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Surge of Settlements Under the SEC's MCDC Initiative Casts Doubt as to the Leniency of Settlement Terms for Self-Reporters

By Kit Addleman and Sarah Mallett[1]

A wave of settlements with municipal underwriting firms under the SEC's Municipalities Continuing Disclosure Cooperation (MCDC) Initiative has brought renewed attention to continuing disclosure obligations in municipal offerings. But, it also raises questions about the initiative's purportedly favorable settlement terms. On July 18, 2015, the SEC announced settlements with 36 municipal underwriters for willfully violating Section 17(a)(2) of the Securities Act.[2] The underwriters agreed to pay a total of $9.29 million and to undertake remedial actions to settle SEC allegations that they sold bonds using offering documents that contained materially false or misleading statements or omissions about issuers' compliance with continuing disclosure obligations pursuant to Rule 15c2-12.[3]

The MCDC Initiative

The SEC's Enforcement Division established the MCDC Initiative in March 2014 to encourage issuers and underwriters of municipal bonds to self-report potential violations of their continuing disclosure obligations pursuant to Rule 15c2-12[4] of the Securities Exchange Act of 1934. The MCDC Initiative claimed that issuers and underwriters that self-reported possible materially inaccurate statements made in offering documents regarding continuing disclosure obligations would receive more favorable settlement terms than if the enforcement staff independently discovered the violations.[5]

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[2] Press Release, *SEC Charges 36 Firms for Fraudulent Municipal Bond Offerings* (June 18, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-125.html. Section 17(a)(2) of the Securities Act—an anti-fraud provision that does not require intent—makes it unlawful "in the offer or sale of any securities . . . directly or indirectly . . . to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." 15 U.S.C. § 77q(a)(2).

[3] Press Release, *SEC Charges 36 Firms for Fraudulent Municipal Bond Offerings* (June 18, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-125.html.

[4] 17 C.F.R. § 240.15c2-12.

[5] *Municipalities Continuing Disclosure Cooperation Initiative*, SEC.GOV, https://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml (last modified Nov. 13, 2014).

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For municipal issuers, MCDC settlements would include a cease-and-desist proceeding in which the issuer neither admitted nor denied the findings so long as the issuer undertook certain remedial and compliance measures. To encourage issuer self-reporting, the initiative promised no civil money penalties. For underwriters of municipal offerings, the SEC would recommend a settlement involving administrative and cease-and-desist proceedings and the imposition of penalties based on the number and size of the fraudulent offerings identified. In July 2014, the SEC modified the initiative to spur greater participation by small- and medium-sized underwriters.[6] These changes included the implementation of a tiered system of caps on civil penalties correlated to underwriters' total reported revenue for the previous fiscal year.[7]

Analysis of Settlements Against 36 Underwriters

Although there was only one settlement under the MCDC Initiative in 2014,[8] the SEC's recent settlements with 36 underwriters heighten the focus on both the initiative and its purportedly favorable settlement terms. In these 36 settlements, the firms did not admit or deny findings in the settled orders that bond offering documents: (1) contained materially false or misleading statements or omissions about bond issuers' compliance with continuing disclosure obligations pursuant to Rule 15c2-12 or (2) violated a provision of the anti-fraud statute, Section 17(a)(2) of the Securities Act. The underwriters agreed to cease and desist from such violations in the future. They also agreed to pay civil money penalties ranging from $40,000 to $500,000, with a median penalty of $250,000. Finally, they agreed to retain independent consultants for two years to review their policies and procedures on due diligence for municipal securities underwriting. [9]

Compliance with Rule 15c2-12 includes filing a "final official statement" setting forth any instances in the previous five years in which an issuer of municipal securities "failed to comply in all material respects" with any

[6] *See* Press Release, *SEC Enforcement Division Modifies Municipalities Disclosure Initiative* (July 31, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542578459.

[7] *Id.* The cap was set at $100,000 for underwriters with a reported total annual revenue of less than $20 million; $250,000 for underwriters with revenue between $20 million and $100 million; and $500,000 for underwriters with revenue greater than $100 million.

