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SEC Could Have Materiality Problem With MCDC

By Kyle Glazier

WASHINGTON — The Securities and Exchange Commission could have trouble punishing issuers and underwriters in court if they choose to fight rather than settle under the Municipalities Continuing Disclosure Cooperation initiative, lawyers and an economist said during a Thursday webinar.

Three Ballard Spahr attorneys joined economist Vinita Juneja to discuss how materiality is proven in court under federal securities laws.

The MCDC allows both issuers and underwriters to get favorable settlement terms if they voluntarily report, for any bonds issued in the last five years, any time they misled investors about their compliance with their continuing disclosure obligations. But Ballard lawyers said showing that omitted information was significant enough to result in a material misstatement could be tough if SEC lawyers can't show an impact on bond prices.

Issuers have been adding in their bond documents statements based on SEC Rule 15c2-12, that they have been complying "in all material respects" with their continuing disclosure obligations. Materiality has been defined by the Supreme Court to mean something a reasonable investor would want to know before making an investment decision.

A National Association of Bond Lawyers paper released Aug. 5 explained that there are two distinct materiality questions that an issuer has address under MCDC. One is whether it made a misstatement if it said in its OS that it has complied in all material respects with its continuing disclosure obligations when there has been some noncompliance. The second is whether the misstatement would be material to investors.

There is widespread agreement in the muni market that materiality is a facts and circumstances-based threshold unique to each case, but it is one the SEC must ultimately show it if a market participant chooses litigation instead of a settlement, the Ballard lawyers said.

Dr. Vinita Juneja

"Materiality has become very similar to pornography, and [Supreme Court Justice Potter] Stewart's famous statement that "I know it when I see it," Ballard's Norman Goldberger said.

Goldberger told webinar participants that proving materiality in court could involve looking at a movement in bond prices when something is disclosed, market volatility, and the testimony of experts.

Juneja, who works for NERA Economic Consulting and serves as an expert witness in securities litigation, said that if a bond's price does not drop because of a disclosure failure, that could be used as evidence that the information is not material to the market. In a case where an issuer failed to make a disclosure, market studies can determine whether the bond's price likely would have been affected or the court could look at whether a similar disclosure on a similar security moved that other bond's price.

But even proving a price impact requires reliable pricing info, Juneja explained, pointing out that muni securities frequently do not trade for long periods of time or can show notable price discrepancies within the same day.

In a phone interview following the webinar, Goldberger and fellow attorney John Grugan said the SEC has set a lower bar for materiality with the MCDC than was set by the Supreme Court in the 1976 TSC v. Northway case. In that case the court held that for there to be materiality, there "must be 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."

In its MCDC settlement with California's Kings Canyon Joint Unified School District in July, the SEC settlement order stated that it was likely that a reasonable investor "would attach importance to" the district's disclosure failures.

"That isn't the standard," Grugan said.

Goldberger said that he was not aware of any case in which the SEC successfully litigated a continuing disclosure muni market case without showing actual market volatility or price changes related to the disclosure or misstatements about the disclosure. Other attorneys interviewed also could not recall such a case. Goldberger said materiality could be easy to prove in extreme cases where an issuer has continually failed to disclose anything over the course of many bond issuances, and that expert testimony about materiality could also come into play in a court case. Issuers and underwriters have always settled before these issues could be litigated, he continued, but the SEC could very well struggle to make that case in court.

"Except in extreme cases, they're going to have a hard time," Goldberger said.

Asked about the issue, SEC enforcement chief LeeAnn Gaunt warned that market participants should not rely on any one factor to determine materiality. "It is well established that materiality is a function of the specific facts and circumstances presented by each situation," Gaunt said. "As a general matter, no one factor will be determinative in making these kinds of assessments."

A securities lawyer who preferred not to be identified said that when deciding whether or not to report under the initiative, it would be wise to be guided by what the SEC has said rather than what would theoretically have to happen in court.

"As a theoretical matter and absent other guidance from the SEC, one could test materiality by seeing whether the release of such information in fact changed the market price," the lawyer said. "But we are not dealing with a theoretical matter. We are dealing with how to respond to the initiative. And for that purpose, the SEC has made clear in both West Clark and Kings Canyon that disclosure about prior compliance is, in their view, material. And in considering whether to respond to the initiative, it would be prudent to be guided by the SEC's clear statements, and not by whether in the abstract there may be a defense that could be established in a litigation context."

Dr. Vinita Juneja is a Senior Vice President with NERA Economic Consulting, and Co-Chair of the firm's White Collar Criminal Litigation, Investigations, and Compliance Practice.