

# **Bond Case Briefs**

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## **Foley & Lardner: Recent MCDC Settlements Provide Guidance Concerning Scope of Materiality in Continuing Disclosure Obligations.**

In responding to the Securities and Exchange Commission's recent Municipalities Continuing Disclosure Cooperation (MCDC) initiative, the unanswered question for many municipalities and broker-dealers was determining whether failure to disclose certain conduct under the relevant continuing disclosure obligations of an issuer or borrower (an "obligated person") of municipal securities constituted a "material" misstatement or omission under the SEC's view of federal securities laws. Some instances, such as a complete failure to file annual financial reports with the Municipal Securities Rulemaking Board's Electronic Municipal Market Access (EMMA) system, were undoubtedly material, but others, such as a filing that was late by only a few days or a failure to file a notice of a widely known rating downgrade of a bond insurer that insured an obligated party's bonds, were less clear. The SEC released the results of two rounds of settlements with broker-dealers under the MCDC initiative on June 18 and September 30, 2015. These initial settlements provide guidance concerning the SEC's views toward materiality relative to an obligated person's continuing disclosure obligations.

Each of the reported settlements between the SEC and a broker-dealer under the MCDC initiative has been identical, with two notable differences: the examples cited by the SEC and the amount of the assessed financial penalty. In each settlement, the SEC listed up to three examples of the due diligence failures that lead to the settlement — thereby helping to identify what the SEC deemed to be material omissions in disclosure. In addition, the amount of the financial penalty assessed on each firm differed depending upon several factors, including the number of violations found and the number and principal amount of the bonds underwritten by such firm over the prior five-year period. In each case, the broker-dealer settling with the SEC neither admitted nor denied the findings of the SEC. As a condition of the settlement, the SEC required each firm to hire an independent consultant to review the firm's policies and procedures regarding due diligence for continuing disclosure and adopt the recommendations of such consultant within 90 days of the report (or demonstrate to the SEC why such recommendations should not be adopted). Importantly, the terms of the settlements imposed by the SEC were fully consistent with the terms announced in the SEC's original notice of the MCDC initiative. Although there have been two rounds of announced settlements with broker-dealers, at least one more round of settlements with broker-dealers, likely followed by several rounds of settlements with obligated persons, is expected to follow.

### **Background and Issues Determining Materiality**

Although federal law prohibits the SEC from directly regulating issuers of municipal bonds, the SEC instead has imposed certain regulations on broker dealers pursuant to Rule 15c2-12, and specifically, regulations requiring broker-dealers to obtain undertakings from obligated persons that they will provide both ongoing annual financial information and notice of certain specified events, including a failure to file required annual financial information by the deadline in the continuing disclosure undertaking. Rule 15c2-12 also provides that it is unreasonable for a broker-dealer to

recommend the purchase or sale of a municipal security unless the broker-dealer has processes in place that provide reasonable assurance that it will receive prompt notice of events, including the failure to file annual disclosure. Further, Rule 15c2-12 provides that the Official Statement issued with respect to a bond issue must include, among other things, a description of all instances within the prior 5 years in which the obligated person has failed to comply, in all material respects, with previous continuing disclosure undertakings.

Responding to allegations that both obligated persons and broker-dealers were not meeting their obligations under Rule 15c2-12 to provide timely notices of the listed events and make timely filings of annual financial information, the SEC announced the MCDC initiative in the spring of 2014. The MCDC initiative provided that obligated persons and broker-dealers that self-disclosed to the SEC by stated deadlines their failures to comply with Rule 15c2-12's requirements regarding providing or monitoring ongoing disclosure within the prior 5 years would be eligible for settlements with the SEC on favorable terms. As a result, both broker-dealers dealing in municipal securities and obligated persons undertook reviews of their compliance with their continuing disclosure undertakings and many parties filed with the SEC by the September, 2014 deadline for broker-dealers and the December, 2014 deadline for obligated persons.

The primary issue that appeared to trouble participants in the market was determining whether an instance of non-compliance constituted a material failure. In general, whether a statement is material or not is determined under the standard articulated by the United States Supreme Court in *Basic v. Levinson*, which states that "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information." Rule 15c2-12 is only violated where an obligated person fails to comply with a continuing disclosure undertaking in all material respects. Accordingly, an immaterial failure would not be a violation of Rule 15c2-12 and would not be reportable under the MCDC initiative. Although market participants sought express guidance from the SEC on this issue, the SEC demurred. Thus, the recent settlements have provided needed guidance on the level of failures to comply with a continuing disclosure undertaking that the SEC considers to be material (and, by implication, those failures that may not be considered to be material.)

## **Lessons Learned From Recent Settlements**

**Failures Deemed Material.** The first lesson learned from the SEC's settlements to date under the MCDC initiative is that the majority of the cited failures to meet the requirements of Rule 15c2-12 are significant failures and would have been considered material by most participants in the municipal market. These include, for example, a complete failure to file any annual financial information and filings of annual financial information that were months late, often consistently so. In the vast majority of the cases where an obligated person failed to file its annual financial information in a timely manner, it also failed to file a notice with EMMA of its failure to file, as required under Rule 15c2-12.

