THE SEC MCDC INITIATIVE

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Introduction

For many years, the United States Securities and Exchange Commission (SEC) and the Municipal Securities Rulemaking Board (MSRB) have increased their regulation of the municipal securities market, with the SEC emphasizing that its general duty to protect investors and maintain fair and efficient markets includes the protection of investors in municipal securities and the municipal securities market. This increased regulation, whether considered direct (under the antifraud provisions of the SEC's rules and related law) or indirect (by regulating the underwriters buying municipal securities) includes the "regulation" of governmental entity issuers of municipal securities. Any Colorado governmental entity which has (1) issued bonds, whether general obligations or revenue obligations of an enterprise, or has entered into lease purchase obligations and (2) sold the bonds or certificates of participation interests in a lease purchase agreement to underwriters and in connection with the sale has entered into a CDA (as described below) is so regulated. The Rule described below applies directly to underwriters and, as it will be shown, indirectly to municipal securities issuers and obligated persons such as Internal Revenue Code Section 501(c)(3) (charitable organizations) borrowers.

This article sets forth only the latest development in the universe of SEC direct or indirect regulation of the issuers of municipal securities and does not provide detailed history or thorough discussion of the securities laws and regulations pertaining to the issuance of municipal securities.

SEC Rule 15c2-12

SEC Rule 15c2-12 (Rule), in general, requires that, prior to bidding for, purchasing, offering or selling municipal securities, an underwriter (1) "obtain and review an official statement that an issuer of such securities deems final as of its date …" and (2) determine "that an issuer of municipal securities … has undertaken, … in a written agreement or contract for the benefit of holders of such securities, to provide … " certain annual financial information and notices of the occurrence of listed (in the Rule) events, some of which are to be made whether or not the event is determined to be material to an investor in deciding to purchase the municipal securities. This written agreement is generally described as a Continuing Disclosure Agreement or Undertaking (a CDA or a CDU). There are certain exceptions to the Rule and detailed requirements for the timing of the filing of the annual financial information and the notices of the occurrence of events with the continuing disclosure service of the MSRB's Electronic Municipal Market Access (EMMA) system. This article does not directly discuss those exceptions or detailed requirements.

In general, because of the Rule, since 1995, the issuers of municipal securities that are sold to underwriters, whether by negotiated or competitive sale, have entered into CDAs under which they have agreed to make post-issuance disclosures to the secondary municipal securities market that are relevant to the purchasers of those municipal securities. A representative of an issuer should be able to review each of the issuer's CDAs to analyze the exact agreements the

issuer has made regarding the content and timing of the issuer's current continuing disclosure obligations.

West Clark Community Schools

In 2005, a school district in Indiana, West Clark Community Schools (West Clark), issued bonds and entered into a CDA regarding those 2005 bonds. In 2007, West Clark again issued bonds and offered to sell the 2007 bonds under its *deemed final* official statement. In the official statement for the 2007 bonds, West Clark represented, and the underwriter accepted the representation, that West Clark was fully compliant with the terms of its 2005 CDA when, in fact, West Clark had never made any of the required filings of annual financial information or any event notices. In its 2007 official statement, West Clark stated that "[i]n the previous five years, the School Corporation has never failed to comply, in all material respects, with any previous undertakings in a written contract or agreement that it entered into pursuant to subsection (b)(5) of the Rule." While there had not been a default with respect to either issue of bonds and the owners of the bonds had not suffered any loss, in July 2013, the SEC undertook enforcement actions against West Clark and the underwriter of the 2005 and 2007 bonds based on what the SEC deemed to be misrepresentations in West Clark's 2007 official statement relating to the 2007 bonds. The SEC alleged that (1) the District had made misrepresentations in its official statement and (2) the underwriter's due diligence efforts were inadequate as it failed to discover the noncompliance on the part of West Clark. The SEC began cease-and-desist proceedings against West Clark and West Clark then offered a settlement. The case was settled with West Clark agreeing to adopt enhanced disclosure and compliance policies and procedures and to provide annual training for its personnel involved in the finance aspects of its operations. The SEC found that the underwriter and at least one employee of the underwriter "provided improper gifts and gratuities to representatives of municipal bond issuers, and then wound up charging these and other expenses back to the issuers under the guise of costs for 'printing, preparation and distribution of official statements.'" The underwriter agreed to be censured and to "pay disgorgement and prejudgment interest … as well as a penalty …" for failing to conduct "adequate" due diligence and providing improper gifts. The underwriter agreed to enhance its disclosure and expense reimbursement policies, including reviewing and amending policies and procedures and engaging independent compliance counsel. The SEC has cited this case as an example of its readiness to bring enforcement actions if it discovers inaccurate statements about compliance with disclosure obligations.

