PUBLIC FINANCE CLIENT ALERT

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SEC MCDC INITIATIVE CREATES QUANDARY FOR MUNICIPAL ISSUERS AND UNDERWRITERS

On March 10, 2014, the Securities and Exchange Commission (the "SEC") announced its Municipalities Continuing Disclosure Cooperation Initiative (the "MCDC")[1]. The program is ostensibly designed to afford favorable treatment terms to municipal issuers and obligated parties (collectively "issuers"), as well as underwriters, who may have violated federal securities laws by misstating or omitting to state in an official statement any instances in the previous five years in which an issuer failed to comply, "in all material respects", with its continuing disclosure undertakings under SEC Rule 15c2-12. The SEC is convinced that compliance with these undertakings, and disclosure of such compliance – or the lack thereof, has been shoddy, and the SEC is determined to correct "sloppy" practices of issuers and underwriters. To participate in the MCDC program, an issuer or underwriter must self-report the material misstatement or omission no later than 11:59 p.m. (EDT), September 9, 2014. The MCDC has created a bit of a firestorm—and a particular dilemma for issuers—exacerbated by the SEC's unwillingness to provide guidance to issuers (or underwriters) as to when an issuer has failed to comply with its undertaking "in all material respects" and when a statement to the contrary is "material" and should be reported, and amplified by clear statements by SEC officials of the SEC's intention to use the MCDC to pit underwriters against issuers.

Legal Background

Rule 15c2-12 generally prohibits any underwriter from purchasing or selling municipal securities unless the issuer has committed to provide annual updates about the financial condition of the issuer and operating data of the type included in the official statement of such issuer, as well as disclosure of various specified events. Rule 15c2-12 also requires that any final official statement prepared in connection with a primary offering of municipal securities contain a description of (a) the undertaking to be provided under Rule 15c2-12 in connection with such municipal securities and (b) any instances in the previous five years in which the issuer failed to comply, "in all material respects", with any previous Rule 15c2-12 undertakings.

The SEC may file actions against issuers for inaccurately stating in final official statements that they have materially complied with their prior continuing disclosure undertakings, or omitting to state instances of non-compliance—if such misstatements or omissions are "material." Because underwriters have a due diligence obligation to determine

[1] http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541090828#.UyEBIPldXQg

whether issuers have complied with such continuing disclosure undertakings, underwriters may also have violated the federal securities laws if the issuer made a material misstatement regarding its compliance with prior continuing disclosure undertakings and the underwriter failed to exercise adequate due diligence to determine if the issuer's statements were true.

In 2013, the SEC imposed cease and desist orders on a school district in Indiana and its underwriter, where the issuer stated in a bond offering document that it had not failed, in the previous five years, to comply with its prior continuing disclosure undertakings. In fact, the issuer had failed to file any annual financial information or other significant event notices as required by its existing undertakings, and the underwriter purportedly did no checking with respect to whether the issuer had made its required disclosures. The SEC stated that an underwriter may not rely solely on a written certificate from an issuer with respect to past compliance. The SEC also said it doubts that an underwriter could form a reasonable basis for recommending any municipal securities by relying on the accuracy of an issuer's ongoing disclosure compliance representations without the underwriter affirmatively investigating the issuer's filing history.

Technically, Rule 15c2-12 applies only to underwriters and not to issuers, but both underwriters and issuers are subject to the federal securities antifraud rules. The SEC's position is that an underwriter could have failed to meet its obligations under Rule 15c2-12, and may have also violated federal securities antifraud rules, if the issuer misstated or omitted to state its filing history in the official statement and the underwriter failed to adequately investigate the issuer's compliance. If an issuer made a materially false statement in an official statement about compliance with its ongoing disclosure undertakings, then under federal securities antifraud rules the SEC may bring an action against the issuer and, possibly, officials of the issuer.

The MCDC Initiative

Who can self-report?

Any issuer (including any conduit borrower who is an "obligated person") or underwriter can self-report. If an issuer or underwriter has been contacted by the SEC about possible inaccurate statements or omissions as to past compliance with continuing disclosure undertakings, it may still be eligible for the MCDC Initiative if no enforcement action has yet been taken when it self-reports. However, *individuals* associated with issuers or underwriters (e.g., public officials or employees) cannot self-report and thus cannot obtain protection under the MCDC Initiative.

