HAWKINS ADVISORY

# SEC'S ENFORCEMENT DIVISION ANNOUNCES ITS "Municipalities Continuing Disclosure Cooperation Initiative"

## *Introduction*

On March 10, 2014, the Division of Enforcement (the "Division") of the Securities and Exchange Commission (the "SEC" or the "Commission") announced the Division's "Municipalities Continuing Disclosure Cooperation Initiative" (the "Initiative") [http://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml]. The purpose of the Initiative is to "address potentially widespread violations of the federal securities laws by municipal issuers and underwriters of municipal securities in connection with certain representations about continuing disclosures in bond offering documents." Under the Initiative, the Division will recommend to the SEC what it considers to be "favorable settlement terms" for issuers (defined in the Initiative to include obligated persons) and underwriters if they "self-report to the Division possible violations involving materially inaccurate statements relating to prior compliance with the continuing disclosure obligations specified in Rule 15c2-12."[1] The "self-reporting" deadline is September 10, 2014. Please note that this is not a proposal that has been distributed for comment, as would be the case for SEC, Municipal Securities Rulemaking Board, or other administrative rulemaking proposals, but is currently in effect with a fixed expiration deadline.

The SEC's press release announcing the Initiative references the SEC's recent enforcement actions involving misleading disclosures in an issuer's official statement regarding its compliance with prior continuing disclosure agreements.[2] In March 2005, a school district, in connection with a bond financing, entered into a continuing disclosure agreement pursuant to Rule 15c2-12, in which it contractually agreed to provide annual financial information and notices of material events. In December 2007, the issuer, in its official statement for another bond financing, stated that it had not failed, in the previous five years, to comply in all material respects with any prior disclosure undertakings. In fact, the issuer had not provided any disclosure that was required by the March 2005 continuing disclosure agreement. The SEC found that both the issuer and the underwriter had violated Section 17(a)(2) and Rule 10b-5 (described below).

## *Legal Standards regarding the Initiative for Issuers*

For municipal bond issuers, the Initiative concerns the general antifraud provisions of the federal securities laws. All securities, regardless of whether they are exempt from registration with the SEC, are subject to the general antifraud provisions of the federal securities laws, namely Section 17(a) of the Securities Act of 1933 (the "33 Act") and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (the "34 Act"). The standards regarding misstatements or omissions are essentially the same in both Section 17(a)(2) and Rule 10b-5. Section 17(a)(2) proscribes "any untrue statement of a *material* fact or any omission to state a *material* fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." Rule 10b-5 provides that it is unlawful for any person "to make any untrue statement of a *material* fact or to omit to state a *material* fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." An enforcement action by the SEC under Section 17(a)(2) is based on a showing of negligence. An enforcement action by the SEC under Rule 10b-5, however, requires a showing of "scienter," which can be either recklessness or intentional acts. An element of either a Section 17(a)(2) or Rule 10b-5 SEC enforcement action is a finding of "materiality." The SEC, in a seminal enforcement action against a municipal issuer, defined "materiality" as follows: "Information is material if there is a substantial likelihood that a reasonable investor would consider it important to an investment decision."[3]

## *Legal Standards regarding the Initiative for Underwriters*

With respect to underwriters, the Initiative relates to both violations of the general antifraud provisions and compliance with Rule 15c2-12.

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[1] The "favorable settlement terms" relate solely to an SEC enforcement action. The Initiative will not, by its terms, restrict any enforcement action by the Financial Industry Regulatory Authority against an underwriter.

[2] *In re* West Clark Community Schools, SEC Rel. Nos. 33-9435 and 34-70057 (July 29, 2013) and *In re* City Securities Corporation, SEC Rel. Nos. 33-9434 and 34-70056 (July 29, 2013), which were analyzed in a Hawkins Advisory dated August 2, 2013.

[3] *In re* County of Orange, Cal., SEC Rel. Nos. 33-7260, 34-36760 (Jan. 24, 1996). The SEC cited as authority for such definition *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) and *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). *TSC Industries* advised in the context of a proxy-solicitation (Section 14 (a) of the 1934 Act) that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote," and further "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available." In *Basic, Inc.*, the United States Supreme Court agreed to "expressly adopt the TSC Industries standard of materiality for the § 10(b) and Rule 10b-5 context."

