

DILWORTH UPDATE

From the Securities Group

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PART IV: THE RELEVANCE OF RATING AGENCIES

"Securities Disclosure: What Lessons Can We Learn from the Securities and Exchange Commission's Proceedings versus the City of San Diego, California?"

by Mark H. Vacha, Esq.

This installment is Part IV in a seven-part series about the Securities and Exchange Commission's (the "Commission") proceedings versus the City of San Diego, California (the "City") as set forth in the November 14, 2006 Release No. 8751 (the "Release"). The Release relates to the settlement between the Commission and the City pursuant to which the City consented to the entry of a cease-and-desist order relating to the City's offer and sale of over \$260 million in municipal bonds in 2002 and 2003. For more factual background on these proceedings and an overview, please see Part I of this series which is available on the Dilworth Paxson website at www.dilworthlaw.com.

This article addresses potential insights from the Release regarding the relevance of the national bond credit rating agencies with respect to an issuer's process of developing its disclosure for investors. Although the Release dealt with a general purpose governmental issuer, the points made by the Commission can also be instructive for the board of a conduit borrower in a transaction such as a tax-exempt qualified 501(c)(3) bond

financing (e.g. the board of directors or trustees of a university or a hospital).

Relevance of Rating Agencies

The Release in several instances shows the importance that the SEC places upon the role of the national bond credit rating agencies (i.e. Fitch, Moody's and Standard & Poor's). The Release indicated that bond ratings are, in effect, a measurement or reference point to assess the materiality of disclosures. The Release specifically stated that, "The materiality of the misleading disclosures was demonstrated by the impact on the City's bond ratings when it finally disclosed key facts about the pension plan on January 27, 2004". Although the City did not default on its bonds or notes, the rating downgrades presumably hurt the holders of the City's debt. The Release did not address this impact explicitly but some adverse effects for holders of the City debt would relate to the downgrades' impact on the secondary market for the City's debt and thus the liquidity of such debt. The bond rating agencies put the City on notice about the importance of the pension and retiree

health benefit issues and provided evidence that the City acted with scienter for anti-fraud purposes. The Release stated that “In light of the City’s officials’ detailed knowledge of the magnitude of the City’s pension and retiree health care liabilities and of the rating agencies’ interest in those liabilities, the City officials acted recklessly in failing to disclose material information regarding those liabilities.”

A Look Ahead

The remaining three installments in this series are:

Part V:

Key Measurements Related to Pension and Employee Benefit Liabilities and the Importance of the Government Accounting Standards Board

Part VI:

The Importance of Projections in Matters Related to Pension and Employee Benefit Liabilities

Part VII:

Remedial Efforts and Undertakings as a Source of Best Practices (with conclusion).



Mr. Vacha is a member of Dilworth Paxson’s Corporate Department and its Public Finance and Securities Groups. He has advised issuers, national, and regional investment banking firms in municipal capital markets transactions. He has handled securitization/structured finance, initial public debt offerings, tax credit financings, bond pools, and tax district financings as well as traditional municipal bond transactions in the general governmental and 501(c)(3) contexts.

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