SQUIRE SANDERS

SEC'S MCDC INITIATIVE OFFERS SELF-REPORTING PROGRAM FOR CONTINUING DISCLOSURE MISSTATEMENTS

The Division of Enforcement of the Securities and Exchange Commission (SEC) announced on March 10, 2014 a voluntary self-reporting program for issuers and underwriters for a limited time and covering a limited topic. Many are likening this program to the Internal Revenue Service "VCAP" program, which is offered to municipal issuers as a means to self-report federal tax compliance problems, but the SEC program is targeted to address only a single disclosure issue.

Some say the program is intended to provide the SEC with a list of market participants (bond, disclosure and underwriter's counsel, in particular) to target with its next round of enforcement actions. Regardless of the SEC's motivation, issuers and underwriters should weigh the benefits of participating in this voluntary enforcement proceeding against potential drawbacks, including a required commitment to cooperating with the SEC in future enforcement proceedings.

Essentially, the SEC program, called the "MCDC Initiative," permits issuers, obligated persons and underwriters, for a limited time only, to self-report misstatements concerning prior compliance with continuing disclosure obligations in an official statement for a municipal bond issue. In exchange, the SEC Division of Enforcement agrees to recommend "favorable" settlement terms for issuers and obligated persons, as well as for underwriters involved in the offering of those municipal securities.

For example, consider a local government that issued bonds in 2008 and entered into a continuing disclosure agreement to provide annual information and material event notices. That same local government issued additional debt in 2012 and included in its official statement a statement that the local government had complied in all material respects with all prior continuing disclosure undertakings. If that statement was inaccurate (i.e., the issuer had not complied in all material respects with its prior undertakings), then the MCDC Initiative offers a procedure for the issuer to settle with the SEC and resolve any federal securities liability with respect to the misstatement without paying a financial penalty to the SEC. Whether a misstatement is "material" is likely to be a significant issue in many, if not all, cases. Under the MCDC Initiative, if the Division concludes that there has been a violation, the settlement would require the issuer (or obligated person) to do the following as part of an agreed cease and desist order resolving the SEC proceeding:

- establish policies, procedures and training regarding continuing disclosure obligations within 180 days;
- comply with existing continuing disclosure undertakings and bring all prior filings up to date within 180 days of the institution of the proceedings;
- cooperate with any subsequent investigation by the Division regarding the false statement(s), including the roles of individuals and/or other parties involved;
- disclose in a clear and conspicuous fashion the settlement terms in any final official statement for an offering by the issuer within five years of the date of institution of the proceedings; and
- provide the SEC staff with a compliance certification regarding the applicable undertakings by the issuer on the one year anniversary of the date of institution of the proceedings.

For underwriters, the terms are not as favorable and require the underwriter to do the following as part of such a cease and desist order:

- retain an independent consultant to conduct a compliance review and, within 180 days of the institution of proceedings, provide recommendations to the underwriter regarding the underwriter's municipal underwriting due diligence process and procedures;
- within 90 days of the independent consultant's recommendations, take steps to enact such recommendations;
- cooperate with any subsequent investigation by the SEC regarding the false statement(s), including the roles of individuals and/or other parties involved; and
- provide the SEC staff with a compliance certification on the one year anniversary of the date of institution of the proceedings.

Additionally, although the Division of Enforcement will recommend there be no civil penalty for issuers, recommended monetary penalties for underwriters are as follows:

- For offerings of $30 million or less, the underwriter will be required to pay a civil penalty of $20,000 per offering containing a materially false statement.
- For offerings of more than $30 million, the underwriter will be required to pay a civil penalty of $60,000 per offering containing a materially false statement.
- No underwriter will be required to pay more than $500,000 total in civil penalties under the MCDC Initiative.

The MCDC Initiative affords no protection for any individuals, including issuer officials and employees, underwriter employees, the financial advisor and its employees, and the lawyers in the deal, including bond counsel, disclosure counsel and underwriter's counsel. As part of the MCDC Initiative process, the issuer must complete and submit a questionnaire that identifies the entire working group and must agree to cooperate with the SEC in any subsequent investigation regarding the misstatements.