[8] *See In the Matter of Kings Canyon Joint Unified School Dist.*, Securities Act Release No. 9610, Admin. Proc. File No. 3-15966 (July 8, 2014); Press Release, *SEC Charges California School District with Misleading Investors* (July 8, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542256676. For a review of SEC actions involving municipal securities issuers and underwriters in the year 2014, see Kit Addleman & Sarah Mallett, *A Year in Review for Municipal Securities: SEC Enforcement Highlights*, Haynes and Boone (May 20, 2015), http://www.haynesboone.com/~/media/files/alert%20pdfs/2015/2014yearinreviewmunicipalsecuritiesenforcement.ashx.

[9] The SEC did, however, grant waivers to the firms to prevent disqualification from certain regulatory exemptions. *See In the Matter of Certain Underwriters Participating in the Municipalities Continuing Disclosure Cooperation Initiative*, Securities Act Release No. 9848, Admin. Proc. File No. 3-16605–3-16640 (June 18, 2015), available at http://www.sec.gov/litigation/admin/2015/33-9848.pdf.

previous continuing disclosure obligations.[10] Per the settlements, the underwriters allegedly failed to conduct adequate due diligence to identify issuers' compliance failures before offering and selling bonds to their customers.

The SEC settlements provide little transparency regarding the determination of the penalty amounts and raise questions regarding the benefits of self-reporting. For example, Smith Hayes Financial Services Corporation ("Smith Hayes") is alleged to have acted as the senior or sole underwriter for two securities offerings in 2011 and 2013, during which an issuer failed to disclose that it had not filed any annual financial reports that it had previously undertaken to make since 2009 and failed to file required notices of late filings.[11] Similarly, Stephens Inc. ("Stephens") is alleged to have acted as the senior or sole underwriter for two 2013 securities offerings in which issuers failed to disclose that they had filed two annual financial reports late and failed to file required notices of late filings.[12] However, while Smith Hayes' settlement required payment of a $40,000 penalty, the penalty in Stephens' settlement was ten times higher ($400,000).

BNY Mellon Capital Markets, LLC ("BNY Mellon") was penalized $120,000 even though the firm was alleged to have acted as the senior or sole underwriter for three offerings in which the official statements contained false or misleading statements or material omissions about prior compliance.[13] The offerings occurred in three different years and involved issuers failing to (a) disclose late filings of annual financial reports, (b) file budgets and other financial information, or (c) file required notices of late filings.

Despite BNY Mellon being a larger firm with significantly higher revenue than Stephens, and serving as the underwriter for a larger number of offerings in which the official statements contained false or misleading statements or material omissions about prior compliance, Stephens was assessed a materially higher penalty. Although penalties may be imposed based on the size of the offerings in question,[14] from the face of the settlement orders, it remains difficult to understand the SEC's method and rationale for determining penalty amounts.

The MCDC underwriters' settlements also raise a recurring question of whether the SEC gives genuine credit for self-reporting. It is not clear in this instance that the MCDC Initiative's terms are more favorable or more lenient than settlement terms reached in certain pre-MCDC enforcement actions. For example, the SEC imposed a $300,000 civil money penalty on an underwriter in July 2013 after finding that—as in the cases of Smith Hayes,

[10] 17 C.F.R. § 240.15c2-12(f)(3).

[11] *See In the Matter of Smith Hayes Financial Services Corporation*, Securities Act Release No. 9842, Admin. Proc. File No. 3-16635 (June 18, 2015), *available at* http://www.sec.gov/litigation/admin/2015/33-9842.pdf.

[12] *See In the Matter of Stephens Inc.*, Securities Act Release No. 9843, Admin. Proc. File No. 3-16636 (June 18, 2015), *available at* http://www.sec.gov/litigation/admin/2015/33-9843.pdf.

[13] *See In the Matter of BNY Mellon Capital Markets, LLC,* Securities Act Release No. 9816, Admin. Proc. File No. 3-16610 (June 18, 2015), *available at* http://www.sec.gov/litigation/admin/2015/33-9816.pdf.

[14] If the penalty caps are not met, then penalties of $20,000 per offering for offerings of $30 million or less, or penalties of $60,000 per offering for offerings of more than $30 million, may be imposed. *See supra* note 6.

