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Practical Due Diligence and Drafting the Disclosure Document

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1) Purpose of Due Diligence (depends on your role in the transaction and which party you are representing)

a) Background

Securities issued or guaranteed by states or their political subdivisions or public instrumentalities are "exempted securities" under the 1933 Securities Act and "municipal securities" under the Securities Exchange Act of 1934 (the "1934 Exchange Act"). As such, they are exempt from the registration provisions of the Securities Act of 1933 (the "1933 Securities Act") and from any requirement pursuant to the 1934 Exchange Act of filing a disclosure document with Securities and Exchange Commission (the "SEC") or the Municipal Securities Rulemaking Board (the "MSRB") prior to issuance. However, they are not exempt from the anti-fraud provisions of the 1933 Securities Act (Section 17(a)) or the 1934 Exchange Act (Section 10(b)).

Rule 10b-5 Standard (mirrored under Section 17(a) of the 1933 Securities Act): "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange … (b) 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..."

The term "due diligence" is not defined in the federal securities laws. Under the 1933 Securities Act, underwriters of municipal securities have a responsibility to perform a "reasonable investigation" or take "reasonable care" that the offering document (Official Statement, Limited Offering Memorandum or similar name) for such securities does not contain any material misstatements or omissions. Underwriters may also assert a "due diligence" defense to legal claims that the underwriter failed to uphold its responsibility by showing that any fraud that occurs in a bond transaction could not have been detected by a reasonable inquiry or "due diligence". As a result, references to "due diligence" in a bond transaction generally refer to the affirmative duty to investigate the business, legal and financial affairs of an entity involved in a securities offering, and to the defense against liability. It should be noted that while issuers of municipal securities do not have a "due diligence" defense to legal liability, issuers are responsible for the accuracy and

completeness of the disclosure document and therefore have a similar duty to investigate and conduct their own due diligence.

For additional information, see *Due Diligence Considerations in Primary Offerings*, NABL, January 2022, available at: https://www.nabl.org/learn/resources/

b) Underwriters

Section 11 of the 1933 Securities Act establishes the affirmative due diligence defenses available to an underwriter of securities subject to registration with the SEC in response to a liability claim made by a purchaser. Because municipal securities are not subject to registration, underwriters of municipal securities are not subject to liability under Section 11 of the 1933 Securities Act, but Section 11 provides by analogy useful guidance for establishing defenses to liability under Section 10(b) of the 1934 Exchange Act.

c) Distinctions between Due Diligence for Underwriters of Registered Securities and Municipal Securities – Who Bears Burden of Proof and the Standard of Liability

i. Statutory Due Diligence Defenses for Registered Securities – Upon a showing of a material misleading statement or omission in a registration statement, the defendant underwriter must prove that it did not act in a negligent manner.

ii. Due Diligence Defenses for Municipal Securities – The plaintiff, including the SEC, must prove, among other things, that the defendant underwriter acted with *scienter* in accordance with the requirements of Section 10(b) of the 1934 Exchange Act, or, with respect only to the SEC as plaintiff, negligence, under Section 17(a)(2) or (3) of the 1933 Securities Act.

d) Key Requirements for a Securities Claim under 10b-5:

- must be an act "in connection with the purchase of sale of a security"
- a misrepresentation or omission of a material fact (and that there is a connection between the misrepresentation or omission and the purchase and sale of a security);
- reliance thereon from the plaintiff;
- damages; and
- "scienter" (Note: "scienter" is an intent to deceive, manipulate or defraud and includes recklessness) or fraudulent conduct.

e) Respective Roles of Underwriter and Underwriter's Counsel

In conducting a due diligence investigation, there are (1) certain tasks that the underwriter must conduct itself (e.g., financial matters such as revenue projections); (2) certain matters as to which counsel is, in effect, rendering legal advice (e.g., whether the trustee has a perfected security interest); and (3) certain tasks that may be delegated to underwriter's

counsel as agent of the underwriter, but that do not amount to legal advice (e.g., factual determinations such as reviewing corporate minutes or material contracts). Disclosure Rules of Counsel In State and Local Government Securities Offerings, 3d ed. ABA (2009), at 144.