The SEC believes that an underwriting constitutes an implied recommendation about the underwritten securities, and that such a recommendation cannot be made without an adequate basis:

> By participating in an offering, an underwriter makes an implied recommendation about the securities. Because the underwriter holds itself out as a securities professional, and especially in light of its position vis-à-vis the issuer, this recommendation itself implies that the underwriter has a reasonable basis for belief in the truthfulness and completeness of the key representations in any disclosure documents used in the offerings.[4]

Accordingly, the Initiative notes that if an issuer has inaccurately stated that it has substantially complied with prior continuing disclosure undertakings, "underwriters . . . may also have violated the anti-fraud provisions to the extent they failed to exercise adequate due diligence in determining whether issuers have complied with such obligations."

In addition to violations of the general antifraud provisions, an underwriter is subject to Rule 15c2-12. Rule 15c2-12 under the 34 Act applies to underwriters; it does not apply to municipal issuers. Rule 15c2-12 requires, among other things, that an underwriter send to any potential customer on request a copy of the "final official statement." A "final official statement" is defined in Rule 15c2-12 as a document that includes disclosure of "any instances in the previous five years in which each person [that is a party to the continuing disclosure undertaking] failed to comply, *in all material respects*, with any previous undertakings in a written contract or agreement."[5] If there had been such failures and they were not disclosed in the official statement, the definition of "final official statement" in Rule 15c2-12 would not have been satisfied. In addition, the SEC has stated that an underwriter, under such circumstances, has violated Rule 15c2-12(c) for not having proper procedures in place to provide reasonable assurance of receiving an issuer's disclosure submissions.[6]

### *Terms of the Initiative - General*

To be eligible for the Initiative, an issuer or underwriter must "self-report" any "final official statement" that failed to disclose "any instances in the previous five years in which [there was a failure] to comply, in all material respects, with any previous undertakings."[7] The "self-reporting" is achieved by completing the questionnaire that is attached to the Initiative and submitting it to the Division by no later than September 10, 2014. The questionnaire requires contact information about the entity that is "self-reporting," identification of "the municipal bond offering(s) (including name of Issuer and/or Obligor, date of offering and CUSIP number) with Official Statements that may contain a materially inaccurate certification on compliance regarding prior continuing disclosure obligations," and a listing of the senior managing underwriter, the financial advisor, the bond counsel, the underwriter's counsel, and the disclosure counsel. It is important to note that the Initiative outlines terms that the Division will recommend to the SEC, but that the SEC could determine to impose different sanctions. Also, the Initiative only applies to issuers and underwriters as *entities* and not to any *individuals* involved, and cautions that the Division "may recommend enforcement actions against . . . individuals and may seek remedies beyond those available through the . . . Initiative." In addition, if an issuer or underwriter does not "self-report" and the Division later determines that a violation of the federal securities laws has occurred, the Initiative notes that "entities are cautioned that enforcement actions outside of the . . . initiative could result in the Division or the Commission seeking remedies beyond those described in the initiative."

### *Terms of the Initiative for Issuers*

For municipal bond issuers, under the Initiative the Division will recommend to the SEC a settlement in which (i) the issuer consents to a cease-and-desist order, (ii) the issuer neither admits nor denies the findings of the SEC, and (iii) such order references a violation of Section 17(a)(2) of the 33 Act (negligence standard). The settlement will require the issuer to agree to the following undertakings (quoting from the Initiative):

- establish appropriate policies and procedures and training regarding continuing disclosure obligations within 180 days of the institution of the proceedings;
- comply with existing continuing disclosure undertakings, including updating past delinquent filings within 180 days of the institution of the proceedings;
- cooperate with any subsequent investigation by the Division regarding the false statement(s), including the roles of individuals and/or other parties involved;
- disclose in a clear and conspicuous fashion the settlement terms in any final official statement for an offering by the issuer within five years of the date of institution of the proceedings; and
- 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.

There would be no payment of a civil penalty by an issuer.

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4 SEC Rel. No. 34-26100 (Sept. 22, 1988).

5 Rule 15c2-12 does not require an affirmative statement as to whether a person has complied; it only requires disclosures of failures to comply "in all material respects."

6 *In re* City Securities Corporation.

7 Separate from the five-year reference in the definition of "final official statement" is the statute of limitations for civil penalty actions by the SEC, which is five years from when the misleading disclosure occurred (not five years from when the misleading disclosure was discovered). *Gabelli v. SEC*, 568 U.S. ___ (2013).

