# MCDC INITIATIVE

## CONSIDERATIONS FOR ANALYSIS BY ISSUERS OF MATERIALITY AND SELF-REPORTING


National Association
*of* Bond Lawyers

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PHONE 202-503-3300 601 Thirteenth Street, NW
FAX 202-637-0217 Suite 800 South
www.nabl.org Washington, D.C. 20005



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Fellow NABL Members:

The paper that follows describes considerations for analysis by issuers and obligated persons involved in the offer or sale of municipal securities (collectively, "issuers") of materiality and self-reporting under the "Municipalities Continuing Disclosure Cooperation Initiative" (the "Initiative") announced on March 10, 2014, by the Division of Enforcement (the "Division") of the Securities and Exchange Commission. The Board of Directors of the National Association of Bond Lawyers ("NABL") has authorized the distribution of this paper to our members and other interested municipal market participants.

The Initiative has a raised a number of interpretative issues. A key interpretative issue is the meaning of "material" in the context of the Initiative. As this paper explains, issuers considering whether to self-report under the Initiative must analyze "materiality" in addressing two different questions: first, whether a prior official statement contains a misstatement (which turns on whether the issuer failed to comply in all material respects with its previous continuing disclosure agreements) and second, if so, whether such misstatement is material within the meaning of the general antifraud provisions of the federal securities law. As this paper also explains, this analysis is different than the decisions made on a daily basis about disclosure in official statements, in which issuers and their counsel almost always avoid reaching conclusions about materiality and err on the side of disclosure.

NABL exists to promote the integrity of the municipal market by advancing the understanding of and compliance with the law affecting public finance. This paper has been prepared by a special committee in furtherance of that mission. NABL Past President John McNally spearheaded the work of the committee and led the drafting effort, with substantial contributions from Ken Artin, Robert Feyer, Robert Fippinger, Teri Guarnaccia, Stanley Keller, Andrew Kintzinger, Alexandra (Sandy) MacLennan, Paul Maco, Faith Pettis, Dean Pope, Walter St. Onge and Frederic (Rick) Weber.

Because materiality is determined on the basis of the particular facts and circumstances in each instance, it is not possible for NABL to articulate definitive rules for determining materiality in the context of the Initiative; however, by suggesting a framework to analyze the issue, we hope that this paper will assist issuers and our members in responding appropriately to the Initiative.

Sincerely,

Allen K. Robertson

Allen K. Robertson
President

National Association of Bond Lawyers

35 Years of Leadership

# MCDC Initiative - Considerations for Analysis by Issuers of Materiality and Self-Reporting

## General Overview

The Division of Enforcement (the "Division") of the Securities and Exchange Commission (the "Commission" or "SEC") released its "Municipalities Continuing Disclosure Cooperation Initiative" (the "Initiative") on March 10, 2014.[1] The Division stated that pursuant to the Initiative, it will recommend the following to the Commission:

> [F]avorable settlement terms to issuers and obligated persons involved in the offer or sale of municipal securities (collectively, "issuers") as well as underwriters of such offerings if they self-report to the Division possible violations involving materially inaccurate statements relating to prior compliance with the continuing disclosure obligations specified in Rule 15c2-12 under the Securities Exchange Act of 1934.

The Initiative has raised a number of interpretive issues, and the Division has declined to provide guidance beyond statements by staff at industry conferences. A key interpretive issue is the meaning of "material" in the context of the Initiative. This document is intended to serve the limited purpose of suggesting a framework to analyze this issue. This document does not address whether a municipal issuer or other obligated person[2] under a continuing disclosure agreement should self-report under the Initiative, as there are numerous factors that are involved in any such determination (some, but not all, of which are briefly described below). In addition, whether to self-report is a determination to be made by each issuer based on its own facts and circumstances and with the advice of its counsel.

