

The SEC MCDC Initiative and Alabama Counties

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ESCALATION OF RULE 15c2-12 ENFORCEMENT:

The SEC's Municipalities Continuing Disclosure Cooperation Initiative:

- March 2014: The Securities and Exchange Commission (the "SEC") Division of Enforcement (the "Division") introduced the Municipalities Continuing Disclosure Cooperation Initiative (the "MCDC").
- According to SEC, the MCDC is *"intended to address potentially widespread violations of the federal securities laws by issuers and underwriters of municipal securities in connection with certain representations about continuing disclosures in bond offering documents."*
- Focus of MCDC: Materially inaccurate statements made by issuers and/or borrowers in a final official statement ("OS") regarding past compliance with continuing disclosure undertakings ("CDUs") entered into pursuant to SEC Rule 15c2-12 (the "Rule").

ESCALATION OF RULE 15c2-12 ENFORCEMENT (continued):

- MCDC encourages issuers and underwriters to self-report possible violations of the federal securities laws involving materially inaccurate statements made in official statements regarding past compliance with CDUs.
- In exchange, Division agrees to recommend “favorable” settlement terms.
- In response to industry objections, the SEC has revised the MCDC Initiative in several respects, as will be discussed.
- The text of the Municipal Securities Continuing Disclosure Cooperation Initiative and the related Questionnaire are attached to your written materials as Attachment A. The amendments to MCDC are attached as Attachment B.

SOME BACKGROUND

Rule 15c2-12:

- Generally, the Rule requires that prior to purchasing or selling bonds, underwriters satisfy themselves:
 - (i) that issuer will enter into a CDU for the applicable bond issue; and
 - (ii) that issuer has materially complied with CDUs for prior transactions.
- Also, the Rule requires that an OS for a bond issue describe any instances in the previous five years in which the issuer failed to comply, in any material respect, with any previous commitment to provide continuing disclosure.

Anti-Fraud Provisions of the Federal Securities Laws:

- The SEC is prohibited by the 1975 “Tower Amendment” from directly regulating local government issuers.
- Thus, municipal bonds are generally exempt from registration under federal securities laws, but remain subject to general antifraud provisions of the federal securities laws.
- These prohibit issuers from making untrue statements of material facts or omitting material facts in connection with the offer and sale of securities.
- Materiality of information is determined by weighing the facts and circumstances in each case.
- Information is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision.

SEC's First Shot Across the Bow: West Clark Community Schools:

- In 2013, for the first time SEC charged an issuer (West Clark Community Schools in Indiana (“West Clark”)) with material misstatements made in an OS regarding continuing disclosure compliance.
- Simply put, West Clark falsely claimed in an OS that it had complied with its obligations under a prior CDU; in fact, West Clark had never submitted its required disclosures.
- SEC’s cease-and-desist order found that the statement in the OS was false and that West Clark knew, or was reckless in not knowing, that the statements were false.

SEC's First Shot Across the Bow (continued):

- West Clark was not charged due to its failure to comply with its prior CDU.
- Rather, the fraud action was based upon the false statement of compliance made in the subsequent OS.
- West Clark case illustrates the SEC's view that statements made in offering documents about compliance with the Rule are material to investors.

The MCDC Initiative

Participation in MCDC:

- MCDC is available to **issuers** who may have made materially inaccurate statements regarding prior compliance with prior CDUs in a final OS published in the last five years.
- MCDC is also available to the **underwriters** of offerings in which final OS may have contained materially inaccurate statements regarding the issuer's prior compliance in that timeframe.
- To participate in the MCDC as originally promulgated, an issuer or underwriter was required to self-report by accurately completing a questionnaire and submitting it to the SEC *no later than 12:00 a.m. EST on September 10, 2014.*

Participation in MCDC (continued):

- **Please note that time is of the essence here - the SEC will not accept issuers into the MCDC after the applicable filing deadline.**
- **In response to widespread objection from various industry trade associations, the issuer deadline was extended until December 10, 2014.**
- **However, the underwriter deadline remains September 10, 2014.**

SEC Staff to Recommend Standardized Settlement Terms:

- Division staff will review the MCDC questionnaires and determine whether to recommend enforcement action against the self-reporting entity.
- Will apply a materiality standard to items that are self-reported and may determine that reported failures were not material.
- If the Division staff finds that enforcement action is warranted, the Division will *recommend* that the SEC accept a settlement on the terms described below.
- However, SEC not required to accept the terms recommended by the Division.
- SEC may determine to impose other terms.