"The underwriter is responsible for all due diligence, whether performed by itself or on its behalf by agents such as underwriter's counsel, and can be held responsible not only for its own actions or inactions, but also for those of its attorneys and agents. Many bankers, even experienced ones, believe that it is the responsibility of underwriter's counsel to lead and manage the due diligence process, and that the underwriter can confine its role to assessing the credit, coordinating with rating agencies and insurers, and marketing the bonds. That view is misplaced." Disclosure Roles of Counsel at 145.

The purpose of an underwriter's due diligence investigation is to "establish a reasonable basis for belief in the truthfulness and completeness of the key representations" made in the Official Statement. The SEC has noted that "Underwriters are critical gatekeepers relied upon by investors to ensure that accurate information is being provided in municipal bond offering documents." *See* SEC Press Release No. 2017-77, available at https://www.sec.gov/news/press-release/2017-77 (Referencing *In re Lawson Financial Corporation* (SEC Rel. Nos. 10334 (April 5, 2017)).

f) Important Considerations:

i. Who is your client and what level of investigation are they expecting you to make? Is there an engagement letter in place that outlines responsibilities with respect to what diligence you will conduct and how it will be conducted? A memo which requires a response?

ii. Obtain and verify information regarding issuer, authorization, use of proceeds and security for bonds.

Due diligence should be conducted sooner rather than later in the deal schedule to uncover and address potential problems with the financing, credit or the project such as, for example, environmental contamination of the project site, pending litigation seeking to enjoin the project, limitations on the authority of the issuer or imposition of significant liabilities, or state or federal legislation that will be enacted during the term of the bonds that will negatively affect the revenue stream. After the engagement and initial "kick-off" call, the first thing that you should do is to contact the issuer's counsel and inquire if there is any material litigation or any environmental matters that cause concern, and determine if there are any matters which would require time to resolve prior to mailing an offering document.

Remember: due diligence is continuous and ongoing during the transaction. Do not end your activities after the formal due diligence Q&A session.

iii. Comfort to deliver 10b-5 opinion (even though the letter generally states (1) no independent investigation has been made by counsel and (2) nothing has

come to the attention of such counsel that would lead it to believe that there was a violation of the 10b-5 materiality standard) even if you are not serving as disclosure counsel.

iv. Tax issues - the performance of tax-related due diligence permits the issuance of the tax opinion and will help show compliance with statutory/regulatory requirements of issuer.

Methods may include tax questionnaire, issuer application, conference interviews, due diligence sessions, closing certificates.

In re Ira Weiss, SEC Rel. Nos. 33-8641 (Dec. 2, 2005) (SEC enforcement action in which bond counsel was found to have violated the antifraud provisions of Sections 17(a)(2) and 17(a)(3) of the 1933 Securities Act by negligently permitting his opinion to be used in the offering of notes by a school district).

v. Establish a defense to securities liability (as shown above), provided that the inquiry satisfies the general standard of professional performance expected of the underwriter and certain other professionals.

vi. Past Compliance with Continuing Disclosure Undertakings. Rule 15c2-12 under the 1934 Exchange Act ("Rule 15c2-12") requires that final official statements contain "a description of the undertakings to be provided…and of any instances in the previous five years in which each [obligated] person failed to comply, in all material respects, with any previous undertakings in a written contract or agreement."

1. In 1994, the SEC stated that, "Critical to the evaluation of a covenant is the likelihood that the issuer or obligated person will abide by the undertakings. The definition of final official statement thus has been modified to require disclosure of all instances in the previous five years in which any person providing an undertaking failed to comply in all material respects with any previous informational undertakings called for by the amendments. This information is important to the market, and should, therefore, be disclosed in the final official statement. The requirement should provide an additional incentive for issuers and obligated persons to comply with their undertakings to provide secondary market disclosure, and will ensure that Participating Underwriters and others are able to assess the reliability of disclosure representations." The 1994 Adopting Release at n. 52.

