THE BOND BUYER

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Disclosure and Diligence: Some Questions Remain Unanswered

By Gregg Bienstock
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It is hard to fathom a market as large and integral to our lives – schools, hospitals, utilities, roads and so much more – where the subject of required disclosure and diligence is still an unsettled issue. While the SEC's MCDC initiative provided an opportunity for underwriters, issuers and obligated persons to self-report possible violations "involving materially inaccurate statements relating to prior compliance with the continuing disclosure obligations specified in Rule 15c2-12", not enough has been done to provide municipal issuers, obligated parties and underwriters the clarity sought and needed by the market.

Since the first round of MCDC settlements, market participants have continued to ask for clarity with regard to "materiality" and the level and type of diligence required for real-world operating scenarios. The seventy-two Cease and Desist Orders each provided up to three examples of "materially false and/or misleading" statements covering competitive and negotiated deals but, as the SEC has said, the examples do not set a bright line for materiality. As such, the market is left with something short of clarity.

Moreover, as we have learned from market participants, the recommendations of the Independent Consultants ("IC"), engaged as required by the MCDC-related Orders, have differed leaving broker-dealers with differing degrees and scopes of diligence based on who the IC was. The divergence in diligence leaves the same market and investors that the SEC seeks to protect with the potential for substantively different results and an uneven playing field for broker-dealers.

By virtue of our role as a resource to help firms meet their 15c2-12 diligence obligations, we are keenly aware of differing perspectives and pain points market participants face. A primary pain points is "the need for clarity so we can comply and get on with serving our clients and the market." We raise the following based on what we have heard, to promote discussion and, importantly, to seek guidance around the uncertainties.

Materiality – What Is it?

The SEC has made clear that the examples of materially false or misleading statements in the Orders are … examples. For example, timing for a late filing is not to be construed as a definitive

marker. Is a filing not tagged to outstanding CUSIPs or an issue material? What about misclassified filings (yes, there are documents on EMMA that were filed in the wrong category or year!)? Given the lack of clarity, some take the view that every "foot fault" must be disclosed.

Independent Consultant Recommendations Lack Consistency

As part of the MCDC settlement, each party that signed an Order has engaged an IC to review their policies and procedures and make recommendations that are likely to be implemented by the underwriter. The IC recommendations have varied. Perhaps the SEC can offer guidance with regard to scenarios where IC recommendations have led to differing standards and requirements. These differing standards can lead to different requirements for issuers, different degrees of information disclosed to investors and create an uneven playing field for underwriters. Several examples are highlighted below.

- Can an Underwriter Rely on a Third Party (syndicate lead, vendor and/or law firm) for 15c2-12 Lookback Analysis? Answers we have heard include yes, no and maybe! Some have been told a "comfort letter" and/or periodic review of the third party's policies and procedures is enough while others have been told to spot check the work of the third party while others have been told they cannot rely on a third party.
- Competitive Deals — How Much Analysis is Needed and When? Answers range from, a quick review of EMMA to see if Financial Filings have been done to an in-depth review of financial filings to ensure they were timely and what they purport to be (is the CAFR filed with EMMA actually the CAFR?) to a comprehensive analysis of required financial filings and tables.
- Negotiated Deals – Most are of the view that more needs to be done when it comes to negotiated deals, but the question remains "how much more?" Most agree that negotiated deals require a review of detailed financial and operating data requirements and to ensure the filings were properly classified while others also require "independently verifiable material events" be reviewed for filing and timeliness. What is an "independently verifiable material event" and to what lengths do market participants need to go to ascertain if an event happened (beyond EMMA)? What about where an underwriter is a co-manager on a deal?

Guidance Can Go a Long Way

Virtually all market participants we encounter want to get it right – tell us what needs to be done and when. Short of amending 15c2-12 or a new rule, practical guidance and help for the day-to-day realities encountered is warranted.

The following are offered as a starting point to a dialogue that, perhaps, can help provide clarity, level the playing field and insure issuers, underwriters and investors are treated fairly.

1. Allow examples cited in Cease and Desist Orders to serve as a baseline for defining materiality.
2. Create a mechanism for market participants to pose questions to the SEC and get timely answers with the resultant Q&A being publically available.
3. Create a "working group" to pose questions and issues and to ensure the SEC has the necessary facts and information to provide guidance.

Given the extensive resources deployed around MCDC and steps to implement IC recommendations, guidance on the points highlighted above and the many others dealt with on a daily basis will allow market participants to proceed with confidence that they are complying with the applicable rules and regulations.

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