Standardized Settlement Terms:

- The issuer consents to a cease and desist proceeding for violations of Section 17(a)(2) of the Securities Act of 1933 (essentially a finding of negligent conduct), but the issuer neither admits nor denies the findings of the SEC.
- No civil penalties will be paid by the issuer.
- The issuer must agree to take the following actions:

Standardized Settlement Terms (continued):

(1) Establish appropriate policies and procedures and training regarding continuing disclosure obligations within 180 days of the institution of the proceedings;

(2) Comply with existing CDUs, including updating past delinquent filings within 180 days of the institution of the proceedings;

(3) Cooperate with any subsequent investigation by the Division regarding the false statement(s), including the roles of individuals and/or other parties involved;

(4) Disclose in a clear and conspicuous fashion the settlement terms in any final OS for an offering by the issuer within five years of the date of institution of the proceedings; and

(5) Provide the Commission staff with a compliance certification regarding the applicable undertakings by the issuer on the one year anniversary of the date of institution of the proceedings.

Self-Reporting by Underwriters:

- MCDC includes separate settlement terms for self-reporting underwriters. Settlement recommended for self-reporting underwriters will include:
 - The payment of monetary penalties;
 - Amount of the penalty is based on issue size of the violative offerings (\$20,000 per offering of \$30 million or less and \$60,000 per offering of more than \$30 million) and was originally capped at \$500,000.

Self-Reporting by Underwriters (continued):

- Revised MCDC provides a tiered approach to the cap on civil penalties based on the underwriter's 2013 total annual revenue:
 - \$500,000 for underwriters with 2013 revenue of more than \$100 million;
 - \$250,000 for underwriters with 2013 revenue between \$20 and \$100 million;
 - \$100,000 for underwriter with 2013 revenue less than \$20 million .
- No cap on penalties will be available to underwriters who do not take advantage of MCDC.
- As a result, cap on civil penalties may incentivize underwriters to report all perceived violations of prior CDUs without regard to materiality.

No Assurances with Respect to Individual Liability:

- MCDC covers only eligible issuers and underwriters.
- Division may recommend enforcement action against **individuals** associated with those entities, such as government officials, if they have engaged in violations of the federal securities laws. The Division may seek remedies against individuals beyond those available through the MCDC.

Failing to Take Advantage of MCDC:

- For issuers and underwriters that would be eligible but that do not self-report:
 - Division offers no assurances that it will recommend the above terms in any subsequent enforcement recommendation. The Division has specifically cautioned entities that enforcement actions outside of the MCDC initiative could result in seeking remedies beyond those described in the MCDC;
 - For issuers, the Division has cautioned that it will likely recommend and seek **financial sanctions**.

SEC's Second Shot Across the Bow: Kings Canyon Joint Unified School District:

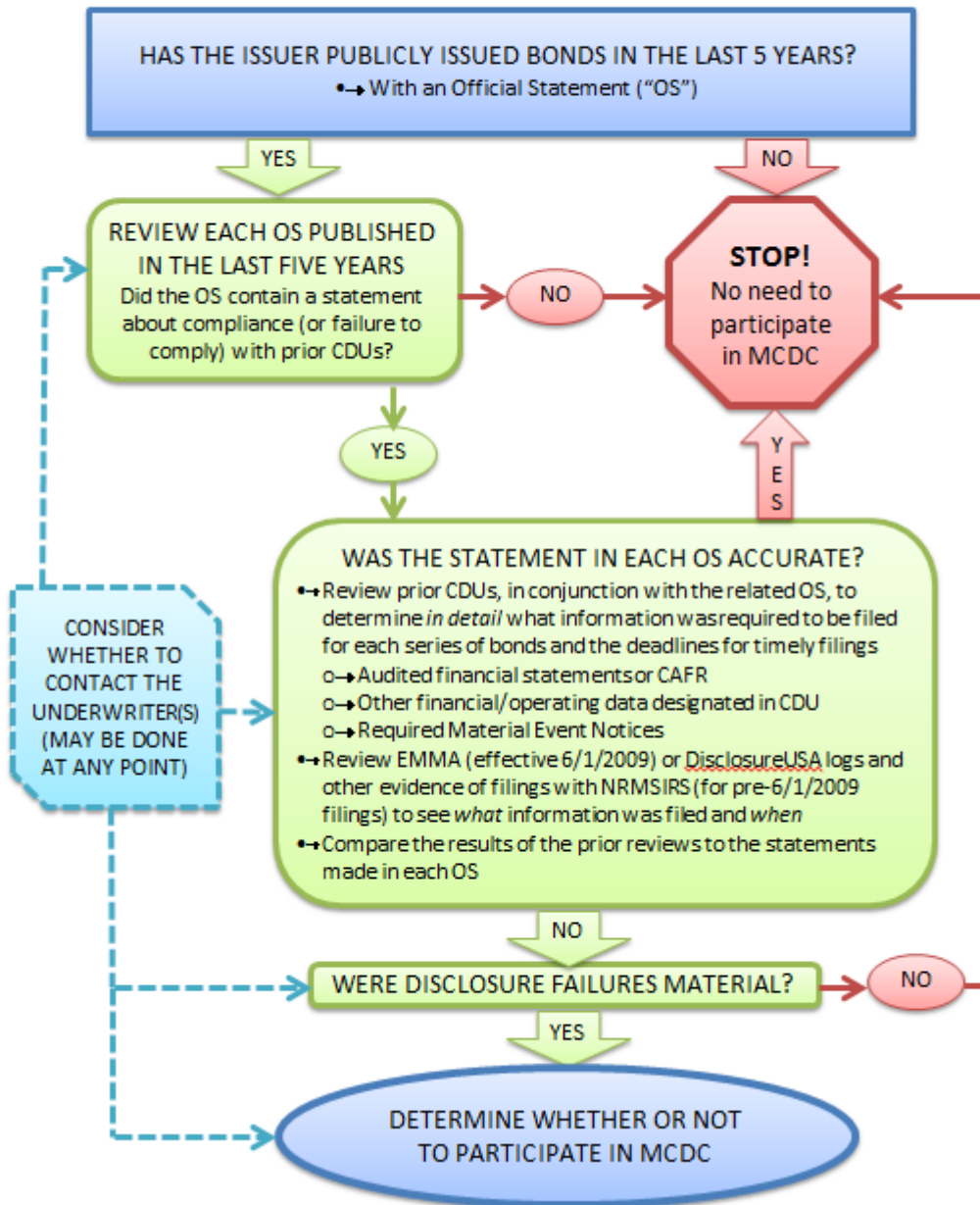
- In July 2014, SEC entered into cease-and-desist order with this California school district that had stated in a 2010 Official Statement that it was in compliance with its previous CDU.
- But there apparently had been some unspecified deficiencies in those disclosures.
- SEC would not state what those deficiencies were or to otherwise give guidance re: materiality.
- SEC appears to be playing both hardball and hide-the-ball.

Actions to Take Now

- Issuers need to determine, with respect to their obligations issued prior to December 1, 2010, whether they had undertaken only a “limited” continuing disclosure obligation because they had less than \$10 million in principal amount of obligations outstanding.
- Issuers need to determine whether each OS published within the last five years accurately described compliance with prior CDUs.
- Because each OS required a description of non-compliance over a five-year look-back period, issuers may be required to verify compliance over the last 10 years.