When and what must be self-reported?

The MCDC Initiative expires at 12:00 a.m. (EDT) on September 10, 2014, so any self-reports must be filed no later than 11:59 p.m. (EDT) on September 9, 2014. To date the SEC has firmly resisted suggestions to extend the time for filing.

Rule 15c2-12 provides that an official statement offering a new issue of municipal securities must describe any instances in the previous five years in which an issuer failed to comply, "in all material respects", with any previous undertakings in a written contract or

agreement under Rule 15c2-12. Because a five-year statute of limitations for civil penalties also applies, arguably any misstatement or omission in an official statement regarding a failure to comply during the previous 10 years (the last five years per Rule 15c2-12, plus the five years before the earliest year of the Rule 15c2-12 period per the statute of limitations) are subject to reporting under the MCDC Initiative. For example, for an official statement dated January 1, 2014 with a statement to the effect that "During the previous five years, the issuer has been in compliance, in all material respects, with its previous undertakings under Rule 15c2-12", the SEC would look back during the previous five years to determine whether the issuer, in fact, materially complied with its undertakings. For an official statement dated January 1, 2010 containing the same statement of compliance, the SEC's review would go back five years from such date.

On a related note, issuers and underwriters may remember that the MSRB's EMMA portal has been in operation only since July 1, 2009, and that prior to such date issuers were required to file their continuing disclosure with the NRMSIRs and/or DisclosureUSA. Despite the fact that filing with DisclosureUSA during its existence was voluntary and that obtaining information from the NRSMIRs is difficult at best (and impossible for NRMSIRs that have ceased to operate), comments from SEC officials suggest that the burden will be on issuers and underwriters to prove adequate and timely filing of annual financial information and specified events – even prior to EMMA's debut. Consequently, issuers are recommended to retain all correspondence and copies of such information and notices for at least 10 years as evidence of compliance with their undertakings.

Self-reporting must be done on a questionnaire[2] which includes (in addition to the name of the self-reporting entity)—

- information regarding each municipal securities offering containing potentially inaccurate or omitted statements;
- the identities of the lead underwriter, any municipal advisor, bond counsel, underwriter's counsel and disclosure counsel, if any, for each offering;
- any facts that the self-reporting entity would like to provide to assist the SEC in understanding the circumstances that may have led to the potentially inaccurate statements; and
- a statement (which acts as a consent to a cease and desist proceeding) that the self-reporting entity intends to consent to the applicable Settlement Terms imposed by the SEC under the MCDC Initiative.

Settlement Terms of MCDC Initiative

If the SEC staff recommends an enforcement action against an issuer or underwriter as a result of self-reporting, the recommended Settlement Terms will include the following

[2] http://www.sec.gov/divisions/enforce/mcdc-initiative-questionnaire.pdf

"generous" terms. The clear implication, as well as subsequent statements by SEC officials, is that Settlement Terms for violations that are not self-reported will be more severe.

Cease and Desist Order. For both issuers and underwriters, the self-reporting party must agree to accept a settlement pursuant to which it consents to the institution of a cease and desist proceeding by the SEC against such party. As is the standard practice, the SEC will apparently recommend that the self-reporting party neither admit nor deny the findings of the SEC in the cease and desist proceeding. Nevertheless, the cease and desist proceeding will be a matter of public record and creates the legal basis for more direct enforcement actions by the SEC in the future.

Undertakings. For ***issuers***, as part of any settlement the issuer must undertake to:

- establish appropriate policies and procedures and training regarding continuing disclosure undertakings;
- comply with existing continuing disclosure undertakings, including updating past delinquent filings within 180 days;
- cooperate with any subsequent investigation by the SEC, including the roles of individuals (e.g., municipal officials) or other parties involved in the offering;
- disclose in a clear and conspicuous fashion the settlement terms in any official statement for an offering by the issuer within the next five years; and
- provide the SEC with a compliance certificate regarding the foregoing on the one-year anniversary of the date of the institution of the proceedings.