2. In 2010, the SEC stated that, "The Commission has determined further to expound upon its prior interpretations regarding municipal underwriters' responsibilities. As articulated in a prior interpretation [the 1994 Adopting Release], the Commission believes that it is

> doubtful that an underwriter could form a reasonable basis for relying on the accuracy or completeness of an issuer's or obligated person's ongoing disclosure representations, if such issuer or obligated person has a history of persistent and material breaches or has not remedied such past failures by the time the offering commences. The Commission believes that if the underwriter finds that the issuer or obligated person has on multiple occasions during the past five years failed to provide on a timely basis continuing disclosure documents, including event notices and failure to file notices, as required in a continuing disclosure agreement for a prior offering, it would be very difficult for the underwriter to make a reasonable determination that the issuer or obligated person would provide such information under a continuing disclosure agreement in connection with a subsequent offering. In the Commission's view, it also is doubtful that an underwriter could meet the reasonable belief standard without the underwriter affirmatively inquiring as to that filing history. The underwriter's reasonable belief should be based on its independent judgment, not solely on representations of the issuer or obligated person as to the materiality of any failure to comply with any prior undertaking. If the underwriter finds that the issuer or obligated person has failed to provide such information, the underwriter should take that failure into account in forming its reasonable belief in the accuracy and completeness of representations made by the issuer or obligated person." The 2010 Adopting Release at n. 351.

Whether in a competitive or negotiated sale, it is critical that review of prior continuing disclosure compliance is undertaken and documented, and that past "failures to comply in all material respects," are disclosed in the offering document. The SEC emphasized its position on the importance of this disclosure when it initiated the 2014 Municipalities Continuing Disclosure Cooperation Initiative ("MCDC Initiative"), a voluntary self-reporting initiative relating to possible securities violations involving materially inaccurate statements regarding prior compliance with continuing disclosure obligations specified in Rule 15c2-12.

If there has been a history of noncompliance, the parties should consider hiring a third party dissemination agent to encourage future compliance and adopting internal procedures and policies that include regular training. The SEC has stated that sole reliance, without independent inquiry, on representations of an issuer is not sufficient.

Two additional listed events were added in 2019 (for undertakings effective on and after February 27, 2019) related to financial obligations. Underwriters inquire about the incurrence of a financial obligation or other event that would trigger notice under these listed events, and whether issuers and obligated parties have updated their policies and procedures to comply with these requirements.

2) Purpose of the Disclosure Document

a) Providing information potential investors need to make an investment decision.

b) Drafts may be used to provide potential credit enhancers, rating agencies and others with data about the use of the bond proceeds, the project and sources of security for payment.

c) Assists with marketing the securities.

d) Post-closing, used by parties to the transaction for a quick reference that summarizes the terms of the deal.

e) Not a "contractual" document in the deal, so does not establish restrictions on the issuer as would an indenture, loan agreement, etc.; but, if things ultimately turn out differently than described or as anticipated, could raise investor concerns about misrepresentations in the original disclosure document.

f) Note that the IRS has used disclosure documents to review deals for potential tax problems.

3) Names of the Disclosure Document

a) Official Statement or Limited Offering Memorandum or Private Placement Memorandum. What do you have and how do you choose? How does diligence differ in each case (including who performs it)?

b) The "preliminary" version of the disclosure document (Rule 15c2-12).

Note: The preliminary official statement ("POS") is "deemed final", which means that, but for the information that becomes available on the day of pricing—interest rates, what bonds are serials and what are term bonds and in what principal amounts, the amounts and timing of sinking fund installments, optional redemption provisions, sources and uses of funds—there should be no changes to the POS when it becomes the final official statement.

4) Contract to Receive the Disclosure Document

An underwriter must contract with an issuer of municipal securities (or its designated agent) to receive within seven business days after any final agreement to purchase, offer, or sell the municipal securities, copies of a final official statement in sufficient time to accompany confirmations to customers and in sufficient quantities to meet requests and the requirements of MSRB Rule G-32.