The MCDC Initiative

In its 2012 Report on the Municipal Securities Market, the SEC indicated that studies have shown years of significant noncompliance with the requirements of CDAs with respect to the dissemination of annual financial information by a wide variety of governmental entities. Perhaps accelerated by the West Clark case described above, on March 10, 2014, the SEC's Enforcement Division introduced an initiative 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." This initiative is titled as the Municipalities Continuing Disclosure Cooperation Initiative (MCDC Initiative). The MCDC Initiative is meant to *encourage* self-reporting by

municipal issuers and underwriters of possible securities law violations related to misrepresentations in offering documents concerning an issuer's prior compliance with its continuing disclosure obligations. It is another in a series of efforts by the SEC to educate issuers and underwriters as well as directly address what are deemed to be violations of securities laws by the making of certain misrepresentations about continuing disclosures in bond offering documents. As stated in the MCDC Initiative, the SEC's Enforcement Division will "recommend [not guarantee] favorable settlement terms to issuers … involved in the offer or sale of municipal securities (collectively, "issuers") as well as underwriters of such offerings [also not guaranteed] if they self-report to the Division possible violations involving materially inaccurate [no definition provided] statements relating to prior compliance with the continuing disclosure obligations specified in Rule 15c2-12 … ." [Bracketed language added.] Whether a recommended settlement is favorable or not, it is most likely to include having the issuer establish explicit policies and procedures and training of personnel regarding continuing disclosure obligations. There are similar elements to a recommended settlement for an underwriter, but, in addition, there are civil penalties (up to an aggregate of $500,000 under the MCDC Initiative) that will likely be imposed. The MCDC Initiative currently states that a recommended settlement for an eligible issuer will not include payment of a civil penalty.

One last note, the MCDC Initiative covers only issuers and underwriters. The SEC provides no assurance that **individuals** associated with those entities, such as municipal officials and employees of underwriting firms, will be offered similar terms if they have engaged in violations of the federal securities laws. As stated in the MCDC Initiative, "The Division [of Enforcement of the SEC] may recommend enforcement action against such individuals and may seek remedies beyond those available through the MCDC Initiative. Assessing whether to recommend enforcement action against an individual for violations of the federal securities laws necessarily involves a case-by-case assessment of specific facts and circumstances, including evidence regarding the level of intent and other factors such as cooperation by the individual."

Who Should Consider Self-Reporting?

Issuers who believe they may have made materially inaccurate statements in an official statement or other bond offering document regarding compliance with a continuing disclosure obligation (as described in the Rule) should consider self-reporting to the SEC to take advantage of the MCDC Initiative. **Underwriters** of a bond offering who have reason to believe official statements contain materially inaccurate statements regarding an issuer's prior compliance with continuing disclosure obligations should also consider self-reporting to the SEC. Issuers and underwriters that have already been contacted by the SEC as of the March 10, 2014 date of the MCDC Initiative regarding possible inaccurate statements, but against whom no formal action has yet been taken, may still be eligible for the MCDC Initiative and should seek advice from the SEC as to their eligibility. The deadline for self-reporting under the MCDC Initiative is September 10, 2014, and is required to be made pursuant to a questionnaire that the SEC attached to the MCDC Initiative. However, before contacting the SEC, it is recommended that an issuer or underwriter contemplating such a self-report first consult with legal counsel. As indicated above, "favorable settlement terms" are not guaranteed.

Conclusion

This article does not discuss issues like materiality, fraud versus negligence and the many other topics pertaining to the issuance of municipal securities in accordance with federal securities laws. Suffice it to say, the SEC is very serious about enforcing the Rule and continuing disclosure obligations. Andrew Ceresney, Co-Director of the SEC's Enforcement Division warns: "West Clark Community Schools defrauded bond investors by leading them to believe that it had provided the annual financial information contractually required in a prior bond offering, when in fact for five years they failed to submit the required information. **This case demonstrates that we will be vigilant in making sure municipal issuers and underwriters comply with their obligations.**" [Emphasis added.]