Client Alert

July 2014

Municipal Issuers and the SEC's Municipalities Continuing Disclosure Cooperation Initiative

In March of this year, the Securities and Exchange Commission (SEC) announced a self-reporting initiative regarding continuing disclosure on municipal bond issues. The initiative is called the Municipalities Continuing Disclosure Cooperation Initiative (MCDC). MCDC invites issuers and obligated persons involved in the offer or sale of municipal securities (collectively, "issuers") as well as underwriters of such offerings to voluntarily report to the SEC possible violations involving materially inaccurate statements in official statements relating to an issuer's prior compliance with the continuing disclosure provisions of Rule 15c2-12. Primarily the question is whether an issuer accurately disclosed any failure on its part over the previous five years to "comply, in all material respects" with its continuing disclosure promises previously made to investors. In return, the SEC proposes to offer standardized enforcement settlement terms to self-reporting issuers and underwriters. Unless extended by the SEC (which the SEC so far has insisted will not occur), self-reporting under MCDC must be made by September 9, 2014.

As many issuers have become aware, whether from the Government Finance Officers Association (GFOA) or in recent bond offerings, there is considerable focus now on issuers (1) reviewing their past compliance with their continuing disclosure agreements, (2) correcting past instances of noncompliance on EMMA and (3) disclosing in much greater detail in official statements instances of noncompliance that have occurred in the five years prior to the offering date, as required by Rule 15c2-12.

On July 8, 2014, the SEC announced its first MCDC settlement with a California school district issuer. According to the settlement order, the school district missed some required continuing disclosures in 2008–2010, but in a 2010 official statement disclosed that it had complied with its continuing disclosure obligations in all material respects. The settlement order provides no information regarding the specific instances of noncompliance and therefore provides no helpful information on what kinds of failures the Commission considers "material."

Below we address the feasibility of issuers self-reporting under the SEC's MCDC. We discuss certain aspects of MCDC applicable to issuers, concerns about the scope and discretion retained by the SEC's Enforcement Division in considering MCDC applications from issuers and considerations about a municipality's participating in MCDC. We also recommend steps issuers should take now given the heightened focus on enforcement of continuing disclosure requirements.

MCDC for Issuers

MCDC extends to issuers[1] of bond offerings in which a final official statement issued during the relevant period contained materially inaccurate statements regarding an issuer's prior compliance with continuing disclosure obligations. MCDC does not expressly state a scope or time period for offering documents containing potentially inaccurate statements. It is generally understood that the SEC's standard five-year statute of limitations for enforcement actions applies. This means that an issuer's scope of review includes bond offering documents during the past five years. In addition, because Rule 15c2-12 requires that final official statements disclose failures to comply with continuing disclosure provisions during the preceding five years, this may require an issuer to go back as much as 10 years to determine whether issuer compliance was accurately disclosed.

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[1] Under MCDC, "issuer" includes not just governmental issuers, but conduit borrowers and other "obligated persons" as well.

To assess whether an issuer should self-report, an issuer must review its offering documents for its issues subject to Rule 15c2-12 during the past five years — and possibly issuer compliance with its continuing disclosure obligations as far back as 10 years — to determine if there were potentially *materially inaccurate statements* regarding continuing disclosure compliance in its official statements. As MCDC is drafted, this would encompass compliance with both annual financial filings and event notices under Rule 15c2-12. When an issuer discovers potential disclosure inaccuracies, the issuer must determine if the inaccuracies were *material.* The general legal meaning of "material" for issuer disclosure is whether the misstated information — or omitted information — would be viewed by a bond investor as important in its decision to buy and hold the municipal bond.

In conduit bond issues, the conduit borrower is usually the obligated person responsible for continuing disclosure filings and for the accuracy of disclosure in an official statement regarding continuing disclosure compliance. A governmental bond issuer should review the continuing disclosure agreements for such bond issues to determine the parties responsible for filings and for the accuracy of official statement disclosure.

Issuers Need to Understand MCDC for Underwriters

MCDC also invites underwriters to "self-report" their participation in bond offerings in which final official statements contained materially inaccurate disclosure regarding issuer compliance with continuing disclosure agreements.[2] This covers an underwriter acting as lead in a syndicate or as sole underwriter, and includes both competitive and negotiated underwritings. As for issuers, this means that an underwriter's scope of due diligence includes official statements for the past five years and monitoring an issuer's failures to comply with continuing disclosure provisions during the five preceding years – as much as 10 years back to determine whether issuer compliance was accurately disclosed.