### *Terms of the Initiative for Underwriters*

For underwriters, under the Initiative the Division will recommend to the SEC a settlement in which (i) the underwriter consents to a cease-and-desist order, (ii) the underwriter neither admits nor denies the findings of the SEC, and (iii) such order references a violation of Section 17(a)(2) of the 33 Act. The settlement will require the underwriter to agree to the following undertakings (quoting from the Initiative):

- retain an independent consultant, not unacceptable to the Commission staff, to conduct a compliance review and, within 180 days of the institution of proceedings, provide recommendations to the underwriter regarding the underwriter's municipal underwriting due diligence process and procedures;
- within 90 days of the independent consultant's recommendations, take reasonable steps to enact such recommendations; provided that the underwriter ma[y] seek approval from the Commission staff to not adopt recommendations that the underwriter can demonstrate to be unduly burdensome;
- cooperate with any subsequent investigation by the Division regarding the false statement(s), including the roles of individuals and/or other parties involved; and
- provide the Commission staff with a compliance certification regarding the applicable undertakings by the Underwriter on the one year anniversary of the date of institution of the proceedings.

Under the Initiative, the Division will recommend to the SEC that the settlement be accepted if the underwriter consents to an order requiring the following civil penalties (quoting from the Initiative):

- For offerings of $30 million or less, the underwriter will be required to pay a civil penalty of $20,000 per offering containing a materially false statement;
- For offerings of more than $30 million, the underwriter will be required to pay a civil penalty of $60,000 per offering containing a materially false statement;
- However, no underwriter will be required to pay more than $500,000 total in civil penalties under the MCDC Initiative.

### *Analysis of the Initiative*

Issuers should determine whether each of their official statements published within the last five years accurately described the status of their compliance with their continuing disclosure agreements. To emphasize, it is not a matter of whether issuers complied with their continuing disclosure agreements, but rather whether they stated in their official statements that they were in compliance in all material respects when they were not. The interplay between the general antifraud provisions and the definition of "final official statement" in Rule 15c2-12 suggests the following analysis for a municipal issuer when considering whether to "self-report" under the Initiative:

> First – If an issuer had been in compliance with its continuing disclosure agreements in all material respects, there was no need to say anything on this point in its final official statements.
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> Second – If an issuer was not in compliance with its continuing disclosure agreements in all material respects and it accurately disclosed such failures in its final official statements, the issuer satisfied its securities law obligations.
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> Third – if the issuer stated in its final official statements that it had been in compliance in all material respects when in fact it had not, this could result in securities law liability if there were a material misstatement.[8] Accordingly, in this instance an issuer should carefully consider whether to "self-report," and in reaching that decision whether or not to discuss this issue with the underwriter.
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> Fourth – if the issuer did not comply with its continuing disclosure obligations but the final official statements included no disclosure at all regarding compliance or non-compliance, as a purely legal matter, such omission may not have been a violation *by the issuer* of the general antifraud provisions, which require that any omission must make the statements *that were made* misleading. On the other hand, undisclosed failures would result in the "final official statement" not meeting the definition of such term in Rule 15c2-12. In such instances, the *underwriter* may be "self-reporting" such failures.

As a practical matter, although Rule 15c2-12's definition of "final official statement" only requires disclosure of failures to comply "in all material respects" with prior continuing disclosure undertakings, many issuers have made disclosure statements that have affirmatively addressed the status of compliance without regard to materiality. In addition, these alternatives are only an analytical framework to assist an *issuer* in determining whether to "self-report" regarding *prior* official statements. For *new* official statements, the best practice is to disclose the status of compliance, whether positive or negative.

Notably, an issuer that has disclosed in recent official statements past failures with its continuing disclosure agreements should examine whether there were prior official statements in which such disclosure was not made but should have been made. In such instances, the issuer should review such prior failures using the analytical framework provided

[8] *In re* West Clark Community Schools.

above, and determine whether "self-reporting" under the Initiative may be prudent. It is unclear, however, what broader investor protection purposes the Initiative would satisfy in this context. Having made the disclosure contemplated by Rule 15c2-12, the issuer would already have been subject to the consequences envisioned by the Rule, namely (i) the risk that an underwriter might not reach the "reasonable determination" as to the issuer's new continuing disclosure undertaking as required under Rule 15c2-12(b)(5)(i) to do a public offering, with the result that the issuer could be subject to the potentially greater cost of a private placement (exempt from Rule 15c2-12), and (ii) the onus of having to disclose in any final official statement relating to a public offering all material continuing disclosure failures that occurred in the preceding five years. If the issuer had already incurred or would incur by operation of Rule 15c2-12 the two sanctions envisioned by the Rule, what additional purpose is served by having the issuer subject itself to a cease-and-desist order under the terms of the Initiative?