- ***Remember, actual compliance with CDUs is not the basis for enforcement actions - it is the accuracy of the statements regarding past compliance made in the OS that are the basis for fraud actions.***
- So, if an issuer has failed to comply with its CDUs during the five-year period but has accurately disclosed the failures in *each* OS published during that time, self-reporting would not be required.
- Below is a decision tree illustrating the analytical steps an issuer should take in determining whether participation in MCDC should be considered. A copy is included in your written materials as Attachment C.

MCDC Initiative Decision Tree



Some Considerations in Determining Whether or Not to Participate in MCDC

- While the SEC considers the MCDC remedies to be *relatively lenient*, the relative gravity of a cease and desist order pursuant MCDC may be difficult to explain to the public, thus, the decision whether or not to participate in MCDC has serious legal and possibly political or public relations ramifications for issuers.
- SEC has repeatedly declined to offer any guidance whatsoever as to what compliance failures would be considered “material” and would therefore warrant disclosure in any subsequent OS. Thus, common problems such as filing of information a day or two late may be considered material by SEC in hindsight.

Some Considerations in Determining Whether or Not to Participate in MCDC (continued)

- MCDC creates a tension between an issuer and its underwriters.
- Underwriters may have incentive to report all instances of noncompliance with CDUs whether material or not.
- Potential to create a “prisoners dilemma” in which one party reports a violation and the SEC uses that information to begin an enforcement action against the other party.
- The extension of the issuer self-reporting deadline until December 1, 2014 while leaving the underwriter deadline at September 10 may actually increase the tension between issuers and underwriters.
- Issuers should contact the underwriter of each bond issue outstanding during the five-year period and request notification of any anticipated reporting to the SEC.
- Likewise, issuer should also notify underwriters of intended filings so the underwriter can also evaluate its MCDC participation with respect to an issue.

Some Considerations in Determining Whether or Not to Participate in MCDC (continued)

- MCDC may also create a tension between an issuer and its officials, employees and advisors.
- MCDC participation does not protect individuals associated with bond issues from further enforcement action.
- Information in the MCDC questionnaire may also lead to investigations of and enforcement actions against issuer advisors such as financial advisors or lawyers.

Some Considerations in Determining Whether or Not to Participate in MCDC (continued)

- Will be difficult for issuers to determine compliance with its CDUs over a 10-year period (and in some instances, over a five-year period).
- Municipal Securities Rulemaking Board established the Electronic Municipal Market Access system ("EMMA") continuing disclosure filings effective June 1, 2009.
- Prior to that time, filings were required to be made with four designated repositories (called "NRMSIRS").
- NRMSIRS were difficult for the public to access and lacked an efficient indexing system.
- Absent receipts from the NRMSIRS will be difficult to demonstrate compliance with prior CDUs.

Some Considerations in Determining Whether or Not to Participate in MCDC (continued)

- Possible that the information in the MCDC questionnaire may be used as an admission to the SEC for purposes of related enforcement actions.
- The entry of the cease-and-desist order carries future ramifications for issuers.
- Should the SEC institute future action against the issuer, the existence of a prior cease-and-desist order may be considered a negative factor when remedies are recommended by the Division to the SEC.
- Determining whether an issuer has made a misstatement and, if so, whether that misstatement is material can be difficult. Attached publications of the Governmental Finance Officers Association (GFOA) (Attachment D) and the National Association of Bond Lawyers (NABL) (Attachment E) may be helpful to your analysis.

Going Forward

Regardless of whether or not an issuer decides to participate in MCDC, each issuer should:

- Consider taking steps to correct past filing failures.
- Ensure that each future OS accurately describes any instances of non-compliance with past CDUs in the preceding five years.
- Consider the adoption of continuing disclosure policies and procedures and the implementation of periodic staff training programs about compliance with the federal securities laws (or modifying existing procedures to address issues that have arisen).
- Consider engaging a dissemination agent such as DAC to ensure compliance with your undertakings.