In thinking about the Initiative, it is important to recognize that the Initiative is not about whether an issuer complied with its continuing disclosure undertakings entered into

[1] The Initiative was modified on July 31, 2014, to extend the deadline for municipal issuers and obligated persons to self-report from September 10, 2014, to December 1, 2014. The deadline for underwriters of September 10, 2014, was not changed.

[2] Use of the term "issuer" throughout this document is intended to refer to both municipal issuers and other obligated persons, which may include governmental agencies, or non-profit or for-profit entities, which have entered into a continuing disclosure agreement pursuant to Rule 15c2-12. Correspondingly, the term "issuer" does not refer to a conduit issuer unless it is a party to a continuing disclosure agreement.

pursuant to Rule 15c2-12.[3] Rather, the Initiative addresses only "possible violations involving materially inaccurate statements relating to prior compliance . . . ."

The analytical framework suggested by this document is comprised of three key elements:

1. Has there been a misstatement? This has two components:

   a. Was there a failure by the issuer to comply in all material respects with its previous continuing disclosure agreements (i.e., was there a material breach of contract), and

   b. What did the issuer disclose in its Official Statement regarding the status of its compliance with its previous continuing disclosure agreements.

2. If there had been a misstatement, was such misstatement material within the meaning of the general antifraud provisions of the federal securities law?

3. If there had been a material misstatement, what factors should an issuer and its counsel consider in determining whether to self-report pursuant to the Initiative?

**Materiality**

*General*. Materiality, while a legal concept, is determined on the basis of the particular facts and circumstances in each instance. Although no set of definitive rules for determining materiality in the context of the Initiative can be established, this document offers general considerations for determining (1) whether statements regarding continuing disclosure compliance might have been misstatements, and (2) if so, whether such misstatements were material. Furthermore, because a determination of materiality is dependent on the unique facts and circumstances in any particular instance, and involves the exercise of judgment informed by experience, different parties may reach different conclusions about what is material with respect to similar facts. Moreover, it can be anticipated that issuers and underwriters will have different perspectives, both regarding what may be material and what should be self-reported, particularly in light of the cap on liability applicable to underwriters and the direct application of Rule 15c2-12 only to underwriters.

Rule 15c2-12 requires, absent an exemption from the Rule, an underwriter to contract to receive a "final official statement," which is defined, for purposes of the Rule, to include, among other things, a description of "any instances in the previous five years in which each person [undertaking to provide annual financial information and notices of material events] failed to comply, ***in all material respects***, with any previous undertakings in a written [continuing disclosure] contract or agreement." Thus, an underwriter's compliance with the Rule in a non-exempt offering requires disclosure in an Official Statement of any material

[3] Accordingly, the Initiative is not relevant to any failures by an issuer to comply with its continuing disclosure undertakings that may have occurred subsequent to the date of its most recent Official Statement.

noncompliance by the issuer with previous continuing disclosure undertakings. Although the Rule is not directly applicable to issuers and does not require an affirmative statement regarding past continuing disclosure compliance, the Rule language has frequently led to the inclusion in the Official Statement of an affirmative statement of the issuer regarding compliance with previous continuing disclosure undertakings, e.g., a statement that over the last five years the issuer has complied in all material respects with any previous continuing disclosure undertakings.[4]

Consequently, two distinct elements of materiality must be analyzed in determining whether there has been a "material misstatement" that is a candidate for being "self-reported" by the issuer pursuant to the Initiative. The first element is whether an issuer's statement that it has in the previous five years complied in all material respects with any previous continuing disclosure agreements (or the failure by the issuer to fully disclose the extent of its noncompliance) is a "misstatement." The second element is whether any such misstatement is material to an investor[5] within the meaning of the general antifraud provisions of the federal securities law. This document suggests a framework for analyzing these two distinct elements and some considerations in applying such framework.