For ***underwriters***, the settlement must include an undertaking by the underwriter to:

- retain an independent consultant, not unacceptable to the SEC, to conduct a compliance review and (within 180 days) provide recommendations to the underwriter regarding its due diligence process and procedures;
- within 90 days of the consultant's recommendations, take reasonable steps to enact the recommendations, provided that the underwriter may seek approval from the SEC to not adopt recommendations that the underwriter demonstrates are unduly burdensome;
- cooperate with any subsequent investigation by the SEC regarding the false statements, including the roles of individuals; and
- provide the SEC with a compliance certificate regarding the applicable undertakings by the underwriter on the one-year anniversary of the date of the proceedings.

Civil (Monetary) Penalties. For ***issuers***, the SEC will recommend no payment of any civil penalty.

For ***underwriters***, the SEC will recommend a civil penalty for each official statement containing a materially false statement, the penalty being $20,000 per offering (for offerings of $30 million or less) and $60,000 per offering (for offerings of more than $30 million), provided that no underwriter will be required to pay more than $500,000 in total civil penalties.

The Dilemma: Underwriters vs. Issuers

The SEC has been upfront and overt in stating that it has intentionally structured the MCDC Initiative to pit underwriters against issuers (SEC officials have publicly referred to this tension as a "Modified Prisoner's Dilemma"). By putting a maximum aggregate penalty of $500,000 on a self-reporting underwriter (that is, $500,000 for all reported matters collectively), the SEC has effectively induced each underwriter, once its total penalties reach $500,000, to report every possible violation by an issuer, whether or not the violation is material or merely technical, or if it could even be well argued that a violation has not occurred. SEC officials have stated in public that this was done intentionally to encourage underwriters to report any and all violations, regardless of materiality, and thereby provide the SEC a free master list of possible violations, effectively without the SEC having to do any investigative work.

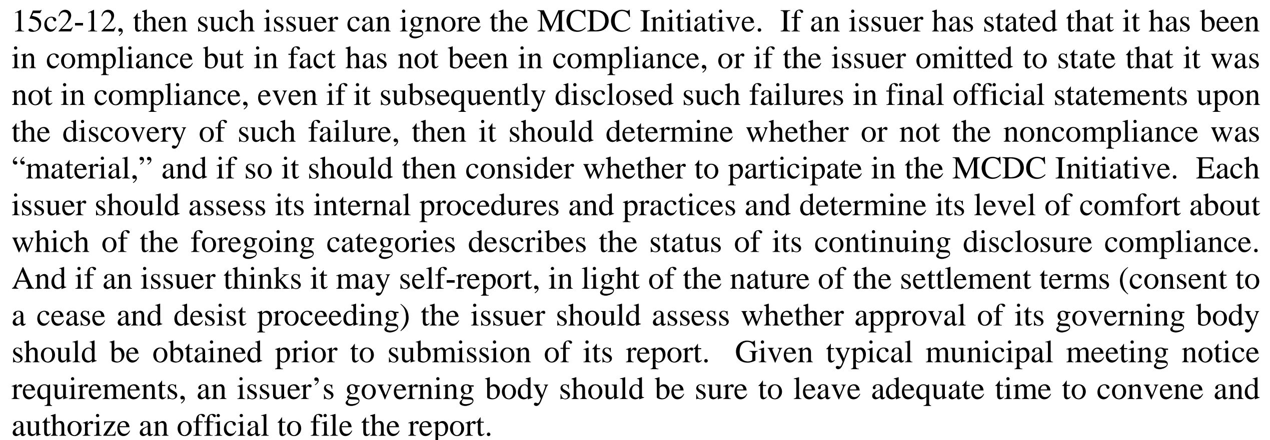
Underwriters are accustomed to dealing with the SEC and cease and desist orders, so the penalty of a cease and desist order and the required adoption of appropriate procedures is of more limited consequence to them. Moreover, at present many underwriters are owned or affiliated with regulated financial institutions which are presently under intense scrutiny by federal regulators at multiple levels, so safe harbors by regulatory bodies such as the SEC are of greater consequence.

Municipal issuers, however, operate in an entirely different milieu, in which a cease and desist order often has serious political consequences. In addition, allocating staff or hiring professionals to review past financings and developing policies and procedures to monitor filings could generate significant expenses for issuers, particularly for small- and medium-sized issuers.

A further concern is that the SEC has suggested that the determination of whether a particular failure to file or report under a continuing disclosure undertaking is "material" may not be tested against the traditional securities law determination of "material"—that is, whether there is a substantial likelihood that the misstatement or the disclosure of the omitted information would have been viewed by a reasonable investor as having significantly altered the total mix of information made available in determining whether or not to invest. Put another way, the SEC is effectively threatening to impose a definition of "material" that is much more expansive than has historically been the case under the federal securities laws.