**Failures Not Cited as Material.** Second, however, it is notable that other than the failure to file a notice of a late or missed filing of an annual financial filing, no other failures to file event notices have been cited in the SEC settlements. Following the financial crisis in 2008, the ratings of all of the municipal bond insurers were downgraded by the rating agencies and, therefore, the ratings on the bonds that were insured were also downgraded. (Notably, since 2008 certain bond insurers have received subsequent upgrades, as well.) One of the events for which a notice must be filed is a rating change to a municipal security subject to a continuing disclosure obligation. Although many obligated persons filed such event notices when the ratings on their bonds were downgraded due to the reductions in the ratings of the insurers, other obligated persons did not make such a filing, for various reasons, generally after determining that such a filing would not be material given the

widespread public knowledge of the downgrades. Although a definitive conclusion cannot be drawn from the SEC's failure to cite the lack of notices of downgrades on bond ratings due to such bond insurers' downgrades as a material omission, this omission does provide some comfort to those obligated persons that determined that failure to make such a filing was not a material omission.

The vast majority of the cited misstatements or omissions were from 2013 or before; very few were from 2014 and none were from 2015. This generally is consistent with many commentators' views that the participants in the municipal market are now highly sensitized to the importance of complying with their obligations under Rule 15c2-12 and may also indicate that the SEC's primary goal of the MCDC initiative — enhancing compliance with continuing disclosure obligations — has been realized.

**Additional Guidance.** One of the most hotly contested questions regarding materiality was how late a filing could be made before the lateness of the filing constituted a material failure to comply with the requirements of a continuing disclosure obligation. Although failure to file annual financial information in a timely manner constituted the majority of the cited material omissions, in no case was a late filing of less than 30 days noted (other than one instance where a filing was not only 16 days late, it was also incomplete), and in most cases, not only were the obligated person's filings much more than 30 days late, but there were multiple late filings, and notice of late filings were not made.

One trap for the unwary is that, although filings compliant with Rule 15c2-12 may be made by reference to other filed documents, a failure to make a filing with respect to each separate municipal security issue that cross references a recent filing, such as an Official Statement for a new issue that includes audited financial information and other required financial information, can constitute a failure to file. EMMA references municipal securities by the separate series or bond issue and by CUSIP number. Thus, if an obligated person wishes to use a recent filing to comply with its annual filing requirements, it must ensure that an appropriate cross-reference citing the location of the document is made with respect to each series of securities to which such requirements applies.

Another oft-cited failure was the failure to include operational data with an annual filing. Rule 15c2-12 requires that, in addition to filing audited annual financial statements, obligated persons must file annual financial information as described in the undertaking (which will typically reference certain financial and statistical information included in the Official Statement), for each obligated person for whom financial information or operating data is presented in the final Official Statement, or, for each obligated person meeting the objective criteria specified in the continuing disclosure undertaking and used to select the obligated persons for whom financial information or operating data is presented in the final Official Statement.

Lastly, the SEC settlements make clear that a material omission is not cured unless the omitted disclosure is filed with EMMA for each municipal security subject to a continuing disclosure undertaking, a notice of the previous failure to file is also filed with EMMA, and the Official Statements for the obligated person for the ensuing five years disclose the prior failures to file.

## **Recommendations**

By publishing examples of material omissions and misstatements in its settlements with broker-dealers under the MCDC initiative, the SEC has provided useful guidance to the municipal marketplace. Based upon these settlements, as well as other recent SEC actions relating to municipal securities, we believe that municipal issuers and borrowers of the proceeds of municipal bonds should consider taking each of the following steps:

- First, one or more officers of the obligated person should review the continuing disclosure undertaking relating to each series of outstanding municipal securities and be familiar with the information that must be provided annually, and quarterly in some cases, and the events that must be disclosed. It would likely be helpful to set up a “tickler” in the calendar of the officer responsible for making such filings – note that EMMA has recently added that capability to its system.
- Second, we believe that obligated persons should consider adopting disclosure policies and procedures that are consistent with the SEC’s oft-stated recommendations. These include designating a responsible person for preparing and making such filings, providing for regular training of the persons that will develop new issue and continuing disclosure, and outlining other relevant matters. In addition, we have noted that requiring that these policies be reviewed and, if appropriate, updated or re-authorized on a regular basis leads to enhanced compliance with and awareness of the requirements of the policies.
- Third, if a deadline for a required filing is missed, the obligated person should nevertheless make the filing as soon as possible, along with a notice of the failure to file. A slightly late filing may not constitute a material failure to comply with the requirements of Rule 15c2-12.
- Finally, the obligated person should ensure that annual filings and applicable event notices are filed with EMMA for each of the applicable series of bonds or other municipal securities, or that appropriate cross-references are filed. As noted above, using a recently filed Official Statement to provide the information required for an annual filing can be sufficient to meet the requirements of Rule 15c2-12, but only if there is an appropriate cross reference filed with EMMA for each applicable series of municipal securities.

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