[Bond Case Briefs]

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[Lawyers: MCDC Changes Foster More Tension.]

WASHINGTON – The Securities and Exchange Commission's changes to its disclosure violation self-reporting program are somewhat helpful to issuers but may create further problems in their relationships with underwriters, market participants said.

This was the reaction from lawyers, issuers, and dealer groups to the SEC's July 31 announcement that it is altering its Municipalities Continuing Disclosure Cooperation Initiative to encourage more participation.

The MCDC allows issuers and underwriters to get favorable settlement terms if they voluntarily report, for any bonds issued in the last five years, any time they inaccurately claimed to be complying with continuing disclosure obligations. The modifications include pushing back the deadline to Dec. 1 from Sept. 10, 2014 for issuers and borrowers, but not for underwriters.

"I don't think this is as helpful as the SEC thinks it is," said Teri Guarnaccia, a partner at Ballard Spahr in Baltimore. "The extension is de facto just creating further tension."

Guarnaccia explained that the SEC's decision to alter the MCDC's civil penalties cap for underwriters just further incentivizes the smallest dealers to participate. Originally all underwriters' penalties would be capped at $500,000 under the program, but the new approach bases penalties on a dealer's size. Civil penalties will now be capped at $500,000 for dealers who report total revenue of more than $100 million for fiscal 2013 on their annual audited report; $250,000 if they report fiscal 2013 revenue of between $20 million and $100 million; and $100,000 if they report fiscal 2013 revenues of less than $20 million.

The low caps are a major incentive for the smaller dealer firms, but the MCDC's "prisoner's dilemma" structure means that a dealer can "rat out" an issuer by reporting a misleading transaction, and vice versa. Both sides of the market have said issuers and underwriters need to have an open dialogue about how to proceed on deals they both participated in, but Guarnaccia said that all those conversations still need to take place by the original deadline despite the extension for issuers.

John Grugan, a partner in Ballard's Philadelphia office whose practice focuses on securities litigation, said the changes will not affect the way underwriters analyze what to self-report. Grugan agreed that the change provides little help for potential MCDC participants.

"I think it's a very marginal benefit," he said.

Grugan has cautioned that SEC examinations under the MCDC could easily transform into other enforcement actions, and said potential self-reporters can still face "pretty significant consequences," by voluntarily disclosing past violations.

Ballard issued a client alert pointing out that it is not clear whether issuers and borrowers will benefit from any cease and desist orders announced against underwriters prior to their new self-reporting deadline. The SEC, in its lone MCDC case to date, that charged Kings Canyon Joint Unified School District with misleading bond investors in a 2010 deal, frustrated some attorneys by not disclosing which missed filings resulted in the cease and desist order.

Ben Watkins, chairman of the Government Finance Officers Association's debt committee and Florida's bond finance director, said the issuer deadline extension is helpful but the failure to extend it for underwriters will result in erroneous reports. Watkins said it is "an extremely heavy lift" for underwriters to go through all their deals before the deadline, and their strong incentive to report will result in errors. Watkins said GFOA is still advising issuers to let underwriters comb the deals and then make a determination with the help of counsel about how to proceed.

Watkins added that it is helpful for the SEC to acknowledge the difficulty of searching the old Nationally Recognized Municipal Securities Information Repository [NRMSIR] system which pre-dated EMMA. The SEC said participants "may use reasonably available sources of information to make good faith efforts to identify potential violations" pre-EMMA.

John McNally, a partner at Hawkins Delafield & Wood in Washington, said the extension for issuers is welcome but that underwriting firms have much more review work to do, perhaps exceeding 1,000 official statements.

"So while some delay for issuers beyond the underwriter deadline is appropriate, it would be good to have seen a three- to six-month extension for the underwriters," he said.

Jessica Giroux, senior counsel and senior vice president for federal regulatory policy at Bond Dealers of America, said the change "strains the relationship" between issuers and underwriters, because underwriters cannot be sure what issuers might do in the months after the underwriter deadline. Although that is a concern, BDA is encouraged that a change was made.

"They responded to the industry," Giroux said. "That means something."

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