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SEC, FINRA Probing Dealers Over Issuers' Continuing Disclosure Compliance.

In a precedent-setting action, the Securities and Exchange Commission is investigating whether underwriters are fulfilling their obligations to determine if issuers are complying with their continuing disclosure requirements.

The probe, which appears to initially be focused in California, has led underwriters to fear enforcement action may be forthcoming, with SEC charging firms for violating its Rule 15c2-12 on disclosure, Municipal Securities Rulemaking Board rules, or even securities fraud laws.

In addition, the Financial Industry Regulatory Authority is examining whether dealers have checked issuers' continuing disclosure compliance before selling their bonds, leading dealers to fear it could fine them for rule violations, sources said.

The SEC and FINRA probes have spurred firms to start scrutinizing their practices and whether they have policies and procedures in place to track issuer disclosure filings and compliance.

One bond lawyer said dealers are nervous about being caught in a "pincer" between the two regulatory bodies. If that happens, he said, it could be a shock that puts even smaller firms on alert.

The SEC probes appear to have originated from the commission's San Francisco office and a heavily-redacted copy of an SEC document request has circulated among some bond lawyers. The request, sent to at least one dealer and several issuers, asks for all documents showing disclosure-related communication between the issuer and underwriter, as well as the names of all issuer officials involved in the drafting of official statements and all underwriter personnel involved in the solicitation and underwriting of several series of bonds.

Rule 15c2-12 requires underwriters to reasonably determine that the issuer will comply with its continuing disclosure agreement before underwriting any new municipal securities. The SEC has said that underwriters may not rely solely on the word of the issuer that it has been and will remain in compliance. Underwriters are required to determine themselves if an issuer has a history of failing to comply with its disclosure obligations. An issuer is supposed to disclose in official statements any material failures to comply with its obligations over the past five years.

In addition, dealers are required to have a reasonable basis for recommending the sale of an issuer's bonds and that includes checking its compliance with its continuing disclosure obligations. An issuer is supposed to file a material event notice to disclose when fails to comply with these obligations.

Broker-dealers are also required, under the Municipal Securities Rulemaking Board's Rule G-27, to have written policies and procedures to ensure they comply with the Securities Exchange Act of 1934, including Rule 15c2-12.

The probes comes after the SEC issued a risk alert on March 19 last year warning that some underwriters do not have adequate written evidence to show they have adequately determined whether state and local governments have met their continuing disclosure requirements before underwriting or selling their bonds to investors.

The SEC has never taken enforcement action against an underwriter for failing to check to see if an issuer has met its disclosure filing obligations, perhaps because the commission is sensitive that its entire disclosure regulatory scheme must go firms to get to issuers since it cannot regulate issuers.

But California could prove to be fertile ground for the SEC if it means to initiate an enforcement action. Several sources believe SEC enforcement action is forthcoming. The Golden State accounts for more bond volume than any other and it has already been demonstrated that many issuers there are woefully out of compliance.

A 2011 California Debt and Investment Advisory Commission report found that more than one in four issuers in the state failed to file their annual financial reports on time, and that only 60% of K-12 school districts filed on time. The report showed that 18% of school districts did not file at all. One market participant, who preferred not to be named, said the SEC could make a case against an underwriter under this rule very easily. Instead of the depositions and other legwork involved in a typical fraud enforcement case, regulators would need only to identify a non-compliant issuer and then obtain a copy of an official statement to demonstrate a shortcoming in the underwriter's approach.

"There's not a whole lot of heavy lifting involved," the market participant said.

The combination of the risk alert, the SEC investigation in California, and the FINRA examinations have thrown a scare into dealers, with many now doing more research on issuers' disclosure compliance.

"What we're seeing is a great deal more attention to it," said Bob Feyer, an attorney at Orrick, Herrington & Sutcliffe LLP. Feyer said firms are now either bringing in outside firms to do the necessary research or assigning an in-house teams to tackle it. On some occasions underwriters have insisted an issuer take some remedial action before underwriting the securities, such as hiring compliance reporting company DAC Bond. Feyer said the more intense scrutiny has shown that compliance problems at issuers are widespread. "Many issuers, including some very sophisticated ones, have made some mistakes," he said.

Bill Hirata, a lawyer at Parker Poe in Charlotte, N.C., agreed that underwriters are sitting up and taking notice of the SEC's intentions. "There is a lot more underwriter attention to past failings," Hirata said.

A securities lawyer who did not want to be named said current SEC and MSRB rules and guidance make it clear that underwriting firms have to have policies and procedures in place to properly assess issuers, but that it remains murky as to what minimum protocols would satisfy the rule.

Leslie Norwood, managing director, co-head of the municipal securities group and associate general counsel at the Securities Industry and Financial Markets Association said the group is not working on any specific guidance but is supportive of more disclosure enhancement. "While we are not currently engaged in a specific project focused on what minimum policies and procedures satisfy 15c2-12, SIFMA has long supported efforts to improve disclosure and to help foster compliance with disclosure requirements," Norwood said. "We wholeheartedly supported the establishment of EMMA and previous amendments to 15c2-12 which were necessary to accommodate the continuing disclosure service, as they promote market efficiency, protect investors by giving free Internet access to this information, and assist the compliance obligations of market participants and the regulatory oversight responsibilities of regulators. SIFMA also supports enhancements to EMMA that would send periodic reminders to issuers as certain annual continuing disclosure deadlines approach."

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