HUNTON & WILLIAMS

Client Alert

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SEC Announces First “Wave” of MCDC Settlements with Municipal Bond Underwriters

Orders Offer Insights to Municipal Issuers on Continuing Disclosure

On June 18, 2015, the SEC released administrative cease and desist orders (the “Orders”) regarding 36 municipal bond underwriters under the SEC’s Municipalities Continuing Disclosure Cooperation Initiative (“MCDC”). Each order is based on disclosure violations that were self-reported by the underwriters regarding municipal issuer non-compliance with the continuing disclosure requirements of Rule 15c2-12. The Orders provide valuable insight into the Commission’s views on underwriter due diligence obligations with respect to continuing disclosure. They also provide some insight into the Commission’s views on what misstatements in offering documents regarding an issuer’s continuing disclosure compliance are sufficiently material to constitute violations of the federal securities laws.

Such insight is important in guiding issuers and underwriters generally in future disclosure regarding continuing disclosure compliance. And it provides limited information that may be of assistance to issuers who either self-reported late last year under the MCDC program or who chose not to self-report after determining that any misstatements as to their continuing disclosure compliance did not materially mislead investors.

As discussed below, the Orders indicate through repeated examples the kind of misstatements and omissions that the SEC clearly regards as material, but they do not provide much help in determining what kind of misstatements are not material to investors and especially in determining when failure to disclose late filings, in the SEC’s view, constitutes an issuer violation under the securities laws. There are no examples in the Orders where simple failure to disclose that one or more filings were made days or even weeks late was itself determined to be material.

Underwriter Orders – Due Diligence Responsibilities

In each Order, the SEC alleges that an underwriter conducted inadequate due diligence in certain municipal bond offerings, resulting in materially misleading disclosure in issuer offering documents regarding the issuer’s past compliance with Rule 15c2-12 continuing disclosure requirements. The underwriters did not admit or deny the SEC’s findings. Under the settlement terms of the MCDC Initiative, the SEC determined that each of the underwriters violated the antifraud provisions of Section 17(a)(2) of the Securities Act. This type of violation is based on a finding of negligence in conducting due diligence.

Rule 15c2-12 requires that a final official statement set forth any instances in the previous five years in which an issuer or obligated person failed to comply “in all material respects” with any continuing disclosure undertakings. The Orders state that the underwriters acted in offerings in which the official statements “essentially represented that the issuer or obligated person had not failed to comply in all material respects with any previous continuing disclosure undertakings.” According to the SEC, certain of these disclosure statements were materially false or misleading because, in fact, the issuer or obligated person had not complied in all material respects with its previous continuing disclosure undertakings. Each of the Orders cites at least one, and as many as four, particular examples of misleading disclosures about prior compliance. The Orders maintain that the underwriters negligently failed to conduct adequate due diligence on these issuer disclosures, failing to form a reasonable basis for believing the truthfulness of the issuer assertions regarding their compliance with prior continuing disclosure undertakings. The SEC found that the underwriters violated anti-fraud provisions by failing to conduct due diligence on continuing disclosure compliance.

Under the Orders, each underwriter has agreed to retain an independent consultant to review the underwriter's due diligence policies and procedures. In addition, pursuant to the terms of the MCDC Initiative, each underwriter is paying a civil money penalty based on the particular underwriter's volume of municipal securities underwritings.

Examples of Misleading Disclosures are Instructive For Issuers

In each Order, SEC Enforcement provides one or more examples of false or misleading statements about prior issuer compliance with continuing disclosure undertakings. Across nearly 100 disclosure examples, the following trends offer guidance to issuers on what SEC Enforcement views as materially misleading disclosure:

