Bond Case Briefs

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Pepper Hamilton: Extended SEC MCDC Initiative Deadline Does Little to Lessen Urgency.

The Securities and Exchange Commission (SEC) has recently modified its Enforcement Division's Municipalities Continuing Disclosure Cooperation (MCDC) Initiative in order to encourage as much participation in the program as possible.

Under the Initiative, the SEC has agreed to recommend favorable settlement terms for issuers, obligors and underwriters of municipal securities who voluntarily report materially inaccurate statements made in offering documents regarding prior compliance with continuing disclosure obligations. Issuers, obligors and underwriters can take part in the MCDC Initiative by completing and submitting a questionnaire by the required deadlines. If the SEC determines the violations should be processed under the MCDC Initiative, the SEC will abide by a predetermined schedule of settlement terms that are relatively lenient and include certain remedial measures aimed at ensuring accurate disclosures.

Extended Deadline for Issuers and Obligors Only

To allow issuers and obligors more time to self-report potential violations, the division has extended the deadline from September 10, 2014 to December 1, 2014 (5:00 p.m. EST). For underwriters, the deadline remains unchanged, ending at 12:00 a.m. EDT on September 10, 2014. To encourage greater participation for underwriters, however, the division has implemented a tiered approach that caps civil penalties according to the size of the firm, which is as follows:

- underwriters with 2013 reported total annual revenue more than $100 million – capped at $500,000
- underwriters with 2013 reported total annual revenue between $20 million and $100 million – capped at $250,000
- underwriters with 2013 reported total annual revenue less than $20 million – capped at $100,000.

Limited Guidance on 'Materially Inaccurate'

Since announcing the Initiative, the division has offered little guidance as to what constitutes "materially" inaccurate disclosures. In a recent case that involved a settlement agreement between the SEC and the State of Kansas, the SEC charged that the state made materially misleading statements by failing to disclose that its pension system was significantly underfunded and posed a risk to the repayment of some municipal bonds. Shedding some light on its notion of materiality, the SEC made clear that violations not only result from materially inaccurate statements, but they also involve the failure to disclose material facts, such as facts relating to the issuer's true financial condition; conflicting interests of various parties; how bond proceeds were used or invested; or how the valuation of bond-financed property was determined.

Finally, although the SEC intended its modifications to the MCDC Initiative to promote greater participation, by extending the deadline for issuers and not underwriters, the SEC has increased the potential for conflict between the interests of issuers and those of underwriters. Because the underlying set of facts only concerns whether there was a material misstatement or omission in a final official statement, both the issuer and the underwriter have potential securities law liability. To obtain the favorable settlement terms, each of these parties has to self-report. If one party self-reports first and the other does not, then a problem arises for the non-reporting party in the event that the SEC staff determines that the facts warrant enforcement action.

Failure to Properly Use Proceeds

Post-bond-issuance monitoring, and associated policies and procedures must be in place. Have you determined whether the facility, built with proceeds from tax-exempt bonds, is being leased out for unauthorized commercial purposes, for example, power generation, cell transmission towers, or to softball and basketball leagues? A qualified private activity bond issue can lose its tax-exempt status if a failure to properly use proceeds occurs subsequent to the issue date, which results in sufficient nonqualified use to cause the issue to fail any of the applicable use requirements. Hence, the issue becomes a taxable private activity bond issue. Generally, a failure to properly allocate proceeds occurs when an action is taken which results in the bonds not being used for the qualified purpose for which they were issued. However, with respect to unspent proceeds, a failure to properly use those proceeds may occur as early as the date on which either the issuer or conduit borrower reasonably determines that the bonds will not be expended on the qualified purpose for which they were issued. More than just a tax issue, however, failure to put proceeds to proper use is a material inaccuracy subject to self-reporting under the MCDC Initiative.

Limitations on Acquisition of Land or Other Property

Under section 147(c) of the Internal Revenue Code, a qualified private activity bond will lose its tax-exempt status if 25 percent or more of the net bond proceeds are used directly or indirectly to acquire real property. However, certain exceptions to this rule are available.

Remedial Actions for Nonqualified Use

Treasury regulations provide that certain prescribed remedial actions can be taken to cure nonqualified uses of proceeds that would otherwise cause qualified private activity bonds to lose their tax-exempt status. Such remedial actions can include the redemption or defeasance of bonds and, when the disposition of bond-financed property is exclusively for cash, the alternative use of such disposition proceeds to acquire replacement property within six months of the disposition date. For conduit borrowers, it is important to assess whether you will be able to enter into a closing agreement under the TEB Voluntary Closing Agreement Program (VCAP).

Pepper Points

Despite the deadline extension, issuers and obligors should not relax their sense of urgency. Put appropriate post-issuance monitoring, policies, and procedures in place. From the outset, the SEC has made clear that where an entity could have self-reported under the MCDC Initiative but failed to do so, and the SEC later decides to bring an enforcement action, more severe sanctions and penalties will be targeted. Accordingly, the extended deadline simply offers the opportunity to accommodate a necessarily labor-intensive review process that will require careful attention to detail.

Issuers, obligors and underwriters all would be well-advised to review their compliance obligations in their offering documents through a wider lens. Beyond materially inaccurate statements, the SEC would appear to expect self-reporting of failure to disclose:

- issuer’s true financial condition
- conflicting interests of various parties
- failure to monitor and manage the legal use of tax-exempt bond proceeds
- methodology for valuation of bond-financed property
- any risk that bonds could lose their tax-exempt status, resulting in potential taxable income to bond holders.

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