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SEC Municipalities Continuing Disclosure Cooperation Initiative: Should A Bond Issuer Self-Report?

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Municipal securities issuers have the opportunity to self-report material misstatements in official statements regarding prior compliance with continuing disclosure undertakings under a new initiative introduced by the Securities and Exchange Commission's (SEC) Enforcement Division. The deadline for municipal issuers and other obligated persons to report violations was originally September 10, 2014, but was later extended to December 1, 2014.

The program, entitled the Municipalities Continuing Disclosure Cooperation Initiative (MCDC Initiative), was originally introduced by the SEC in March.

The deadline for underwriters to self-report was in September, so it is possible that issuers may have been contacted by an underwriter of their bonds to inform them that the underwriter found what it believed to be a violation and was going to report the violation to the SEC as part of the MCDC Initiative. Under the MCDC Initiative, underwriters were not required to notify issuers prior to reporting a violation so it is also possible that an underwriter reported a violation without informing the issuer. Underwriters who reported violations were required to pay a fine of $20,000 - $60,000 per offering with a cap of $500,000 to avoid further enforcement action by the SEC for any reported violation. As a result, underwriters had an incentive to over-report potential misstatements without regard to whether the misstatement was material. We understand that dozens of underwriters filed these reports with the SEC, paying the full fine.

Issuers who believe they may have been reported or who believe they may have made a misstatement in an official statement since 2009, should consider whether or not to participate in the MCDC Initiative. Conventional wisdom is that an overwhelming majority of issuers across the country have omitted some information from one or more official statements. Most issuers did not report changes in insurer or other credit-enhanced ratings during the last five years, particularly during the Great Recession when those ratings were changing frequently. Those same issuers tended not to disclose such changes in their disclosure filings often because they were unaware of the change or that the news of a change was publicly available. Ultimately, the issuer has to decide whether or not to participate in the MCDC Initiative and to evaluate the risks of doing so or not. The challenge is that the MCDC Initiative does not define "materiality" with respect to prior misstatements, and provides only that the SEC will consider enforcement action on a case-by-case basis.

Summary of the MCDC Initiative

Rule 15c2-12 of the Securities Exchange Act of 1934 (the "Rule") prohibits underwriters from purchasing or selling a municipal security unless the issuer has committed to providing continuing disclosures about itself and the security. The Rule also requires final official statements to contain a statement describing any instance in the past five years in which the issuer failed to comply with previous continuing disclosure commitments. The latter part of this Rule is the focus of the MCDC Initiative. In other words, the MCDC Initiative focuses on issuer misstatements in official statements concerning compliance with prior continuing disclosure undertakings rather than the particular substantive compliance failure (i.e. delinquent filings of annual audits). The MCDC Initiative gives issuers the opportunity to self-report material misstatements in official statements regarding its prior compliance in return for more lenient settlement terms in SEC

enforcement actions.

If an issuer self-reports by December 1, 2014, the Enforcement Division will recommend that the SEC accept a settlement with no financial penalties to the issuer, in which the issuer consents to a cease–and-desist order. The issuer would also be required to agree to undertake to:

- Establish policies, procedures and training regarding continuing disclosure obligations;
- Comply with existing continuing disclosure obligations;
- Cooperate with subsequent investigations;
- Disclose the settlement (including the cease and desist order) in all offerings within the following five years; and
- Provide the SEC with a compliance certificate after one year.

Determining Whether or Not to Self-Report

The SEC has not provided details on what types of misstatements rise to the level of materiality. Organizations within the municipal bond industry such as the National Association of Bond Lawyers (NABL)[1] and governmental organizations such as the Government Finance Officers Association[2] have provided some guidance on circumstances in which an issuer might consider self-reporting—or not. Acknowledging that the decision to self-report needs to be made by issuers on a case-by-case basis, NABL has outlined the following series of questions for an issuer to ask itself to help determine if self-reporting is appropriate:

1. Determine if there has been a misstatement. A misstatement occurs when (a) the issuer has failed to comply in all material respects with one or more of its previous continuing disclosure undertakings, and (b) the issuer disclosed in an official statement that it *had* complied. If no misstatement has occurred, then the issuer has nothing to self-report.
2. If there has been a misstatement, determine whether such misstatement is material within the general anti-fraud provisions of the federal securities law. Even if a misstatement has occurred, if it is not material, the issuer does not have to self-report.
3. If there has been a material misstatement, the issuer will need to weigh the advantages and disadvantages of self-reporting to decide whether to do so.

