Dangers and Pitfalls in Continuing Disclosure

The SEC’s Municipal Continuing Disclosure Cooperation Initiative (MCDC)
A Little Rule 15c2-12 History

• Enacted in 1989 - requires underwrites to obtain and review a “deemed final” official statement before offering any bonds in a public sale

• 1995 amendments add requirement for – Continuing Disclosure Undertakings (CDU)s
  – Annual Financial Reporting
  – Reportable Event Notices (14)
• Indirectly this regulates issuers (Tower Amendments)
• The SEC’s definition of “final official statement” requires issuers to disclose any lapse in complying “in all material respects” with any previous CDU
• The MCDC initiative is focused on this disclosure
Components of the CDU

• Annual Financial Statements – Audits
• Annual Operating Data – specific tables as defined in official statement - applies when the issuer has $10,000,000 or more in bonds outstanding in the market place
• Reportable Event Filings – 14 different events
  – Most common are; payment delinquencies, non-payment defaults, bond calls, adverse tax opinions, rating changes
SEC CDU Concerns

• The SEC has been very concerned about the lax attitude of the market - both issuers and underwriters with compliance to Rule 15c2-12
  – Many market participants are “retail” investors
  – The Financial Crisis
  – Congressional pressure
    • Dodd Frank Act
• SEC created new Division of Enforcement
• Transparency and information access
• Harrisburg (2013)
  – Guaranteed $260 million in debt for incinerator
  – 2009 – 2011 failed to file CDU information
  – Investors relied on other information from the city’s web site including a 2009 “State of the City” address
  – SEC felt such information was materially misleading
  – City settled with SEC agreeing to remedial measures
SEC Secondary Market Disclosure Actions

- West Clark Schools (Indiana) 2013
  - Entered into a CDU for a 2005 issue
  - In their 2007 issue the OS represented the District was fully compliant with the 2005 CDU
  - SEC charged the District with falsely representing its CDU compliance
  - Underwriter also charge with failing to perform sufficient due diligence with respect to CDU compliance
  - District and Underwriter entered into settlement agreement with the SEC
SEC’s MCDC Initiative

• Announced March 10, 2014
• Encourages Underwriters and Issuers to self report securities law violations with respect to inaccurate statements of CDU compliance in Official Statements
• Underwriters had until September 10, 2014 to self report
• Issuers have until December 1, 2014 to self report
SEC’s MCDC Initiative (cont.)

- Standard settlement terms for those who self report
- Settlement terms more favorable under the MCDC initiative than under an enforcement action
- Favorable terms include no monetary penalty for issuers and caps on penalties for underwriters
- Prisoner’s dilemma
SEC and Anti-Fraud Provisions

• SEC is taking this initiative under the ’34 Act – Section 10 & Rule 10b-5 and the ‘33 Act – Section 17(a)
• Prohibits Fraud in the sale of securities
• Unlawful to make an untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading
• To violate the anti-fraud provisions, a statement or omission of information must be “misleading as to a material fact”

• A fact is material “if there is a substantial likelihood that a reasonable investor would consider it important in making the decision to buy or sell the securities”

• Omitted information is material if there is 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.”
OS CDU Compliance Disclosure - Materiality

• In the SEC’s view materially false statements about CDU compliance are violations of the anti-fraud provisions and this position is the foundation for the MCDC initiative

• SEC has declined several attempts to define what they consider “material”

• They will consider materiality on a case by case basis
• July 8, 2014 – SEC issues Cease-and-Desist order to Kings Canyon Joint Unified School District
• District’s 2010 OS stated that it was in the past 5 years it was in compliance with prior CDU requirements
• SEC found this was an untrue statement of a material fact and District knew or should have know it was untrue
• SEC’s review found annual financial information and audits were in some cases over 1 year late being filed while some were late by shorter time periods
• SEC’s actions did not give any guidance as to what delay it considered material
• Cease-and-Desist Order
  – Establish written polices, procedures and periodic training regarding CDU obligations
  – Update all past delinquent filings
  – Cooperate with any subsequent SEC investigation
  – Disclose terms of this settlement in future OS’s for next 5 years
  – Provide certification with supporting evidence to the SEC of compliance with above
Should You Self Report?

• No need to self report if:
  – No material failure to comply with CDUs during the past 5 years
  – Had no obligation under Rule 15c2-12 (generally issues under $1,000,000 or private placements)
  – There were material failures during the 5 year look back period but the failures were fully disclosed in the OS
Should You Self Report?

- Consideration should be given to self reporting when
  - OS falsely stated the issuer was in material compliance with all previous CDUs
  - Issuer failed to disclose in an OS its material failure to comply with any previous CDU
  - An underwriter self-reported an issue

- District should consult with legal counsel in determining whether or not to self report
Going Forward

- Issuers need to recognize they are responsible for their CDU compliance
- Know what your CDU’s require
- Establish procedures to assure compliance
- Establish an organization account on EMMA and sign up for email reminders
Resources

• Government Finance Officers Association

• National Association of Bond Lawyers
Contact Information

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This presentation has been prepared for general informational purposes only. It is not intended to be legal advice. Issuers should consult with their own counsel as to how the MCDC initiative applies to their specific situation.