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MCDC Spurs More Notices of Disclosure Failures.

WASHINGTON — Issuers are disclosing more failures to comply with their continuing disclosure agreements than in past months — a development some market participants said stems from a Securities and Exchange Commission’s program encouraging them and their underwriters to self-report instances in which bond documents falsely stated the issuer was in compliance with its CDA.

Event notices of failures to comply with CDAs posted by issuers to the Municipal Securities Rulemaking Board’s EMMA website in April and May far exceeded those in any of the previous several months before the announcement of the SEC’s Municipalities Continuing Disclosure Cooperation initiative on March 10.

Searches for such event notices reveal almost 300 were posted in both April and May, compared with less than 100 in February.

The MCDC focuses only on OS’ that omitted past disclosure failures. Correcting past mistakes does not shield an issuer from SEC action, but some market participants said the controversial program’s existence has spurred a much more detailed look at whether any disclosure failures have remained unacknowledged.

“We’re taking a second look to make sure,” said Anthony Inverso, a senior managing director at municipal advisor firm Phoenix Advisors in Downingtown, Pa.

Phoenix filed a May 27 notice on behalf of one of its clients, Hamilton Township, N.J., indicating that the municipality failed to file its annual financial information in a timely manner in 2008, 2009, and 2010. Under a provision of the SEC’s Rule 15c2-12 on disclosure, an OS must disclose anytime within the last five years that the issuer failed to meet its self-imposed deadline for filing annual financial and operating information filing. But in 2010, Hamilton sold more than \$24 million of general obligation bonds and said in the official statement that its filings were late only in 2002, 2003, 2006, and 2007.

The MCDC allows issuers and underwriters to get favorable settlement terms if they voluntarily report their own CDA violations by Sept. 10, when the initiative expires. The program creates what SEC enforcement officials have termed a “modified prisoner’s dilemma,” in that it creates tension between issuers and underwriters who can effectively turn one another in to the SEC.

Dealer groups have said most firms will probably participate in the MCDC, tempted by the promise of relatively low financial penalties, which cannot exceed \$500,000. Issuers face no financial penalties if they participate, but would effectively be pleading guilty to securities fraud and would be it with an order to cease and desist from further such violations.

Inverso said he is very aware of the MCDC and the SEC’s increased scrutiny of continuing disclosure in general. The SEC issued a risk alert in March 2012 warning that underwriters can be exposed to enforcement action if they do not have policies and procedures in place that allow them to reasonably determine that issuers will comply with their continuing disclosure obligations.

In November, the SEC collected the first ever financial penalty from a muni issuer when it fined both an issuer in Wenatchee, Wash. and its underwriter Piper Jaffray & Co., in connection with misleading investors with false information in an official statement.

"It's important to make sure everything is done to a 't,'" Inverso said. "You could get the wrath of the SEC on you." Inverso added that the SEC's intense focus on this issue will probably result in many issuers making corrections to their filings on EMMA.

Some issuer officials have questioned whether the MCDC initiative is an SEC scare tactic, but the commission has maintained that the purpose of the entire effort is to improve the disclosure behavior of market participants.

"You may see a flood," Inverso said of the corrected filings and past failure notices. "I think you'll see quite a few."

Issuers who participate in the MCDC will have to take remedial action to correct their failings, including filing any necessary notices, annual financial reports, or other obligated information to EMMA. They would have 180 days after the SEC files the MCDC case to correct delinquent filings. Securities lawyers said it is unlikely that any issuers have concluded an MCDC agreement yet, but that many are aware of the program and are taking it seriously.

Michael Decker, managing director and co-head of municipal securities at the Securities Industry and Financial Markets Association, said he does not know if issuer notices of disclosure failures are connected to the MCDC program, but acknowledged that it has "magnified" awareness of 15c2-12 obligations. Many dealer firms are still in the process of looking back over the last five years' worth of their transactions to see if they have any problematic ones that might warrant self-reporting, he said.

Some issuers said their recent corrections had nothing to do with SEC activity. Rockland County, N.Y. disclosed in an event notice filed on May 27 that it had not filed notices of its rating changes in a timely fashion several times from 2009 to 2012, during which time both Standard and Poor's and Moody's Investors Service cut the county's rating multiple notches. Stephen DeGroat, deputy commissioner of finance for Rockland County, said the notice wasn't inspired by any looming SEC threat, but is instead part of the county's continuing effort to recover from recent hardship.

Cindy Epperson, finance and budget director for Yakima, Wash., said she has heard of the MCDC and knows the SEC is becoming more serious about preventing disclosure-based fraud. But she said that Yakima's recent admission that it failed to disclose bond insurer downgrades and was late filing some financial operating data was prompted by a new bond offering and the past mistakes were detected either by the underwriter or by bond counsel.

Securities lawyers said issuers should be making an effort to correct past mistakes on EMMA, but added that there is no "one size fits all" advice for issuers considering whether or not to participate in the MCDC if they find themselves eligible.

"We're trying to encourage issuers to review their records," said Teri Guarnaccia, a partner at Ballard Spahr in Baltimore. "We think that if they found a failure, they should correct it."

Guarnaccia said the key issue for participation in the MCDC is whether an issuer's claim in its OS that it was in compliance with its CDA, when it wasn't, is materially misleading. The SEC has said it is highly unlikely to offer any guidance on what it would consider material, despite calls from issuers, underwriters, and many attorneys to do so. Materiality has generally been defined in

Supreme Court cases as whether an investor would want to know the information in question before making an investment decision.

Guarnaccia said underwriters are probably more likely to have a tendency to report more failures as material than issuers. She added that, while making corrections or new disclosures on EMMA will not save an issuer from SEC scrutiny if a past bond sale had a misleading OS, it will at least prevent future OS' from containing false statements.

Kenneth Artin, a shareholder in Bryant Miller Olive's Orlando office, said his firm is getting calls from issuers asking them what to do. "It's a case-by-case situation," he said. "It has heightened the awareness of continuing disclosure."

Orrick, Herrington, & Sutcliffe has put together a national task force of its lawyers to work on the MCDC, said Roger Davis, a partner in the firm's San Francisco office and chair of its public finance practice. That task force includes former SEC muni enforcement leader Elaine Greenberg, who joined Orrick's Washington, D.C. office last year. Davis said there is no generic advice to be offered to potential MCDC participants, and called counseling such clients a "tricky exercise."

"This is occupying a lot of people's time and attention," he said.

Market participants have expressed a desire to see the MCDC extended beyond its current expiration date, to include the remainder of 2014 or possibly beyond. SEC officials have downplayed that possibility.

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