*Is there a Misstatement*? If an issuer discloses in an Official Statement that in the previous five years it has complied "in all material respects" with its previous continuing disclosure undertakings (or has not fully disclosed the extent of its noncompliance), is that a misstatement? It is generally accepted by experienced practitioners that certain failures to comply with the terms of any previous continuing disclosure undertakings would be considered material non-compliance. For example, if there had been a complete failure to comply with any provision of the previous continuing disclosure undertakings (no annual filings, no event filings), yet the affirmative statement regarding prior compliance described above had been made, such statement would have been a misstatement. It also is generally accepted by experienced practitioners that certain other failures to comply with the terms of the previous continuing disclosure undertakings would not be considered failures to comply in all material respects. An example would be a delay in filing a particular annual report by a few days. Many failures, however, are likely to fall into neither category, i.e., the affirmative statement regarding prior compliance is neither clearly a misstatement nor clearly not a misstatement.

*Is any Misstatement a Material Misstatement*? If an issuer stated in its Official Statement that in the previous five years it had complied in all material respects with its previous

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[4] Note that there are numerous variations on this generic statement and the actual statement included in any particular Official Statement will necessarily inform the analysis in terms of both the accuracy of the statement and the materiality of any inaccurate statement.

[5] The SEC has stated, in the context of material omissions by municipal issuers, that an issuer's disclosure in its Official Statements is important to both the prospective investors in the securities being offered and to holders of the issuers' then-outstanding bonds:

> The fact that Miami needed to use bond proceeds to satisfy operational expenses demonstrated the gravity of the cash flow deficit, and, thus, the City's need to disclose this fact to public investors and the marketplace. Miami's financial disclosures would be no less important to investors, who held previously issued City bonds, and were entitled not to be mislead about Miami's current financial condition in deciding whether to hold or sell their bonds. *In re* City of Miami, SEC Rel. No. 33-8213 (Mar. 21, 2003).

continuing disclosure undertakings when in fact there had been instances of material noncompliance, or if the issuer did not fully disclose the extent of its noncompliance (i.e., there was a misstatement), such inaccurate disclosure must be material to investors for there to be a violation of the antifraud provisions of the federal securities law. The SEC considers the compliance history of an issuer under its continuing disclosure undertaking to be material to investors. As it stated in the recent *West Clark* proceeding[6]: "There is a substantial likelihood that a reasonable investor determining whether to purchase the municipal securities would attach importance to the School District's failure to comply with its prior continuing disclosure undertakings." In order to apply this reasoning to other fact situations, however, it is important to understand why the SEC considers the misstatement to be material to investors. According to the SEC in both the *West Clark* and *Kings Canyon*[7] proceedings, the statement is important to enable an evaluation of the continuing disclosure undertaking for the bonds being offered by the Official Statement and, in particular, the likelihood of future compliance. The following language is included in both the *West Clark* and *Kings Canyon* orders: [8]

> Moreover, critical to any evaluation of an undertaking to make disclosures, is the likelihood that the issuer or obligated person will abide by the undertaking. Therefore, the Rule requires disclosure in the final Official Statement of all instances in the previous five years in which any person providing an undertaking failed to comply in all material respects with any previous undertakings. This provides an incentive for issuers, or obligated persons, to comply with their undertakings, allowing underwriters, investors and others to assess the reliability of the disclosure representations.

Using this principle of assessing the reliability of the disclosure representations as a guide to evaluate future compliance, relevant factors in any analysis to determine whether any misstatement (or omission) is material could include the following:

- the importance of the information or notice to be provided (e.g., a delay in filing notice of an unscheduled draw on debt service reserves reflecting financial difficulties may merit different treatment than the substitution of a credit provider comparable in rating to the prior provider, particularly if notice of the substitution was provided separately to the affected bondholders under the terms of the governing bond document)

[6] *In re* West Clark Community Schools, SEC Rel. Nos. 33-9435, 34-70057 (July 29, 2013).

[7] *In re* Kings Canyon Joint Unified School District, SEC Rel. No. 33-9610 (July 8, 2014).

