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Justice Probes Municipal-Bond Issuers Over Treasury Profits.

The U.S. Justice Department is investigating whether two local governments improperly made about $180 million by trading special Treasuries purchased with money raised in the municipal-debt market.

The agency that runs Louisville, Kentucky's sewer system disclosed in an August bond-offering document that officials may file a civil lawsuit against it for exploiting interest-rate moves to profit from Treasuries that are sold only to state and local governments. The securities were created to help governments comply with federal rules that limit how much they can earn by investing the proceeds of tax-exempt bond issues.

The government is also probing Gulf Breeze, Florida, a 6,000-resident city that frequently sells debt on behalf of non-profits and private corporations, city records show.

"We're just trying to figure out what they need," said Edwin Eddy, the city manager of Gulf Breeze, which hired the law firm Jenner & Block to respond to the inquiry.

Justice Department spokeswoman Nicole Navas and Treasury Department spokesman Rob Runyan declined to comment. Attorneys for Gulf Breeze and the Louisville and Jefferson County Metropolitan Sewer District — which have been barred from executing such trades since 2014 — dispute that they ran afoul of U.S. regulations. A lawyer for Enhanced Financial Solutions, the firm that managed the two borrowers' investments, said he expects that the Justice Department will determine that there was no wrongdoing.

Enforcement Target

The investigations are the latest in a decades-long effort to police the business of investing money raised in the $3.8 trillion municipal market, where governments can borrow cheaply for schools, roads and other public works because the interest payments bondholders receive aren't subject to federal income tax. State and local governments can't exploit that subsidy to profit by borrowing to speculate with stocks, corporate bonds or other higher-yielding securities.

Governments are allowed to purchase Treasuries and guaranteed investment contracts, or GICs, to pick up some income until bond proceeds are spent, though there are limits on how much they can earn. Municipalities also use Treasuries for so-called advanced refundings, in which they borrow money, buy U.S. bonds and use the income to pay off debt before it can be repurchased from investors.

Such products have been a frequent target of regulators. More than a decade ago, the Securities and Exchange Commission settled with banks that allegedly inflated the prices of Treasuries sold to local governments in the 1990s. More recently, 20 bankers and brokers pleaded guilty to or were convicted of rigging the bidding for GICs, resulting in fines of about $750 million against banks.

[For an in-depth look at the bid-rigging investigation, click here.]

The probes of Gulf Breeze and Louisville center on a $109 billion Treasury niche known as State and Local Government Series securities, or SLGS, that are tailor made for local governments. Treasury officials claim that Louisville and Gulf Breeze used quirks in how SLGS are issued to reap speculative gains, according to correspondence with regulators obtained by Bloomberg through public-records requests.

Federal officials say the local-governments put in orders for SLGS — whose prices are set just once a day — and then utilized the ability to change the requested amounts and maturities before they were issued if the broader bond market moved in their favor. As soon as the next day, they sold the securities back to the Treasury Department, profiting if interest rates declined, the department said in letters to Gulf Breeze and Louisville. The strategy resulted in earnings of about $64 million for Gulf Breeze between 2007 and 2012, while Louisville made $115 million from 2008 to 2011, according to the letters.

Gulf Breeze sought the Treasury Department's approval for the strategy. C. Willis Ritter, an attorney who advised the Treasury Department in the 1970s on the initial tax-exempt bond regulations, asked officials in March 2007 to confirm that the earnings were permitted under rules adopted in 2005. The department didn't provide a written response, according to its reply to a public records request submitted by Bloomberg.

Exoneration Seen

Enhanced Financial anticipates that the Justice Department will conclude that there was no wrongdoing, said Michael Schwartz, a lawyer who is representing the firm. The principals of Enhanced Financial, Christopher Monaghan and Michael Garner, currently work at another Pennsylvania financial adviser, Echo Financial Products LLC.

"We are fully cooperating with the Department of Justice and expect when the Department of Justice thoroughly reviews all of the evidence they will determine there's no basis to believe that Enhanced Financial Solutions did anything improper," Schwartz said.

The Treasury Department ordered Enhanced Financial in late 2013 to stop its transactions in SLGS, according to SEC records. Louisville and Gulf Breeze in 2014 were also barred from buying them for five years, according to public records.

"They said don't do that anymore and we said, OK, we won't," said Eddy, Gulf Breeze's city manager.

The city started using SLGS in the mid-2000s to invest the reserves from a 1985 bond issue that funded local government loans because guaranteed investment contracts weren't available at the time, Eddy said.

"We looked at the state and local government desk as an alternative based on advice from consultants and attorneys," Eddy said. "It's our job as administrators of the loan pool to earn as much money as we can."

Bloomberg Business

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October 27, 2016 — 2:00 AM PDT Updated on October 27, 2016 — 8:57 AM PDT