It is very important to understand and appreciate that the MCDC Initiative is tantamount to voluntarily submitting to an SEC enforcement proceeding. Self-reporting will focus the Division of Enforcement on the misstatement as a potential violation of federal securities laws, for which individuals as well as entities could have liability. Any information submitted to the SEC on the questionnaire or otherwise in connection with enforcement proceedings is subject to federal perjury laws and penalties. Additionally, a settlement with the SEC will not resolve any potential criminal proceedings as neither the SEC nor its staff has the authority or responsibility for settling or otherwise disposing of criminal proceedings. That authority and responsibility are vested in the Attorney General and representatives of the Department of Justice.

The MCDC Initiative expires September 10, 2014, after which there is no assurance the Division of Enforcement will recommend the same settlement terms for issuers and underwriters that do not self-report pursuant to the terms of the MCDC Initiative. In fact, the Division specifically stated that it will likely recommend and seek financial sanctions in amounts greater than those available under the MCDC Initiative.

What Should Issuers and Obligated Persons Do in Response to This MCDC Initiative?

If the issuer or obligated person (collectively the "Issuer") has been diligent in its compliance with continuing disclosure undertakings and has accurately disclosed in its official statements any prior instances of material non-compliance, then the MCDC Initiative is of little importance to the Issuer.

If the Issuer's compliance is good now, but during the course of the last bond issue (or otherwise), the Issuer became aware that certain annual filings were filed later than the required date or the filings were incomplete (missing certain operating data tables, for example), the Issuer should review how this non-compliance was disclosed in any recent official statement (i.e., within the last five years). If the official statement accurately describes the prior non-compliance, the Issuer should have no reason to consider participating in the MCDC Initiative. If the disclosure in the official statement was not accurate, the Issuer should consult legal counsel to help determine whether, based upon all the facts and circumstances, the disclosure was materially misleading. The MCDC Initiative may afford some issuers and obligated persons an efficient method to address potential liability under federal securities laws.

Regardless of whether an official statement might have inadvertently misstated prior compliance, there are certain steps an Issuer can take now to protect itself from liability for disclosure lapses. In a series of settlement orders over the past few years and again in the MCDC Initiative's recommended settlement terms, the SEC refers to the implementation of appropriate policies and procedures and compliance training for Issuer officials and staff.

As we have stated in a previous alert, municipal issuers and obligated persons would be well-served to take a fresh look at their current compliance by discussing with their financial and/or administrative staff (and legal advisors) at least the following questions:

- Are you current in all filings required under continuing disclosure agreements?
- Have you filed all required material event notices over the past five years?
- What is your procedure for developing new disclosure documents either for new bond issues or for annual reports and providing "event" notices, and are these reflected in written policies and procedures?
- What do your official statements for recent bond issues say about your prior compliance with continuing disclosure?
- What is your procedure for review of information contained in your comprehensive annual financial report?
- Do the employees responsible for the preparation and/or review of disclosure materials have sufficient training?

Voluntarily implementing or enhancing formal written disclosure policies and procedures is good practice and, when done in advance of an SEC investigation, has been looked upon favorably by the SEC. If this is done on a widespread basis, it will improve the overall quality of disclosure in the municipal market and, perhaps, allay the SEC's call for legislative authority to require municipal issuers to adopt SEC mandated policies and procedures.

It has been reported that some underwriters are now combing their files to determine whether they have transactions that might fall under the MCDC Initiative. Although it is expected that an underwriter would alert the Issuer before submitting a transaction to the SEC under this initiative, notification is not required. If an Issuer decides to participate in the MCDC Initiative, it would be appropriate (but also not required) to advise the affected underwriter of that decision.

If you have questions about the MCDC Initiative or your prior compliance with continuing disclosure undertakings, or would like assistance in developing or implementing enhanced disclosure policies and procedures, please contact the Squire Sanders public finance lawyer with whom you regularly work.

The contents of this update are not intended to serve as legal advice related to individual situations or as legal opinions concerning such situations nor should they be considered a substitute for taking legal advice.

© Squire Sanders.

All Rights Reserved 2014

13398/05/14