[8] The language cited mirrors language that the SEC used in adopting the continuing disclosure amendments to Rule 15c2-12, in which it stated:

> The requirement should provide an additional incentive for issuers and obligated persons to comply with their undertakings to provide secondary market disclosure, and will ensure that Participating Underwriters and others are able to assess the reliability of disclosure representations. SEC Rel. No. 34-34961 (Nov. 10, 1994)

- the extent to which the information or reported event was otherwise public, either on the issuer's investor information webpage or using commonly available internet search engines

- was the information otherwise available to institutional investors and rating agencies upon request, such that the information may have been taken into account in any pricing or rating of the bonds

- as an example of the immediately preceding two bullets, did any misstatement relate to an unreported failure to provide notice of one or more rating changes of monoline bond insurers or bank credit enhancers from the period 2008-2009 when the news of such rating changes was widely reported

- did the failures occur prior to the date of the initial operation of EMMA (July 1, 2009)[9]

- the length of any delay in filing a report or notice

- the reason for the failure

- the extent to which there is a significant pattern of noncompliance

- the issuer disclosed several events while failing to disclose a single similar event

- how long after the end of the fiscal year an annual report was undertaken to be filed (e.g., if investors buy municipal revenue bonds with nine-month reporting deadlines without pricing differences, a filing that is three months late after a six-month deadline is less likely to be material than one three months late after a nine-month deadline)

- were the primary failures early in the five-year reporting period and has the issuer been fully compliant with its obligations in more recent years

- whether municipal securities for comparable credits were sold disclosing comparable non-compliance and, if so, whether market acceptance or pricing was impacted

- whether subsequent to the reporting failures the issuer engaged an independent dissemination agent

- were the failures the result of a single employee who has either been replaced or properly trained subsequently to make such filings

[9] In the July 31, 2014, press release announcing the modification to the Initiative, the Enforcement Division noted that issuers and underwriters "may not be able to identify certain violations during the period of the initiative due to the limitations of the pre-EMMA NRMSIR system."

- whether the issuer has adopted continuing disclosure procedures and conducted associated training, such that past results are not indicative of future performance

The above list is not intended to be, and is not, comprehensive. It is indicative, however, of why any such analysis will be dependent upon the unique facts and circumstances in any particular instance.

**Other Elements of a SEC Enforcement Action**

An issuer should be counseled that, for a successful SEC enforcement action against the issuer, the SEC must establish scienter (fraudulent intent or recklessness) under Rule 10b-5 or negligence under Section 17(a)(2) or (3). Those same elements apply to an SEC enforcement action against an underwriter regarding the general antifraud provisions. However, an underwriter also must consider whether the SEC might allege against the underwriter a violation of Rule 15c2-12 without regard to any culpable conduct. [10]

**Misstatement versus Omission**

In the two enforcement proceedings cited above, *West Clark* and *Kings Canyon*, the relevant Official Statement contained a specific statement, found to be materially misleading, that the issuer had complied in all material respects with its previous continuing disclosure undertakings. In addition, the Initiative by its terms states that issuers who should consider self-reporting are those "[i]ssuers who may have made materially inaccurate statements in a final official statement regarding their prior compliance with their continuing disclosure obligations as described in Rule 15c2-12."

Would the analysis be any different if, with the same facts, the relevant Official Statement had made no statement as to the issuer's compliance with its previous continuing disclosure undertakings? Given the Commission's previous statements and goals, the Commission might assert that, in such case, the failure to state that the issuer had never made any required filings would be a material omission under applicable standards of the federal securities law, particularly in the context where the issuer is describing the new continuing disclosure undertaking. But the language prohibiting material omissions in Rule 10b-5 requires that the omission result in "the statements made" in the Official Statement being misleading, i.e., the omission must render some statement actually made misleading. So the unanswered question is what statements in an Official Statement are rendered misleading by total silence on the non-compliant continuing disclosure performance of the issuer when no statement is made as to such performance.