Stephens, and BNY Mellon—the underwriter had conducted inadequate due diligence to identify instances of an issuer's failure of compliance before offering and selling municipal securities.[15] The underwriter in the 2013 case was also charged with violations of various other statutory provisions.[16] Accordingly, it seems incongruous that the penalty imposed on a non-self-reporting firm that committed additional violations beyond Section 17(a)(2) of the Securities Act would be similar or even less than the penalties imposed on some self-reporting firms under the MCDC Initiative.

While the MCDC Initiative will likely improve the municipal securities market for investors,[17] questions remain about credit for self-reporting and whether the SEC could have dealt with issuers' disclosure failures by alternative, less disruptive means.[18] Moreover, the 36 underwriters' settlements indicate that the SEC has defined the term "material" very broadly, as it pertains to Rule 15c2-12's obligations. In particular, some of the securities offerings for which underwriters allegedly failed to exercise "adequate due diligence" involved issuers' financial documents that were filed mere weeks, or months, late.[19]

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[15] *See In the Matter of City Securities Corporation and Randy G. Ruhl*, Securities Act Release No. 9434, Admin. Proc. File No. 3-15390 (July 29, 2013), *available at* http://www.sec.gov/litigation/admin/2013/33-9434.pdf.

[16] City Securities was charged with willful violation of Section 17(a)(2) of the Securities Act, Sections 10(b), 15(c)(2) and 15B(c)(1) of the Exchange Act and Rules 10b-5(b) and 15c2-12 thereunder, and MSRB Rules G-17 and G-20.

[17] *See generally* Luis A. Aguilar, *Statement on Making the Municipal Securities Market More Transparent, Liquid, and Fair*, SEC.gov (Feb. 13, 2015), http://www.sec.gov/news/statement/making-municipal-securities-market-more-transparent-liquid-fair.html (outlining the municipal securities market's problems of opacity, illiquidity, and decentralization and how these problems can be solved by, among other things, improved disclosures by municipal issuers and underwriters).

[18] The settlements under the MCDC result in a statutory disqualification under Section 3(a)(39) of the Exchange Act. Rather than bringing administrative actions under Section 15(b) of the Exchange Act, the SEC could have elected to bring the actions as cease-and-desist proceedings under Section 8A of the Securities Act which does not invoke a statutory disqualification. While the SEC granted waivers of that disqualification (see note 9 above), the existence of the harsher enforcement actions and the disqualification, may place the settling underwriters—particularly the smaller firms—at a competitive disadvantage. *See also* Kyle Glazier & Jack Casey, *36 Underwriters to Pay $9.3M to Settle Under SEC MCDC Program*, THE BOND BUYER (June 18, 2015), http://www.bondbuyer.com/news/washington-enforcement/36-underwriters-to-pay-93m-to-settle-under-sec-mcdc-program-1076803-1.html.

[19] *See, e.g.*, *In the Matter of Morgan Stanley & Co. LLC*, Securities Act Release No. 9834, Admin. Proc. File No. 3-16627 (June 18, 2015) ("Among the offerings in which the official statements contained false or misleading statements about prior compliance were . . . A 2012 negotiated securities offering in which an obligor failed to disclose that it filed four quarterly reports between 36 and 99 days late . . ."); *In the Matter of Stifel, Nicolaus & Company, Inc.*, Securities Act Release No. 9845, Admin. Proc. File No. 3-16638 (June 18, 2015) (". . . A 2012 negotiated securities offering in which an issuer failed to disclose that it had filed its audited financial statements for three years between 14 and 94 days late . . ."). For discussion of how the SEC's broad definition of the term "material" may impact enforcement actions against non-self-reporting issuers and underwriters, see Anne N.

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In light of these 36 underwriter settlements, the leniency of the settlement terms offered under the MCDC Initiative remains questionable. However, the true measure of credit afforded self-reporting underwriters will be clearer if, as SEC officials claim, additional—and potentially harsher—actions are brought against non-self-reporting underwriters and issuers in the future. If so, then those firms may regret not participating in the MCDC Initiative.

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