When an underwriter discovers potential disclosure inaccuracies, the underwriter must determine if the inaccuracies are material regarding underwriter compliance with Rule 15c2-12. If so, the MCDC self-reporting questionnaire requires the underwriter *to identify the issuer and bond issue,* along with extensive detail about the offering. As described further under **Enforcement Division Review of MCDC Submissions** below, underwriters are motivated to self-report issuers and bond issues whenever they have concerns about potentially inaccurate disclosures by issuers regarding past continuing disclosure compliance. It is currently expected that a substantial number of municipal underwriters will self-report under MCDC, which is due by September 9, 2014*. It is expected that over the next 30–60 days, underwriters will contact issuers to notify them if the underwriters have decided to "list" an issuer and one or more of the issuer's official statements from the past five years.*

Under MCDC, the SEC has created what many refer to as a "modified prisoner's dilemma": the prospect of underwriters turning in issuers and vice versa. For example, an issuer may have discovered a missed or significantly late delivery of annual financial information required by a continuing disclosure agreement. The issuer may have fixed the filing on EMMA and disclosed the noncompliance in a subsequent official statement. While the issuer may view this as not material, an underwriter may seek to report this instance as material under Rule 15c2-12.

Enforcement Division Review of MCDC Submission – Impact on Issuers

Under MCDC, the SEC Enforcement Division will recommend that an issuer receive an enforcement settlement with the SEC under which the issuer consents to a "cease and desist" proceeding under applicable federal securities laws for negligence-based fraud.[3] The issuer will not need to admit or deny the findings of the SEC. Importantly, this settlement extends only to the issuer *entity.* The MCDC settlement terms do not extend to *individuals* associated with an issuer entity. In other words, the SEC

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[2] In such instances, underwriters for these bond offerings may also have violated the antifraud provisions to the extent they failed to exercise adequate due diligence in determining whether issuers have complied with such obligations, and as a result, failed to form a reasonable basis for believing the truthfulness of a key representation in the issuer's official statement, i.e. the issuer's statements regarding its compliance with its continuing disclosure obligations.

[3] Section 17(a)(2) of the Securities Act of 1933.

may settle with the issuer, but not necessarily with individuals at the issuer responsible for continuing disclosure compliance and official statement disclosure. Thus both elected and appointed officials remain subject to enforcement proceedings.

Importantly, to be “eligible” for an MCDC settlement, an issuer must agree to do the following:

- within 180 days of the SEC order, establish policies, procedures and training regarding continuing disclosure;
- comply with all existing continuing disclosure undertakings, including updating past delinquent filings within 180 days of the SEC order;
- cooperate with any subsequent SEC investigation regarding the inaccurate disclosures, including the roles of individuals and other parties involved;
- disclose clearly and conspicuously the settlement terms in any final official statement for a period of five years after the SEC order; and
- provide the SEC with a compliance certification regarding the above undertakings on the one-year anniversary of the SEC order.

For issuers that agree to these SEC terms, the SEC will not seek payment of a civil penalty by the issuer. For underwriters that self-report, civil penalties will be collected and “capped” at $500,000. This is a “carrot and stick” approach: if, for example, an underwriter reports an issuer and its disclosure, and the issuer has not self-reported the same issue, the SEC presumably can pursue an enforcement action against the issuer, seeking more severe penalties, including fines. In addition, an underwriter that actively underwrites hundreds of bond issues will be motivated to report as many issues as possible to avail itself of the $500,000 cap on exposure.

Does Self-Reporting Make Sense for an Issuer?

When assessing the need to self-report, issuers should consider the following:

- The SEC Enforcement Division holds significant discretion regarding whether it will recommend MCDC standardized settlement terms for an issuer. SEC enforcement staff will be making baseline decisions regarding whether disclosure statements are inaccurate and whether such inaccuracies are material. An issuer will need to be well informed about its past disclosures and whether the issuer can fairly assert that any inaccuracies were not material. The key issue for issuers will be negotiating “materiality” with enforcement staff. Presumably, the SEC will apply some reasonableness standard. Assumedly making the required annual filing 10 days after the required filing date will not be “material.” However, the SEC has not stated its views, or announced any “safe harbor,” on what types of noncompliance or accompanying disclosure may or may not be “material.”
- While the MCDC questionnaire invites “any facts…to assist Staff of the Division of Enforcement in understanding the circumstances” of inaccurate statements, MCDC does not state that relief will be granted for mitigating circumstances.
- MCDC standardized settlement terms only extend to inaccurate disclosures regarding compliance with continuing disclosure obligations. In other words, if SEC staff finds there are other concerns with an issuer’s official statement disclosures, such alleged misstatements or omissions may not be covered by MCDC.
- MCDC does not extend to individuals.
- Enforcement staff retains significant discretion over an issuer’s complying with all terms of a settlement agreement, including enlisting issuer cooperation in further, related investigations and in accepting the one-year continuing compliance certification.
- It is widely assumed that after the MCDC expires on September 10th, the Enforcement Division will pursue cases against issuers and other market participants who have not self-reported.