- In the cited examples, the SEC focused on lateness and failures with respect to filing annual financial information, operating data and audits. No examples address late or missed material event disclosures, except failure to file required notices of late filings for each of the cited late annual filings. Of particular interest, no examples include lateness or failure to file event notices of rating changes.
- In examples of misleading disclosure on annual financial information, audits and operating data, there was *real and significant* lateness or failure to file altogether – typically months and even years of lateness; one example of misleading disclosure included a lateness of only 14 days, but this occurred in the context or pattern of several other significantly more late filings.
- Disclosures were treated as materially misleading when non-compliance consisted of: real lateness in filing single items; overall lateness in filing multiple annual financial information filings; and instances of completely missed filings.
- In three Orders, SEC Enforcement addressed instances where issuers corrected past filing lateness or failures prior to an offering and simply disclosed in the official statement that "the issuer is currently in compliance" with its continuing disclosure obligations. The SEC found this disclosure misleading: late fixes do not erase the need to disclose past filing problems.
- In three Orders, SEC Enforcement highlighted issuers that failed to provide EMMA cross references to annual financial information. The issuers were delinquent or had missed filing annual information. Although that missed information was included in earlier or subsequent official statements filed by the issuers, the issuers did not cross reference the official statements on EMMA. This provides a useful reminder that making full disclosure of past failures in an official statement does not constitute required disclosure to holders of previously issued bonds unless appropriately notated EMMA filings are also made.
- While in most of the disclosures discussed, issuers essentially stated that they had not failed to comply with continuing disclosure obligations in all material respects, there were multiple instances of issuers making no statement in their official statements regarding past compliance when late or missed filings were occurring. The Orders make clear that, in the SEC's view, silence on past compliance is a material omission if the issuer in fact has not timely filed the required information.
- In certain examples, SEC Enforcement cited incomplete annual financial information or omission of certain required operating data – a signal that SEC Enforcement can be very detailed in what it believes is material noncompliance with continuing disclosure obligations leading to materially misleading official statement disclosures.
- In one instance, an issuer disclosed that it had completed remedial continuing disclosure filings, but failed to disclose that the remedial filings were erroneously made in 2011 to the old NRMSIR filing system rather than to the newer EMMA filing portal.

- In instances when issuers and obligated groups had agreed to filings of quarterly information (more than the annual requirements of Rule 15c2-12), the SEC found misleading disclosure when quarterly reports were filed late or omitted certain required information. In other words, if an issuer agrees to make disclosures beyond what is required by Rule 15c2-12, it may violate the securities laws if it does not disclose non-compliance with the contractual obligation to make such additional disclosures.

Issuers Should Expect Vigorous Review of Continuing Disclosure Compliance by Underwriters and by SEC

The examples of materially misleading issuer disclosures cited by the SEC in many instances reflect poor continuing disclosure filing practices. At the same time, the examples of false disclosure involve filing violations that are highly technical and may not be viewed by many issuers as material rule violations, particularly when past filing mistakes have been remediated. However, the underwriter Orders suggest the following for issuers:

- Issuers need to consider carefully the Orders because the Orders reflect a rigid application by SEC Enforcement of what may constitute misleading disclosure. If an issuer sees a disclosure example that is close to its facts and on which the issuer decided not to self-report, the issuer may be advised to correct or mitigate its disclosure in the event the SEC seeks to review.
- Issuers should check EMMA to ensure continuing disclosure filings are correctly cross-referenced or linked to relevant bond issues.
- Issuers should adopt detailed continuing disclosure policies and procedures, much like post issuance tax compliance policies and procedures adopted by issuers to satisfy detailed and complex tax requirements that apply to municipal bonds; such policies and procedures will be helpful as a defense to issuers that have previously self-reported under the MCDC Initiative and helpful to issuers on future bond offerings in ensuring good disclosure on continuing disclosure compliance.
- Issuers should expect keen attention from their underwriters on adequacy of issuer disclosure regarding past compliance with continuing disclosure requirements. Underwriters are likely to require detailed proof of prior issuer compliance and will almost certainly not proceed with bond issues until such proof is in hand. Whenever late, incomplete or missed filings have occurred during the five years prior to release of an official statement, issuers should expect to disclose all non-compliances, regardless of the materiality of the non-compliances.

What's Next?

We expect additional underwriter settlements under the MCDC Initiative in future months. Given the large volume of self-reporting filings by issuers last year, it is uncertain when the SEC will begin releasing issuer settlements. The SEC also can be expected to bring actions against issuers, both those that did not self-report and those that self-reported in the limited sense of providing notice to the SEC that the issuer did not believe its noncompliance was material to investors and therefore was not agreeing to accept the settlement terms set forth in the MCDC announcement. The self-reporting of the underwriters almost certainly identified noncompliance by a number of issuers that themselves did not self-report, either because they simply did not address the issue or because they concluded that their noncompliance was not material to investors.

It is important to remember that the Orders reflect voluntary settlements by underwriters under substantial pressure to accept the SEC's conclusions. In any action brought by the Commission against an issuer, the issuer will be able to assert that its noncompliance in fact did not materially mislead investors. [1] We

[1] An extremely useful analysis of the issue of whether limited noncompliance materially misled investors is discussed in MCDC Initiative – Considerations For Analysis By Issuers Of Materiality and Self-Reporting, National Association of Bond Lawyer, August 5, 2014. Copies are available from Hunton & Williams LLP upon request or at www.nabl.org.

are interested in answering any questions you may have regarding your continuing disclosure practices and on adopting disclosure policies and procedures. In addition, we are prepared to advise you promptly should you be contacted by the SEC Enforcement group regarding any of your disclosure content in official statements.

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