5) Contents of the Disclosure Document

a) What information and how much detail?

i. Using a prior disclosure document as a starting point is common practice. Should only serve as a starting point; keep in mind current operations, risks and other information, and disclosure trends.

ii. Industry standards (see GFOA, NFMA, SIFMA) can be helpful.

iii. Type of transaction (variable vs. fixed rate) may dictate level of detail.

iv. Type of security (e.g. general credit of the issuer/borrower, project revenues, etc.) will dictate contents.

v. Resistance from others – group discussions and decisions – and what to do when parties do not want to provide the information. Discuss with client and/or group; keep in mind confidentiality concerns for sensitive information. Make a note to file regarding reasons why a decision may have been made to disclose or not to disclose in the event that the decision is questioned later on.

b) The importance of clarity.

c) Investor cautionary language – the "boilerplate."

i. Description of responsibility for information; disclaimer of guaranty.

ii. Limitations on offer.

iii. Limitation on date of information.

iv. Possibility of "stabilizing" transactions.

d) Description of the bonds and relevant bond documents (Indenture or Bond Resolution, Ordinance, or Loan Agreement, if any, and other operative documents).

i. Interest rate provisions.

ii. Redemption provisions.

iii. Tender provisions.

iv. Funds and accounts.

v. Flow of funds.

vi. Covenants.

vii. Events of default and remedies.

viii. Amendment of terms.

ix. Permitted and anticipated use of funds.

e) Description of issuer/borrower, security and matters affecting security.

f) Information concerning the issuer/borrower (organization, operations and financial data, powers/authority, important decision makers).

g) Risk factors.

i. Sources/industry standards. See NABL website for upcoming paper addressing risk factors.

ii. Should be specific to your deal.

iii. Climate issues (e.g., flooding, hurricanes, extreme heat/drought, etc.). This is an area that is taking on more importance each year. Climate change potentially affects all core functions of government, including energy, land use, emergency management, public health, transportation, water, and agriculture. Climate change risks are becoming clearer for municipal issuers and market participants are counting on more disclosure about how those risks affect credit and global investor perceptions of the market.

iv. ESG refers to three key factors that affect a government's credit profile, including an exposure to climate risk and other Environmental factors ("E"), long-term Social factors ("S"), and Governance issues ("G"). ESG factors represent areas affecting the long-term sustainability of a community. Both investors and rating analysts have increasingly utilized outside resources to assess ESG risks for municipal issuers.

v. Any differences when your deal is backed by a letter of credit or insured?

vi. Current risk factors such as cybersecurity, climate change, environmental considerations and impacts of the COVID-19 pandemic.

h) Limitations on potential purchasers – who can buy these? Must be clear.

i) Tax information – Exempt? Taxable? Bank qualified? AMT? Tax Credit Bonds?

j) Tax credit stripping information (if tax credit bonds)

k) Ratings (or non-rated).

l) Litigation.

m) Continuing disclosure undertaking (form or description if required; and disclosure of failure to comply, in all material respects, with prior undertakings for the past 5 years).

Note: Make sure that form or description of continuing disclosure reflects all amendments to Rule 15c2-12 and any other agreed upon disclosures.

n) Bond numbers (preliminary vs. final) – typically prepared by underwriter or municipal advisor.

i. Principal amounts, maturities, interest rates.

ii. Price and/or yield.

iii. Sources and uses (including original issue discount or original issue premium).

iv. Debt service tables.

o) Differences in the document when a competitive sale (including who prepares).

6) Gathering and Verifying the Information included in the Disclosure Document - the Due Diligence process

a) Consider who is conducting the diligence and who is providing you with information? Before you begin: becoming informed about the subject matter (e.g. do you understand airport deals well enough to know what to ask?). Different credit structures entail different points of emphasis and review. Also consider which person at the issuer/obligor is providing you with the information you request. Are your questions being forwarded to persons with expertise in the area of inquiry and direct access to the information requested?

b) Questionnaires/Lists

NOTE: There is no official set of due diligence guidelines or lists. Consider each transaction at the outset and what is appropriate to ask for both in terms of what is included in the disclosure document and with respect to the various factors in the deal.

i. Focus on items affecting the issuance and repayment of the bonds (see security above).

ii. Ask for (and review!) back-up documentation. Examples of such documentation include (but are not limited to):

- Enabling legislation.