Considerations for Issuers and Underwriters

An issuer may wish to commence its own review of its level of compliance with its continuing disclosure agreements, instead of waiting to be contacted by an underwriter. If an issuer (a) has been in compliance with its continuing disclosure undertakings, "in all material respects", for the previous five years, (b) has not issued any municipal securities subject to Rule 15c2-12 within the previous five years or (c) issued municipal securities within the previous five years but at the time of such issuance had no previous continuing undertakings pursuant to Rule



15c2-12, then such issuer can ignore the MCDC Initiative. If an issuer has stated that it has been in compliance but in fact has not been in compliance, or if the issuer omitted to state that it was not in compliance, even if it subsequently disclosed such failures in final official statements upon the discovery of such failure, then it should determine whether or not the noncompliance was "material," and if so it should then consider whether to participate in the MCDC Initiative. Each issuer should assess its internal procedures and practices and determine its level of comfort about which of the foregoing categories describes the status of its continuing disclosure compliance. And if an issuer thinks it may self-report, in light of the nature of the settlement terms (consent to a cease and desist proceeding) the issuer should assess whether approval of its governing body should be obtained prior to submission of its report. Given typical municipal meeting notice requirements, an issuer's governing body should be sure to leave adequate time to convene and authorize an official to file the report.

Underwriters are well-advised to review financings for which they have been the lead banker for at least the last five years and go through the same analysis as described above for issuers.

In any event, any issuer or underwriter who intends to self-report under the MCDC Initiative should contact and cooperate with at least the underwriter or issuer involved, and preferably also notify other parties who are listed on the self-reporting form required to be filed with respect to each municipal securities offering. Early notice and contact is clearly advisable. An issuer may want to notify its senior underwriters of bonds over the previous five years that the issuer will need notice well in advance of the deadline if an underwriter intends to self-report, as the issuer will have political and statutory issues that most likely cannot be addressed quickly.

Please let us know how we can assist you with this process.

Additional Information

For more information regarding the Municipalities Continuing Disclosure Cooperation program, contact your Kutak Rock LLP attorney or a member of our Public Finance Practice Group. For more information on our Public Finance practice and for recent news and alerts, please visit us at www.kutakrock.com.

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Kutak Rock – Contact Information

Atlanta
303 Peachtree Street, NE
Suite 2750
Atlanta, GA 30308-3201
404-222-4600

Chicago
One South Wacker Drive
Suite 2050
Chicago, IL 60606-4614
312-602-4100

Denver
1801 California Street, Suite 3000
Denver, CO 80202-2626
303-297-2400

Fayetteville
234 East Millsap Road, Suite 200
Fayetteville, AR 72703-4099
479-973-4200

Irvine
5 Park Plaza, Suite 1500
Irvine, CA 92614-8595
949-417-0999

Kansas City
1010 Grand Boulevard, Suite 500
Kansas City, MO 64106-2220
816-960-0090

Little Rock
124 West Capitol Avenue
Suite 2000
Little Rock, AR 72201-3706
501-975-3000

Los Angeles
601 South Figueroa Street
Suite 4200
Los Angeles, CA 90017-5747
213-312-4000

Minneapolis
220 South Sixth Street, Suite 1750
Minneapolis, MN 55402
612-334-5000

Oklahoma City
6305 Waterford Boulevard
Suite 475
Oklahoma City, OK 73118-1116
405-848-2475

Omaha
The Omaha Building
1650 Farnam Street
Omaha, NE 68102-2186
402-346-6000

Philadelphia
Two Liberty Place, Suite 28B
50 South Sixteenth Street
Philadelphia, PA 19102-2519
215-299-4384

Richmond
Bank of America Center, Suite 800
1111 East Main Street
Richmond, VA 23219-3500
804-644-1700

Scottsdale
8601 North Scottsdale Road
Suite 300
Scottsdale, AZ 85253-2738
480-429-5000

Washington
1101 Connecticut Avenue, NW
Suite 1000
Washington, DC 20036-4374
202-828-2400

Wichita
1605 North Waterfront Parkway
Suite 150
Wichita, KS 67206-2935
316-609-7900