GFOA ALERT: THE SEC MCDC INITIATIVE AND ISSUERS
GUIDANCE REGARDING ISSUER PARTICIPATION AND POTENTIAL IMPLICATIONS

The information contained in this document was developed to educate members about the SEC MCDC Initiative and should not be construed as legal advice.

On March 10, 2014, the Securities and Exchange Commission's Enforcement Division (the SEC) announced the Municipalities Continuing Disclosure Cooperation (MCDC) Initiative to provide issuers and underwriters the opportunity to self-report instances of ***material*** misstatements in bond offering documents regarding the issuer's prior compliance with its continuing disclosure obligations. The deadline for self-reporting under the MCDC Initiative is September 10, 2014. SEC is not defining the term ***material*** and has indicated that a determination of the materiality of submissions under the initiative will be made on a case by case basis depending on the overall facts and circumstances of a situation.

While SEC is encouraging issuers and underwriters to participate by offering predetermined and more lenient settlement terms, the GFOA is urging members to exercise caution and familiarize themselves with the details of the initiative before consenting to engage in this program. For example, though the terms of the initiative preclude SEC from imposing monetary fines on participating issuers, the SEC reserves the right to pursue separate enforcements against individuals within a government who it deems to be culpable of the misstatements. Additional information on individual liability and standardized settlement terms under the initiative are listed in Appendix A at the end of this document.

By way of background, SEC Rule 15c2-12 (the Rule) prohibits an underwriter from purchasing or selling municipal securities unless an issuer has committed to annually provide financial information and operating data specified in a written Continuing Disclosure Agreement (CDA). Additionally, the Rule requires underwriters to obtain and review a "final official statement" that discloses whenever the issuer has failed to file information required by the CDA during the previous five years. While the Rule only applies to underwriters and SEC is prohibited from directly regulating issuers under the 1975 Tower Amendment to the Securities Exchange Act of 1934 (Exchange Act), SEC has demonstrated through recent enforcement actions that making false statements in official statements about compliance with continuing disclosure obligations will be construed as securities law violations under Section 17(a) of the Securities Act of 1933 and/or Section 10(b) of the Exchange Act. Due to the typical five-year statute of limitations for securities law violations, the MCDC Initiative covers bond transactions dating back to September 2009. However, since final official statements must disclose compliance failures for the five years prior, the scope of the initiative actually looks back to 2004.

In response to the MCDC Initiative the underwriter community is actively conducting internal compliance investigations by reviewing the official statements for all bonds underwritten over the last five years and associated continuing disclosure filing data, to confirm whether the official statements for this period accurately described the issuer's prior compliance with continuing disclosure undertakings. The MCDC Initiative incentivizes underwriters to participate by placing a cap of $500,000 on all instances of material misstatements contained in an underwriters MCDC report. As a result many underwriters have indicated their intent to participate in the initiative, and are now compiling a list of bond issues that contain a misstatement regarding continuing disclosure compliance so that they can limit their financial and legal exposure to potential SEC enforcement actions. The lists being compiled by underwriters will identify issuers that the underwriters believe have not made all of their continuing disclosure filings required by the CDA, but indicated they have done so in official statements.

In most cases these lists will be compiled using continuing disclosure filings since 2009 made through the MSRB's Electronic Municipal Market Access (EMMA) platform. However, some underwriters are

attempting to verify filings prior to 2009 when the dysfunctional Nationally Recognized Municipal Securities Information Repository (NRMSIR) system was in use. This is likely to lead to many erroneous findings of failures to file because of the known deficiencies of the NRMSIR system and difficulties in locating filings. Although underwriters are being encouraged to contact issuers with the results of their review to discuss any potential misstatements, they are not required to do so and may not have time to contact all issuers because of the unreasonably short deadline for the MCDC Initiative (September 10, 2014). These factors could result in underwriters participating in the initiative and falsely reporting that statements made by issuers pertaining to their prior continuing disclosure compliance are material misstatements when in fact they are not. For these reasons issuers should consider contacting all underwriters who have been senior or co-managers on their bond deals over the past five years and asking these underwriters for at least a month of notice in advance of September 10 of any planned participation in the MCDC initiative related to these bonds.

Further, if issuer is unsure of prior compliance or has reason to believe that it has failed to file information required by its CDA and inaccurately described this failure in its official statement over the last five years, they should consult with their legal counsel to ensure prior compliance. Issuers can evaluate the MCDC Initiative in light of their own circumstances and review their compliance with the CDA by using the guidance outlined below.

Guidance on Self-Examination in Response to MCDC Initiative:

- ***An issuer should disregard the MCDC Initiative entirely if:***
  - Has not issued bonds within the last five years.
  - Has issued bonds in the last five years but has:
    - personal knowledge and supporting documentation that continuing disclosure filings required by the CDA have been made;
    - policies and procedures in place to ensure compliance; or
    - an outside vendor or counsel under contract engaged to assist with continuing disclosure filings that can confirm continuing disclosure compliance for the five-year period in question.
- If an issuer has publicly offered bonds since September 10, 2009 and is unsure whether it has complied with continuing disclosure undertakings, it should:
  - Review the description of past compliance in any official statements for bonds issued during the past five years. (The section is typically titled “Continuing Disclosure” in the official statement).
  - If the description in the official statement says the issuer is in compliance with its continuing disclosure requirements, consider the best way to verify the statement including:
    - review of internal files that document continuing disclosure filings made on EMMA;
    - if internal files not maintained, review EMMA to verify continuing disclosure filings made;
    - contact the senior managing underwriter for the bond issue to determine if they have files documenting compliance with the CDA or are conducting a review of their prior bond deals to identify possible non-compliance; or
    - contact appropriate transaction participants that would be most knowledgeable about this matter, e.g., underwriters counsel, disclosure counsel, financial advisor or bond counsel.

