Bond Case Briefs

Municipal Finance Law Since 1971

SEC Charges 71 Municipal Issuers and Obligated Persons Pursuant to Municipalities Continuing Disclosure Cooperation Initiative: Andrews Kurth

On March 10, 2014, the Securities and Exchange Commission's ("SEC") Enforcement Division (the "Enforcement Division") introduced the Municipalities Continuing Disclosure Cooperation Initiative ("MCDC Initiative"). The SEC's stated intent in introducing the MCDC Initiative was to address potentially widespread violations of federal securities laws by municipal issuers and obligated persons (each, an "issuer" and collectively, "issuers") and underwriters of municipal securities in connection with representations in bond offering documents related to prior compliance with continuing disclosure undertakings. To that end, the MCDC Initiative sought to incentivize issuers and underwriters of municipal securities to self-report possible violations by offering what the SEC described as favorable, standardized settlement terms to participants.

The MCDC Initiative accepted self-reported submissions from underwriters through September 10, 2014, and from issuers through December 1, 2014. The Enforcement Division began the MCDC Initiative on July 8, 2014, by charging one California school district and then shifted its focus to municipal underwriting firms. In three separate waves (occurring on June 18, 2015, September 30, 2015, and February 2, 2016, respectively), the SEC announced enforcement actions against a total of 72 municipal underwriting firms. In its third announcement of charges against underwriters under the MCDC Initiative, the SEC affirmatively stated that the actions would "conclude charges against underwriters." According to the SEC, the municipal underwriting firms charged comprised approximately 96% of the market share for municipal underwriting services.

On August 24, 2016, the SEC announced that it had entered into settlement agreements with 71 issuers in connection with the MCDC Initiative. The SEC found that the issuers had sold municipal bonds using offering documents that contained materially false statements or omissions about their prior compliance with continuing disclosure obligations.

A review of the cease and desist orders relative to the settlements with these issuers provides the following insights:

- The bulk of the orders related to issuers that, despite either stating within official statements that the issuers had materially complied with prior undertakings or omitting to state whether they had so complied, failed to file annual financial information, audited financial statements, or both on more than one occasion during the prior five year period. This indicates that such failures are considered material failures to comply with a continuing disclosure undertaking. For example, one issuer "filed its audited financial reports for fiscal years 2006, 2007, 2009, and 2010 late by two months, two months, a month, and nine months, respectively, and failed to file timely certain operating data for fiscal years 2008 through 2010. [The issuer] also failed to file timely notices of late filings for each of those."
- Depending on the facts and circumstances, a single failure to file audited financial statements and/or annual financial information could be considered a material failure to comply with a continuing disclosure undertaking. For example, one issuer stated that it had not failed to comply

with its prior continuing disclosure undertakings in any material respect, but it had actually filed one set of audited financial statements 1,014 days late. The orders did not contain any allegations of an issuer with a single failure to file within a short timeframe (i.e. less than one month after being due).
- Depending on the facts and circumstances, even an issuer's failure to file notices of defeasances could be considered a material failure to comply with a continuing disclosure undertaking. For example, in one order, the issuer "failed to file certain notices of defeasances prior to the offering, though due before, resulting in bonds in the outstanding principal amount of over $24.5 million trading with significantly different credit structures for up to two years." No other failures by that issuer were noted within the order. However, it is implicit in the order that the failure to file potentially caused a large number of bonds to be traded without material information regarding the security for the bonds.
- As evidenced by the repeated references in the orders to issuers failing to file notices of late and delinquent filings, the filing of such notices could potentially mitigate the consequences of the issuer's original failure to file. Similarly, many of the orders emphasized the fact that filings should have been made before the offering document at issue was circulated, indicating that an issuer could potentially lessen the severity of an enforcement action if it corrects any failures prior to subsequent bond offerings.

The summaries above are provided for illustrative purposes only. Notwithstanding the general insights from the cease and desist orders summarized above, if an issuer is concerned about either ongoing compliance with its continuing disclosure undertakings or potential exposure to an SEC enforcement action, it should discuss the matter directly with its bond counsel, disclosure counsel or both. In such an event, the issuer and legal counsel should assess the unique facts and circumstances of the issuer, its continuing disclosure compliance history and the potential legal consequences, if any, in light of the guidance afforded by the MCDC Initiative enforcement actions.

The issuers included within the August 24th actions were diverse, including two states, seven state authorities, eight special districts and local authorities, six institutions of higher education (including a non-profit education foundation), 31 localities, eight school districts, five hospitals, one retirement community, one charter school, and two private service providers. All issuers received what the SEC has characterized as "favorable settlement terms." Such terms included compliance with a cease and desist order, but did not contain an admission or denial by the issuer with respect to the SEC's findings or a requirement that the issuer pay fines to the SEC. In addition, the orders required the issuers to:

- 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 Enforcement 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 SEC 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.

It is unclear whether the August 24th charges represent the only round of enforcement actions that will be brought by the SEC against issuers. Unlike the SEC's third round of actions against municipal underwriting firms, the SEC did not indicate that this would "conclude" their actions against issuers. Rather, the SEC stated that the actions were "**the first** against municipal issuers

since the first action under the initiative was announced in July 2014." But some observers have speculated that this will be the only round of enforcement actions against issuers, noting that the SEC has already shown that continuing disclosure failures are not an isolated or infrequent issue. Other observers have speculated that the SEC will now pursue enforcement actions against issuers and underwriters that did not voluntarily self report pursuant to the MCDC Initiative. Since the MCDC Initiative did not apply to individuals, the SEC could also potentially pursue individuals involved in municipal offerings containing material misstatements and omissions related to compliance with prior continuing disclosure undertakings.

While it is not clear whether more charges against issuers will follow in connection with the MCDC Initiative, it is clear that the SEC is focused on material misstatements regarding prior compliance with continuing disclosure undertakings. According to the SEC, the "diversity among the 71 entities in these actions demonstrates that continuing disclosure failures were a widespread and pervasive problem in the municipal bond market." The cease and desist orders should send a strong message that representations within bond offering documents related to prior compliance with continuing disclosure undertakings should be diligently vetted by both issuers and underwriters.

Last Updated: September 1 2016

Article by James Hernandez, Thomas A. Sage, Rick Witte and Edward B. Morse

Andrews Kurth LLP

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.