- Board minutes/articles of incorporation/by-laws (if applicable) - evidencing proper authorization of transaction as well as overall governance of the entity (most common in 501(c)(3) conduit financings).

- IRS Determination Letters – to verify 501(c)(3) status for not-for-profit borrowers (if applicable).
- Financial statements (3-5 years) and related auditor's letters.
- Changes in auditors, if applicable, within the preceding 5-year period.
- Form 990s if it is a 501(c)(3) entity.
- Current enacted budget, proposed budget and prior budgets (for comparison).
- Publicly available economic data and forecasts (e.g. census data, labor statistics).
- Issuer's (or borrower's) strategic plan (if applicable), capital plan and annual report.
- Evidence of issuer/borrower indebtedness unrelated to financing and any material agreements that the issuer/borrower is a party thereto.
- Licensing and accreditation, material compliance with a licensing authority, evidence of good standing.
- Litigation documents, litigation letters submitted in connection with audits and regulatory notices.
- Evidence of conflicts of interest policies and any reported conflicts.
- Title report(s) regarding project realty and any other property to be pledged as security for the bonds.
- Environmental assessments, appraisal, zoning, surveys and insurance.
- Indentures, borrowing agreements, lending agreements, major leases and key contracts.
- Industry background materials - to discover problems facing the "industry.
- Prior offering documents and explanation of revisions.
- Annual financial information and event notices filed pursuant to Rule 15c2-12.
- Investment policies.
- Swaps and other derivatives.

- Retirement plans and other postemployment benefits and pension actuarial valuations.
- Updates for financial and operating information for current events, such as COVID-19.
- Information provided to rating agencies.
- Cybersecurity policies and related insurance, details of any cyberattacks.
- Flood, earthquake and other related insurance, information regarding recent occurrences.

iii. Explain expected use of information and any certificates that will be required at closing (establish that it is the underwriter's duty to probe and to cross-check information).

iv. To what extent do you have to independently verify information? Examples of independent verification includes investigation of:

- Continuing disclosure filings on EMMA.
- Filings with federal, state and municipal entities.
- Press releases, promotional materials and media articles.
- Internet research and research through services such as Lexis-Nexis or Westlaw.
- Industry studies (may be relevant in connection with revenue bond financings, such as for airports and water and sewer entities).

c) Updating a prior disclosure document (pros and cons).

d) Follow-up due-diligence/document review sessions (if necessary).

e) How far do you have to dig behind an answer?

f) Looking for trends in historical data.

g) Sources of information for learning about and understanding financial reports.

7) Consents to Include Information in Disclosure

a) Auditor's (1) consent (or "inclusion") letter and (2) agreed-upon-procedures letter (or evidence that the engagement letter permits inclusion if certain language is used in the offering document).

b) Feasibility and other studies.

c) Rating agencies?

d) Other.

8) Certificates/Opinions Supporting the Information Provided

a) From (1) issuer and issuer's counsel; (2) borrower and borrower's counsel in conduit issues; and/or (3) a state/county/city in municipal-supported or appropriation backed bond issues.

b) From credit enhancement provider.

c) From bond counsel.

d) From municipal advisor.

e) From dissemination agent/continuing disclosure compliance review service.

f) To the underwriter.

9) A few words on logistics

a) Getting sign-off/consent before "printing"; deeming the POS "final."

b) What is "printing"? (hard copies versus posting).

c) Getting the pdf document to the printer and proofing the cover and reviewing the document for "layout" issues.

d) Dealing with attachments – coming from different parties (auditor, insurer, bond counsel, engineer, etc.).

e) "Stickering" or "supplementing" a POS or final official statement for material updates during underwriting period or errors in the document.

f) When the final official statement must be delivered.

10) Record Retention Issues

a) Drafts of official statements and other documents.

b) Email.

c) Attorney notes.

d) File memos, diligence lists and questionnaires – law firms have different policies on documenting and retaining due diligence findings. Some maintain detailed

findings – while others do not (and note that maintaining detailed records, while intending to demonstrate that a reasonable investigation was conducted, may in fact, reveal that it was not).

Some underwriters require due diligence memos from counsel, so if you are serving in such capacity, you should ascertain if such a memo is required/expected by your client.