

SEC MCDC Enforcement Initiative Update: SEC Announces Final Actions against Municipal Bond Underwriters and Beginning of an Issuer Sweep

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In a third and final round of settlements with underwriters, the SEC announced on February 2, 2016 enforcement actions against 14 firms for alleged misstatements and omissions in municipal bond offerings.¹ With this latest wave of settlements, brought under the SEC's Municipalities Continuing Disclosure Cooperation ("**MCDC**") Initiative, the SEC has instituted actions against a staggering 72 underwriters – comprising approximately 96 percent of the market share for municipal underwritings² – in eight short months with payments totaling more than \$17 million.

The SEC's press release also announced that the Initiative was continuing as to municipal debt issuers.³ Only a few days later, the Government Finance Officers Association ("**GFAO**") issued an alert warning that the SEC's Enforcement Division had begun contacting municipal issuers that participated in the Initiative regarding potential resolution.⁴ Issuers and their legal staff should prepare for and be responsive to those SEC calls.

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 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

For underwriters of municipal offerings, under the MCDC, the SEC would recommend a settlement involving administrative and cease-and-desist proceedings and impose monetary penalties based on the number and size of the fraudulent offerings identified.⁶ Although the SEC touts the benefits of self-reporting under the Initiative, it is not clear that the MCDC Initiative's terms are more favorable or more lenient than settlement terms reached in certain pre-MCDC enforcement actions.⁷

Previous Settlements against Underwriters

The first wave of enforcement actions against underwriters under the MCDC Initiative were brought in June 2015 against 36 municipal underwriting firms.⁸ Those firms, including many large financial institutions, agreed to pay a total of approximately \$9 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. (See our [previous coverage](#)). In September 2015, an additional 25 firms – mainly smaller regional firms – reached similar settlements totaling about \$4 million. (See our [previous coverage](#)).

In the first round of settlements, the penalties ranged from \$40,000 to \$500,000, with an average penalty of \$258,000.⁹ In the second round, the penalties ranged from \$20,000 to \$500,000, with an average penalty of \$187,000.¹⁰ Notably, only one firm in the second round reached the \$500,000 ceiling, as compared to the first wave of settlements in which ten underwriters paid the maximum \$500,000 penalty.¹¹ Without admitting or denying the findings, all the underwriters agreed to cease and desist from further violations and hire an independent consultant to review their policies and procedures on due diligence for municipal securities underwriting.

Final Wave of Underwriter Settlements

The settlements announced this month are very similar to the previous two rounds. The SEC found that between 2011 and 2014, 14 underwriting firms sold municipal bonds using offering documents that contained materially false statements or omissions about the bond issuers' compliance with continuing disclosure obligations. The SEC also found that the firms failed to conduct adequate due diligence to identify the misstatements and omissions before offering and selling the bonds to their customers. Each firm, without admitting or denying the findings, again agreed to cease and desist from such violations, paid civil penalties based on the number and size of the fraudulent offerings identified (up to \$500,000), and agreed to retain an independent consultant to review its policies and procedures.

The majority of the settlements with underwriters involved municipal securities offerings in which the official statements represented that the issuer had not failed to comply with its previous continuing disclosure obligations. However, the issuers had indeed failed to disclose previous delinquent filings of audited financial reports or similarly material information, which ranged from one month to more than four years late. The issuers also failed to file the required late notices of filing. The SEC claimed that the underwriters failed to form a reasonable basis, through adequate due diligence, for believing the truthfulness of the assertions by these issuers regarding their compliance with previous continuing disclosure obligations.

Future Issuer Focus

The municipal securities community has wondered why the SEC addressed the underwriter violations separately from those of the issuers and to what degree the SEC's Enforcement Division would take action against such issuers. To date, the only action against an issuer was brought in July 2014 against Kings Canyon Joint Unified School District shortly after the MCDC Initiative was announced.¹² Without admitting or denying the SEC's findings, Kings Canyon consented to an order to cease and desist from committing or causing any future violations of Section 17(a) of the Securities Act. It also agreed to adopt written policies for its continuing disclosure obligations, comply with its existing continuing disclosure obligations, cooperate with the Enforcement Division in further investigations, and disclose the terms of its settlement with the SEC in future bond offering materials.

In addition to the SEC's announcement that it was beginning to review the self-reporting materials from issuers, the GFAO reported on February 10, 2016 that the SEC staff was initiating contact with certain municipal issuers.¹³ As in the Kings Canyon matter, the SEC's settlements with issuers for

failures to comply with their continuing disclosure obligations will likely not involve the assessment of civil penalties, which would only harm municipalities and bond holders. The standard terms the SEC announced when originating the MCDC Initiative – a cease-and-desist order coupled with certain compliance and remediation measures – are expected to be followed in the anticipated settlements with issuers.

Conclusion

These actions reinforce the SEC's commitment to protecting investors in the \$3.7 trillion municipal bond market. As the SEC's 2012 Municipal Market Report identified, issuers' failure to comply with their continuing disclosure obligations is a major challenge for investors seeking important information about their municipal bond holdings.¹⁴ Through the MCDC Initiative, the SEC is seeking to rectify this problem primarily by holding both issuers and underwriters accountable for making and, when required, updating disclosures to investors.

Any of the counsel in Haynes Boone's SEC Enforcement or [Public Finance](#) Groups would be happy to discuss these settlements or other compliance concerns with you.

¹ See Press Release, [SEC Completes Muni-Underwriter Enforcement Sweep](#) (Feb. 2, 2016).

² See *id.* (Andrew J. Ceresney, Director of the SEC's Enforcement Division stated: "As part of the settlements, 72 underwriting firms – comprising approximately 96% of the market share for municipal underwritings – have agreed to improve their due diligence procedures and we expect that investors will benefit from those improvements.").

³ See *id.*

⁴ See [GFOA Alert: The SEC MCDC Initiative and Issuer Settlements](#) (Feb. 10, 2016).

⁵ See Press Release, [SEC Enforcement Division Modifies Municipalities Disclosure Initiative](#) (July 31, 2014).

⁶ In July 2014, the SEC modified the initiative to spur greater participation by small- and medium-sized underwriters. 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. See Press Release, [SEC Enforcement Division Modifies Municipalities Disclosure Initiative](#) (July 31, 2014).

⁷ See generally Kit Addleman & Sarah Mallett, [Surge of Settlements Under the SEC's MCDC Initiative Casts Doubt as to Leniency of Settlement Terms for Self-Reporters](#), Haynes Boone (June 2015). For example, the SEC imposed a \$300,000 civil money penalty on an underwriter in July 2013 (pre-MCDC) after finding that the underwriter had conducted inadequate due diligence to identify instances of an issuer's failure of compliance before offering and selling municipal securities. In that case, 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. 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).

⁸ See Press Release, [SEC Charges 36 Firms for Fraudulent Municipal Bond Offerings](#) (June 18, 2015).

⁹ See Kit Addleman & Phong Tran, [Round Two of the SEC's MCDC Initiative: 22 Municipal Underwriters Settle Charges of Disclosure Failures](#), Haynes Boone (Oct. 2015).

¹⁰ See *id.*

¹¹ See *id.*

¹² See [In the Matter of Kings Canyon Joint Unified School District](#), Securities Act Release No. 9610 (July 8, 2014).

¹³ See [GFOA Alert: The SEC MCDC Initiative and Issuer Settlements](#) (Feb. 10, 2016).

¹⁴ [U.S. Securities and Exchange Commission](#), Report on the Municipal Securities Market (July 31, 2012).