Questions an issuer will want to ask to determine materiality include:

a) The importance of the information or notice to an investor (e.g., whether it would have affected pricing);
b) The extent to which the information was otherwise publicly available;
c) Whether the information was otherwise available to institutional investors and rating agencies upon request;
d) The extent to which there is a significant pattern or trend of noncompliance by the issuer;
e) Whether municipal securities for comparable credits were sold disclosing comparable non-compliance and, if so, whether market acceptance or pricing was impacted;
f) Whether subsequent to the reporting failures the issuer engaged an independent dissemination agent; and
g) Whether, since the reporting failures, the issuer has adopted enhanced continuing disclosure procedures and

implemented training on such procedures.

Advantages and Disadvantages of Self-Reporting

Panelists in a NABL teleconference held October 15, 2014, discussed advantages and disadvantages of self-reporting and the procedural aspects of an issuer's decision whether or not to self-report under the MCDC Initiative.

If an issuer self-reports under the MCDC Initiative, the SEC has assured that the settlement terms in any SEC enforcement action will be more "lenient" than those available in an SEC enforcement action if the issuer elects not to self-report. Under the MCDC settlement terms, the issuer would not have to pay a monetary penalty; however, the SEC may still pursue enforcement actions against elected or appointed issuer officials or other individuals who are considered by the SEC to be culpable of material misstatements concerning continuing disclosure, or for alleged misstatements omitted from the self-report. Issuers who self-report under the MCDC Initiative will have a limited opportunity to explain to the SEC staff any extenuating circumstances regarding the misstatement, including why they believe a particular misstatement is not material.

However, the NABL panelists stated that because the MCDC Initiative is intended as an expedited process for settlement, SEC staff discussions with issuers are unlikely to be as extended or formal as in a typical SEC enforcement proceeding, where the issuer would have more opportunity to present a defense and the SEC could have a tougher time proving its case. Of course, the typical SEC proceeding is also time-consuming and expensive. Furthermore, unnecessary self-reporting may also expose the issuer to further SEC scrutiny and enforcement actions that the issuer might have avoided had it not self-reported. If an issuer does not self-report, the SEC may bring a later enforcement action against the issuer for alleged material misstatements, which may include financial sanctions and other remedies beyond those described in the MCDC Initiative, including securities fraud charges and monetary penalties.

Conclusion

A determination of whether or not to self-report requires an in-depth analysis of the circumstances of each potential misstatement or omission by an issuer. An issuer will want to determine not only whether it has made a misstatement or omission regarding prior compliance with continuing disclosure requirements, but whether the misstatement or omission is material. In addition to an assessment of potential material misstatements, the issuer must determine whether to self-report any misstatement pursuant to the MCDC Initiative. The decision to self-report is ultimately a risk management decision that needs to be made by the issuer.

Finally, if the issuer decides to self-report, or is contacted at any time by SEC officials regarding continuing disclosure compliance or the MCDC Initiative, it should consult with legal counsel before engaging in any discussion with the SEC by phone or otherwise. If an issuer decides not to self-report, it should maintain a file documenting the factual basis on which that decision was made.

This has been prepared for informational purposes and is not intended as legal advice. Issuers should seek advice from legal counsel if they have discovered possible material misstatements about noncompliance with disclosure requirements.

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[1] See NABL paper dated August 5, 2014 entitled "MCDC Initiative Considerations for Analysis by Issuers of Materiality and Self-Reporting."

[2] See alert dated July 7, 2014 entitled "GFOA Alert: The SEC Initiative and Issuers."