Most importantly, entering into an MCDC settlement with the SEC is not merely a "reporting exercise" or a simple matter of correcting past late or missed continuing disclosure filings. It is a formal federal administrative proceeding and settlement order against an issuer entity that must be reported in issuer official statements for five years after the order is agreed to. The proceeding will be a matter of public record and likely to lead to local news stories on the issuer's acceptance that it failed to meet its continuing disclosure obligations to its bond investors.

Steps To Take Now and Going Forward

The only issuers that cannot be affected by MCDC are issuers that have not issued bonds in a public offering in the past five years. These issuers are protected by the SEC's five-year statute of limitations. Issuers who have sold municipal bonds in a public offering in the past five years should consider the following steps:

- Conduct a thorough review of past continuing disclosure agreements and compliance with filing annual financial information and event notices. Since July 1, 2009, filings should have been made with EMMA. For the time period prior to July 1, 2009, filings should have been made with DisclosureUSA, Bloomberg or other Nationally Recognized Municipal Securities Information Repositories.
- If an issuer finds late filings or missed filings, take steps to bring filings up to date on EMMA.
- Compare official statement disclosures over the past five years regarding continuing disclosure compliance with *actual compliance facts*; consult with legal counsel regarding any potential inaccuracies in disclosing past compliance; and consult with legal counsel regarding whether any inaccurate disclosures may be "material" to investors. It is always safer to err on the side of disclosing any late filings even if the issuer believes that the lateness was not material. Issuer experience suggests that the market does not react negatively to notice of prior late filings, especially if all filings are currently up to date.
- Formulate and adopt new continuing disclosure policies and procedures to ensure that required continuing disclosure filings are timely made and that disclosures in official statements accurately state the filing history over the last five years.

Communications from Underwriters Regarding MCDC

Issuers should review any MCDC communications received from underwriters regarding the issuer, its issues and whether an underwriter is or is not reporting the issuer under the MCDC program. Issuers should consult with legal counsel regarding the content of these communications and whether or not the issuer should self-report under MCDC.

Communications with the SEC

Issuers should remember that any communications with the SEC, formal or informal, voluntary or involuntary, are effectively "testimony" that the SEC may use in an enforcement proceeding against an issuer or individuals associated with an issuer. Consult with legal counsel regarding any such communications.

What May Be Expected

It is expected that a substantial number of municipal underwriters will consider self-reporting. Underwriters will likely include an expansive list of past bond issues due to the $500,000 overall cap on underwriter liability. It is expected that underwriters will communicate with their issuer clients if they are reporting an issuer or its bond issues. In many instances, an issuer and underwriter may agree that a particular disclosure about past compliance, while potentially inaccurate, is not *materially* inaccurate and will not be reported to the SEC under MCDC.

Contacts

Washington, DC

Andrew R. Kintzinger
akintzinger@hunton.com

Atlanta

Douglass P. Selby
dselby@hunton.com

Caryl Greenberg Smith
carylsmith@hunton.com

Laurie L. Schwartz
schwartzl@hunton.com

Dallas

J. Nicholson Meindl
nmeindl@hunton.com

New York

Betty Cerini
bcerini@hunton.com

Bud Ellis
ellisb@hunton.com

Kevin C. Felz
kfelz@hunton.com

Michael F. Fitzpatrick, Jr.
mfitzpatrick@hunton.com

Steven C. Friend
sfriend@hunton.com

S. Christina Kwon
ckwon@hunton.com

Peter K. O'Brien
pobrien@hunton.com

Raleigh

William H. McBride
wmcbride@hunton.com

Mary Nash Rusher
mnrusher@hunton.com

Kristen M. Kirby
kkirby@hunton.com

Richmond

Edward J. Fuhr
efuhr@hunton.com

Christopher G. Kulp
ckulp@hunton.com

Bryar C. Nettles
bnettles@hunton.com

John D. O'Neill, Jr.
joneill@hunton.com

Robert Dean Pope
dpope@hunton.com

Brendan M. Staley
bstaley@hunton.com

Martha A. Warthen
mwarthen@hunton.com