Regardless of the merit of the above analysis, an issuer and its counsel should take into consideration the public statements of SEC staff indicating their view that both the SEC's enforcement authority and the terms of the Initiative extend to cases where silence on the issuer's failure to comply with its continuing disclosure undertakings could constitute a material

[10] See *In re* City Securities Corporation and Randy G. Ruhl, SEC Rel. Nos. 33-9434 and 34-70056 (July 29, 2013), in which the SEC charged the underwriter with a violation of, among other things, Rule 15c2-12(c).

omission actionable under the securities laws. Furthermore, total silence in any Official Statement on prior failures over the previous five years may result in an allegation that the Official Statement failed to qualify as a "final official statement" under the Rule, and that therefore the underwriter violated the Rule in connection with the sale of the bonds. An issuer should take into account that this analysis may cause its underwriter to self-report with respect to the bond offering.

**Distinction between Disclosure Decisions and Self Reporting Decisions**

In making disclosure in Official Statements, issuers and their counsel have often disclosed past failures to make all required filings on the specified dates without concluding or admitting that such failures were material. This reflects the trending disclosure practice, ensuring that investors are informed, even in cases where the failures were almost certainly not material.

But making decisions in response to the Initiative is different. Making disclosure that may or may not be material in an Official Statement is generally without a pricing penalty and does not require a conclusion of materiality. A decision to self-report under the Initiative is significantly different and involves assuming risks inherent in accepting the potential results of Commission determinations involving both an issuer and its personnel. The fact that Official Statements for other issuers in the past have disclosed certain continuing disclosure failures is not proof that any other issuer's similar failures to make disclosure was material to investors.

There are numerous other factors that must be considered by an issuer and its counsel in determining whether to self-report, including, without limitation:

- is there a material misstatement
- is there a material omission
- has an underwriter self-reported on the same set of facts
- has the issuer disclosed any misstatements or omissions regarding continuing disclosure compliance in a recent Official Statement
- if the issuer has determined there is no material misstatement or omission, does the issuer wish to explain (pursuant to section 5 of the Questionnaire) the context of what it perceives to be certain immaterial misstatements or omissions
- is the issuer already the subject of an SEC enforcement proceeding (see *Kings Canyon*)
- is the issuer prepared to accept the undertakings mandated by any settlement, including cooperating with any subsequent investigations by the Division, disclosure of any settlement terms in final official statements for a five year period, and establishing appropriate policies, procedures, and training regarding continuing disclosure obligations

- is the issuer prepared to accept whatever publicity may be attendant to entering into a cease-and-desist settlement order with the SEC

- is the issuer official who is considering self-reporting prepared to bring that decision to the appropriate approving officials or elected body of the issuer, if necessary or appropriate, and to explain the recommendation

- is the issuer official making any such determination also the issuer official who would be named in the Questionnaire submitted to the SEC

- has the issuer reviewed and does the issuer understand the implications of SEC Form 1662[11]

**Conclusion**

The focus of the Initiative is material misstatements with respect to compliance by the issuer with any previous continuing disclosure undertakings. In determining whether there is a material misstatement for purposes of the Initiative, there are two distinct elements to be considered: (i) if an issuer disclosed in an Official Statement that it had complied in all material respects in the previous five years with its previous continuing disclosure undertakings, or had not fully disclosed the extent of its noncompliance, was there a misstatement, and (ii) if there was, was any such misstatement material within the meaning of the general antifraud provisions of the federal securities law. This document offers a framework to analyze each of these distinct elements of a potential securities law violation and suggests certain considerations in making any such analysis.

Separate from the analysis of whether there has been a potential material misstatement is the question of whether an issuer should self-report such misstatement pursuant to the Initiative. As indicated, any such determination should be based on the unique facts and circumstances in each instance after careful consideration by the issuer and its counsel of the many factors involved.

[11] SEC Form 1662 is entitled, "Supplemental Information for Persons Requested to Supply Information Voluntarily or Directed to Supply Information Pursuant to a Commission Subpoena." In that form, the SEC cautions that it "often makes its files available to other governmental agencies, particularly United States Attorneys and state prosecutors."