- If the information in the official statement describes any instances of prior non-compliance (including instances that may be immaterial), the issuer can probably conclude that it has not misstated compliance and no further investigation is necessary.

- If an issuer discovers through a self-examination or through a discussion with counsel or an underwriter that the final official statement potentially contains inaccurate statements relative to past compliance with continuing disclosure obligations, the issuer should:
  - Contact the bond or disclosure counsel to assess the materiality of the misstatement and assess/discuss the advantages/disadvantages of self-reporting under the MCDC Initiative if the misstatement is determined to be material.
  - Correct any prior non-compliance, if possible.
  - Adopt or enhance policies and procedures to ensure compliance with continuing disclosure obligations going forward and add a process for the thorough review of all issuer statements in the final official statement regarding compliance with the CDA.
  - Adopt policies and procedures that require all filings on EMMA to be documented and maintained.

Take the MCDC Initiative Seriously but Exercise Caution

The legal consequences of participating in the MCDC Initiative are significant and should be thoroughly evaluated with the assistance of counsel. Issuers should also consider the following information if contacted by an underwriter or asked to participate in the MCDC Initiative:

- Consult with legal counsel and exercise caution when determining if self-reporting under the MCDC Initiative is beneficial.
- Participating in the MCDC Initiative will need to be approved by the governing board of the issuer because of its legal significance.
- Self-reporting under the MCDC Initiative ***does not limit the personal liability of municipal officials and may expose an issuer or official to further SEC investigation and enforcement.***
- Self-reporting under the MCDC Initiative requires an issuer to sign and submit a questionnaire. By signing the questionnaire, the issuer:
  - Agrees to cooperate with the SEC and testify in the event of an SEC investigation; and
  - Consents in advance to all settlement terms (which will likely require approval of the governing body of the issuer prior to submission).
- Financial penalties for underwriting firms participating in the MCDC are capped at $500,000. As a result, ***underwriters have an incentive to over-report transactions without regard to materiality of any misstatements***.
- If contacted by an underwriter, request the underwriter's list of findings so that the issuer can either verify that they are accurate or show that they are erroneous. Additionally, the facts can be evaluated to determine whether any inaccuracies are considered "material".

GFOA Advocacy on the Initiative

In an effort to streamline the requirements of the MCDC Initiative, make any review of CDA compliance process more manageable, and avoid unnecessary costs to issuers and underwriters, GFOA and several other industry groups including the National Association of Bond Lawyers (NABL) and Securities

Industry and Financial Markets Association (SIFMA) met with the SEC Enforcement Division staff on June 18, 2014 and requested, among other things, the following:

- An extension of the deadline for participation in the MCDC Initiative to ensure that issuers and underwriters have sufficient time to work together to self-report true instances of non-compliance and allow time for issuers to meaningfully evaluate the merits of participating in the MCDC Initiative.
- A narrowing of the scope of the review to only consider annual filings made to the MSRB's EMMA platform after July 1, 2009.
- A clarification from SEC as to what will ***not*** be considered *material* under the initiative.

The initial feedback from the SEC indicated an unwillingness to streamline the MCDC Initiative to improve the efficiency and effectiveness and reduce the uncertainties and burdens being imposed on issuers. GFOA will continue to press for common-sense changes to modify the MCDC Initiative and focus on constructive ways to improve continuing disclosure compliance.

Resources

- SEC MCDC Initiative
- GFOA Best Practice: Understanding Your Continuing Disclosure Responsibilities (2010)
- GFOA Best Practice: Using the Comprehensive Annual Financial Report to Meet SEC Requirements for Periodic Disclosure (2006)

APPENDIX A

Standardized Settlement Terms and Individual Liability

SEC's Enforcement Division has established standardized settlement terms for participating issuers and underwriters under MCDC, which are covered on pages 4-5 of the MCDC summary released by SEC on March 10, 2014, and are reiterated below.

For Issuers

- establish appropriate policies and procedures and training regarding continuing disclosure obligations within 180 days of the institution of the proceedings;
- comply with existing continuing disclosure undertakings, including updating past delinquent filings 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 Commission 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 eligible issuers, the Division will recommend that the Commission accept a settlement in which there is no payment of any civil penalty by the issuer.

For Underwriters

- retain an independent consultant, not unacceptable to the Commission staff, 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 reasonable steps to enact such recommendations; provided that the underwriter make seek approval from the Commission staff to not adopt recommendations that the underwriter can demonstrate to be unduly burdensome;
- cooperate with any subsequent investigation by the Division regarding the false statement(s), including the roles of individuals and/or other parties involved; and
- provide the Commission staff with a compliance certifications regarding the applicable undertakings by the Underwriter on the one year anniversary of the date of institution of the proceedings.
- For eligible underwriters, the Division will recommend that the Commission accept a settlement in which the underwriter consents to an order requiring payment of a civil penalty as described below:
    - 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;
    - However, no underwriter will be required to pay more than $500,000 total in civil penalties under the MCDC Initiative.

Individual Liability

As mentioned earlier in this document, though the terms of the initiative preclude SEC from imposing monetary fines on participating issuers, the SEC reserves the right to pursue separate enforcements against individuals within an issuing entity who it deems to be culpable of material misstatements reported under MCDC.