack of current disclosure will impact the interest rate and market participation on the issuer's next primary offering as well.

However, in determining the level of disclosure to contractually provide during the term of a bond issue, an issuer must exercise business judgment. Issuers in the municipal credit market should continue to consider the mandated scope of their legal obligations when negotiating a continuing disclosure agreement and weigh the legal obligations against the benefits of voluntarily exceeding those minimums on the marketability and cost of the bond issue. Additional factors to take under consideration include the costs or difficulty associated with gathering and disseminating the extra information, any potential liability, whether in content, timing, or means of communication, for making errors associated with the additional disclosure, and any competitive risks associated with disclosing more information than required.

Some benefits of improved disclosure may not immediately be obvious. A program of good disclosure reduces the number of phone calls analysts make to issuers' financial officers for information or, at least, better focuses and limits any inquiries, freeing the financial officers for other tasks. If a situation arises in which an issuer needs a covenant waiver, an owner of securities will generally be more receptive if good information has been consistently provided, and the problem was therefore foreseeable. Good disclosure improves investor relations.

Even the small, infrequent issuer should provide good disclosure. Issuers who do not provide sufficient disclosure may find that underwriters have difficulty determining that they can rely on the issuer's Rule 15c2-12 undertakings if the issuer returns to the market. If an underwriter is unable to make that determination, the underwriter would not be able to recommend the purchase or sale of the bonds of that issuer.

Telephone Inquiries and Investor Relations

Additionally, issuers should be cautious when responding to telephone inquiries about their financial or operating status. Certainly any information provided should be consistent, accurate and not misleading. Issuers might designate one person to be in charge of investor relations, including being the contact person for phone inquiries, to advance these goals. The investor relations officer could direct callers to sources of publicly available information, including the issuer's Web site, as discussed below.

There is some concern about answering any one party's question by phone due to the possible creation of a situation in which nonpublic information becomes available to a limited number of persons, which may then be used in a trading decision. Although many analysts greatly value opportunities to speak directly with issuers and reason that if they can get information

by calling, then anyone else inquiring could also get the same information by calling, nullifying the possibility for insider trading. Analysts may reason that if anyone can obtain the same information simply by calling and asking, then the information is public. Other analysts do not have the time or desire to make phone calls for information and prefer information that is readily available.

Divulging information only to those who request it is problematic from a legal standpoint. Material information relating to an issue of bonds that an issuer intends to disclose should be disclosed to the market and not to only a few individuals who happen to call. For guidance, SEC Regulation FD (fair disclosure) may be consulted. While Regulation FD covers extremely few municipal securities, SEC staff has encouraged its use as a model for the municipal market on a voluntary basis. In addition to requiring public disclosure in instances in which an issuer discloses material information, Regulation FD allows that an inadvertent selective disclosure of material information may be corrected by prompt public disclosure of the information.

One way for issuers to deal with the difficulties of balancing an effective investor relations program with the need to prevent the release by the issuer of material, nonpublic information is to promptly provide to the nationally recognized municipal securities information repositories (NRMSIRs) any material information that is to be provided to a caller but has not yet been publicly disseminated. The opinion of the forum in Washington was that NRMSIRs could be better utilized than they are presently and that filing additional information beyond the Rule 15c2-12 requirements would not harm issuers but would benefit the market. Martha Haines, the chief of the SEC's Office of Municipal Securities, commented that she sees no additional risk in filing information with a NRMSIR that is being disseminated by other means.

This approach, however, has its problems as well. There is currently no mechanism for removing information submitted to a NRMSIR, and extraordinary filings may have a limited useful life (for example, they may become subsumed or updated by subsequently filed financial data) yet because they remain in the repositories, they may become misleading. Also, issuers may not wish to have an event considered a material event, and the action of filing a notice of the event with the NRMSIRs may create that presumption. While the NRMSIRs should accept any filing relating to a bond issue, there is no mechanism for differentiating categories of notices.

Issuer Web Sites

Issuer Web sites and e-mail were discussed at the MSRB forum as methods of disclosure highly favored by some participants, and issuer Web sites are also addressed in the adopting release for Regulation FD. The

ease of access by all market participants (with access to the Internet) to issuers' Web sites at no charge would seem to make increased use of this dissemination method very desirable.

Care must be exercised in using Web sites for information dissemination. Mere posting of information alone is not currently considered to be adequate public disclosure. The release does suggest, though, that as technology evolves and more investors access and use the Internet, that for at least some issuers with active sites and a strong investor following, simply posting information on the Web could become sufficient. Still, the release continues that the Web can be an important component in an effective disclosure process.

In line with guidance provided by the SEC, issuers should exercise caution in determining what information to post and how to post it on their Web sites. The SEC generally has expressed interest in promoting electronic disclosure as long as it does not exclude market participants and is in compliance with requirements that apply to paper disclosure, including general antifraud principles.

Issuers should consider use of a disclaimer investors would be required to accept before viewing disclosure information. A disclaimer might include provisions warning that user equipment or electronic difficulties could cause a document to appear differently from the original (paper version) posted, and that the investor may request a paper version, which controls.

Disclosures should be clearly marked with a date, and any items that are not current should be moved to a separate archive area. Care must be taken with historical information to clearly indicate that it is date sensitive, or historical information may simply be removed from the site.

A difference between paper and electronic disclosure results from the immediacy of the Web and the impression that information accessed is immediate, fresh and up-to-date. The SEC, in a May 2000 interpretive release, noted that Web postings have a longer life than printed, mailed information since they may theoretically be accessed by investors at any time. As such, a statement may be considered to be "republished" each time it is accessed by an investor. The release continued that commentators have suggested that statements deemed republished could create liability under the antifraud rule.

The 2000 interpretive release requested comment on how to facilitate the availability of historical information on the Internet with a minimum of investor confusion. Further, comments by SEC staff have consistently attempted to clarify this portion of the release. The release and these comments demonstrate a strong objective by the SEC to encourage the use of electronic media for dissemination of disclosure but in a manner that does not exclude any market segment from participation. At the time of the release, the SEC found

that a significant part of the market did not have Internet access or did not wish to use the Internet for this purpose. As use and acceptance of the Internet grows, it may be increasingly relied on for communications. For example, see the discussion of Regulation FD above, which suggests that future Internet use could result in Web site postings being considered sufficient disclosure for at least some issuers.

In addition, several SEC staff members have stated directly that the release was not intended to indicate that the SEC was adopting or advocating the republication view and that the reference was meant to elicit comment on the issue. If the SEC were to adopt the republication concept, it would contradict the stated objective of the SEC to foster increased use of the Internet to improve the level and availability of continu-

ing disclosure. SEC staff became increasingly clear as this discussion continued in the industry that the SEC had not adopted the concept of republication in the release but had merely invited comment.

¹ For ease of reference, the term "issuer" shall be read to include both the nominal issuer of bonds, which in many cases will be a conduit issuer, and the economic obligor relating to the bonds, generally being the entity for whose benefit the bonds are issued, as is appropriate in context.

² The NFMA Best Practices may be viewed at www.nfma.org.

³ Presentation at Health Management Academy's CFO Forum, June 2002.