In addition, the notion that the Initiative's settlement terms are "favorable" is simplistic. The ramifications for a public issuer and its officials in admitting violations of the federal securities laws are quite different than for a registered company, whose considerations may be limited to the financial impact of such an admission on shareholders and other financial factors.[9]

Underwriters should determine whether they have underwritten securities for which the official statement misstated the status of the issuer's compliance with its continuing disclosure agreements.[10] Notably, however, at a recent conference, an SEC staff member cautioned that underwriters could face enforcement actions for unreported failures even when "self-reporting" other disclosure failures.[11] In addition, even if an underwriter were to conclude that any failures by an issuer to comply with prior undertakings were not material, and therefore did not have to be disclosed to satisfy the "final official statement" definition in Rule 15c2-12, the issuer could decide to "self-report" such failures to the Division.

The SEC staff recognizes that the Initiative creates "tension" between issuers and underwriters, and refers to the Initiative as creating a "modified prisoner's dilemma."[12] This dilemma can be mitigated by issuers and underwriters conferring with each other, both with regard to particular bond issues and through their respective industry organizations. Clearly, any material misstatements or omissions merit serious consideration for "self-reporting." On the other hand, it would appear to serve no purpose to "self-report" pursuant to the Initiative all failures to comply with prior agreements, without regard to materiality. Rule 15c2-12(b)(5)(i)(D) requires that notice be provided of *any* failure to provide required annual financial information when due. In contrast, Rule 15c2-12's definition of "final official statement" requires disclosures of failures to "comply, *in all material respects*, with any previous undertakings." Thus, Rule 15c2-12 recognizes that not all failures are material. Accordingly, cooperation between issuers and underwriters in determining whether the legal standard was satisfied is appropriate.

Finally, it would be very useful for the Division to provide some guidance as to what standard it expects to use to determine a minimal threshold of variance from full literal compliance below which "self-reporting" under the Initiative would not be expected, consistent with the use of the phrase "in all material respects" in Rule 15c2-12's definition of "final official statement." Although the SEC staff has a long-standing policy of not providing specific guidance as to what is "material" in the context of the general antifraud provisions (i.e., *substantive* materiality), in this instance the guidance would be with respect to a definition in an SEC rule (i.e., *procedural* materiality). Such guidance could address common occurrences, such as, for example, those instances of (i) incorrect CUSIP numbers for a few maturities of bonds, and (ii) failures to file notices of rating changes during the financial crisis when rating changes occurred rapidly without notice to the issuer.[13]

[9] A registered company may consider a negligence charge, the imposition of a cease-and-desist order, and a settlement by which it neither admits nor denies the findings of the SEC, to be a very favorable outcome of an SEC enforcement action. But a governmental issuer may view such a settlement very negatively, with its potential negative news stories and political repercussions for those who were in the position of authority at the time of the possible violations.

[10] In the context of a new offering, even if an issuer has made complete disclosure of its prior failures to comply with its continuing disclosure undertakings, an underwriter must consider whether it can satisfy the requirement under Rule 15c2-12(b)(5)(i) to reasonably determine that the issuer will comply with the new continuing disclosure undertaking that relates to the underwritten securities. On this point, the SEC has cautioned:

> [T]he Commission believes that it is doubtful that an underwriter could form a reasonable basis for relying on the accuracy or completeness of an issuer's or obligated person's ongoing disclosure representations, if such issuer or obligated person has a history of persistent and material breaches . . . .
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> SEC Rel. No. 34-32184A (May 26, 2010).

[11] "*SEC Explains Self-Reporting Muni Enforcement Program*," The Bond Buyer (Mar. 31, 2014).

[12] The premise of the "prisoner's dilemma" is that each of two prisoners is placed in a separate isolation cell and therefore does not know what the other prisoner may be saying to the prosecutor. The dilemma is "modified" in the sense that if one party goes to the Division and "self-reports," the other party would have the option to also report to the Division any time prior to the deadline of September 10, 2014, assuming such party was aware of the report sufficiently in advance of the deadline. For an analysis and formulation of the prisoner's dilemma, see Stanford Encyclopedia of Philosophy, "*Prisoner's Dilemma*," at http://plato.stanford.edu/entries/prisoner-dilemma.

[13] More generally, the SEC staff could advise, outside the context of the Initiative, that a continuing disclosure agreement's requirement to provide material event notices regarding rating changes would be satisfied if such changes were provided directly by the rating agencies to EMMA, together with CUSIP numbers of the affected bonds. As recent examples, see the Standard & Poor's Research Updates dated March 18, 2014, in which (i) the insurance operating subsidiaries of Assured Guaranty Ltd. were raised from "AA-" to "AA," (ii) the rating on National Public Service Finance Guarantee Corp. was raised from "A" to "AA-," and (iii) the rating on MBIA Inc. was raised from "BBB" to "A-." Such updates could result in thousands of filings by affected issuers, rather than a single filing by the rating agency.

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