

The MCDC Initiative: What To Do When The SEC Calls

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SEC's New Interest in Municipal Issuers

- SEC new focus on municipal issuers
- Increasing enforcement activity in bond market
- Municipal securities are generally exempt from registration requirements under Securities Act of 1933
 - But, are subject to anti-fraud provisions of the securities laws

MCDC Initiative Announced

- On March 10, 2014, the SEC’s Enforcement Division introduced an initiative to encourage self-reporting:
 - By municipal securities issuers, obligated persons, and underwriters of possible securities law violations; and
 - Related to misrepresentations in offering documents concerning an issuer’s prior compliance with its continuing disclosure obligations
- *“Municipal bond disclosures must provide investors with an accurate portrayal of a project’s prospects and the municipality’s ability to repay those who invest[.]”* — Andrew J. Ceresney, Director of the SEC Enforcement Division
- The Municipalities Continuing Disclosure Cooperation Initiative (MCDC Initiative) is the latest SEC effort in a long campaign to require timely, accurate, and uniform secondary market information from municipal securities issuers

MCDC Initiative: An Overview

- Under the MCDC Initiative, the Enforcement Division will recommend “favorable settlement terms” upon self-reporting of such possible violations
- For eligible self-reporters, the Enforcement Division will recommend:
 - Settlement through cease-and-desist proceedings that do not require an admission of liability
 - Not levying a financial penalty against issuers
 - Tiered financial penalties against underwriters

Self-Reporting Deadlines

- Deadline for underwriters to self-report was September 10, 2014
- Deadline for issuers to self-report is December 1, 2014
- What's next...

Self-Reporters

- Expect to hear from the SEC
- SEC has broad authority
- SEC most likely to go after self-reporters first
- For more serious violations:
 - Full disclosure of all documents
 - Subpoenas sent to transaction participants for records and/or testimony
 - Individual prosecution

Self-Reporters: Be Prepared

- Gather all materials and documents
 - Document retention policies
 - IT systems
 - Compliance training
- Preserve the attorney-client privilege
- Individuals subject to exposure require separate counsel
 - Conflict of interest
- How the SEC will proceed

Non-Reporters

- Where underwriter has elected to self-report, but issuer has not reported, or vice versa, SEC is likely to act
- SEC can proceed both:
 - Informally
 - Formally

SEC Initiates Investigation

- Obtain counsel
- Retain/preserve documents
- Preserve the attorney-client privilege
- Seek to narrow the scope of broad document requests
- Evaluate whether there is a duty to disclose

Informal Investigation

- SEC has not yet sought authority to issue subpoenas for compelling documents and testimony
- Informal inquiries are not publicly disclosed

Informal Investigation

- SEC likely to approach issuers or underwriters and ask for:
 - Voluntary production of documents
 - Witness testimony
- Results of an informal inquiry
 - No evidence of violation
 - Evidence of violation

Formal Investigation

- Does not require prior informal investigation
- Generally remains non-public
- Begins with formal order of investigation
- Witnesses receive greater procedural protections
- Concludes with either:
 - No action
 - Enforcement action

Wells Notice

- Invites subject of an investigation to provide the SEC with a statement setting forth their position and interests
- No right to receive this notice
- Contents of the Wells Submission

Defenses at the Wells Stage

- Materiality
 - Engage an expert early
- Omission versus misstatement
- Lack of intent
- Reliance on professionals
- Good Faith – Control Person

Materiality

- As stated in the *West Clark* proceeding: “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.”
- A company has a duty to disclose material nonpublic information when:
 - 1) regulation, statute or rule requires disclosure
 - 2) disclosure is required to prevent a voluntary statement from being misleading
 - 3) defendants are engaging in insider trading

Materiality

- Two-step inquiry
 - 1) Whether a prior official statement includes a misstatement
 - Was there a failure by the issuer to comply in all material respects with its previous continuing disclosure agreements?
 - What did the issuer disclose in its Official Statement regarding the status of its compliance with its previous continuing disclosure agreements?
 - 2) Whether that misstatement is material

Misstatement vs. Omission

- **Misstatement:**
 - Where issuer states that in the previous five years it has complied in all respects with its previous continuing disclosure undertakings which in fact there have been instances of material noncompliance
 - or
 - Where issuer did not fully disclose the extent of its noncompliance
- **Omission:**
 - Official Statement makes no statement as to issuer's compliance with its previous continuing disclosure requirements
 - The U.S. Supreme Court has stated that “[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5” or Section 10(b), and thus does not constitute a fraud
 - “[F]irms are entitled to keep silent (about good news as well as bad news) unless positive law creates a duty to disclose.”

Materiality

The Well-Established Standards

- To violate Rule 10b–5, a statement or omission must be “misleading as to a material fact.”
- For the purposes of Rule 10b-5, a fact is material “if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”
- Omitted information is considered material if there is a “substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available.”

Compare with

“There is a substantial likelihood that a reasonable investor determining whether to purchase the Issuer’s municipal securities would attach importance to the Issuer’s failure to comply with its prior continuing disclosure undertakings”

Penalties: Civil Actions

- Injunctions
- Monetary fines
 - Considerations in imposing monetary fines:
 - fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement
 - harm to other persons
 - extent of unjust enrichment (consider restitution)
 - previous violations
 - need to deter such acts or omissions
 - such other matters as justice may require

Penalties: Administrative Proceedings

- Cease-and-desist order
- Monetary fines
 - Dodd-Frank Act amended Section 21B(a)(2) to provide:
 - The Commission may impose a civil penalty, if the Commission finds, on the record after notice and opportunity for hearing, that such person
 - a) is violating or has violated any provision of this chapter, or any rule or regulation issued under this chapter; or
 - b) is or was a cause of the violation of any provision of this chapter, or any rule or regulation issued under this chapter
 - Up to \$150,000 fine may be imposed on “any person”

Home Court Advantage

- Administrative law judge (ALJ) process
 - WSJ: SEC has not lost a case before an ALJ in 2014
 - In contrast, has won 61% of federal court trials
 - Judge Rakoff
- Jury trial or no jury trial
- Appeals process
- Burden of proof, as a practical matter

Conclusion

- Thank you for coming!
- Please feel free to email us any questions that you were not able to ask during the webinar today:

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