[Bond Case Briefs]

Municipal Finance Law Since 1971

[SEC Continues Public Finance Enforcement Agenda Two Recent Cases Filed: Orrick]

Just in the last weeks of August, the Public Finance Abuse Unit of the Enforcement Division of the Securities and Exchange Commission (SEC) announced settlements of securities fraud actions involving a city, an underwriter, a municipal advisor and four individuals. The first case concerned inaccurate descriptions by a city of its prior compliance with continuing disclosure undertakings. This was the second instance of SEC enforcement following closure of the voluntary reporting program known as the Municipalities Continuing Disclosure Cooperation Initiative (MCDC).**[i]** The other case was brought against a financial advisory firm for violation of the Dodd-Frank Act obligation that municipal advisors owe a fiduciary duty to their municipal clients. This is one of the first cases to explore the meaning of fiduciary duty for municipal advisors.**[ii]**

I. Beaumont, CA Finance Authority and O'Connor & Company Securities, Inc. and Anthony Michael Wetherbee (August 23, 2017)

Beaumont, CA (a small city between Los Angeles and Palm Springs) created a joint powers authority (the Beaumont Financing Authority, or BFA) to issue bonds on behalf of a Community Facilities District (CFD) to fund infrastructure for housing developments. The CFD signed numerous Continuing Disclosure Agreements (CDAs) in connection with the BFA's bonds requiring annual reports on many aspects of the developments such as tax delinquencies, description of facilities financed, fund balances, etc. During a period from 1995 to 2015, Alan Kapanicas was Beaumont's City Manager and Executive Director of the BFA, and was responsible for overseeing all of the bond issuances and CDA reporting.

Between 2012 and 2013, five bond issuances by the BFA were solely underwritten by a small firm, O'Connor & Company Securities, Inc. (O'Connor). According to the SEC, each of the Official Statements (OS's) in these five issues contained a misstatement about the CFD's compliance with its CDAs. The OS's reported one late filing of an annual report, and stated that except for this occurrence, the CFD had not failed to meet its continuing disclosure obligations. The SEC stated that, in fact, the OS's failed to disclose many other late filings, up to 117 days, and that every annual report was missing one or more elements of information required by the CDA.

Had the BFA and the underwriter reported these instances under MCDC, they would have been subject to certain pre-arranged sanctions. Now, the sanctions were more severe:

1. Beaumont Financing Authority entered a cease and desist order, neither admitting nor denying the SEC's charges, in an administrative proceeding based on violations of Section 17(a)(2) and (3) of the Securities Act of 1933 (a charge based on negligent, rather than purposely intentional, action to make a material misstatement of facts to investors). There was no monetary penalty, although compliance with the settlement terms will cost the City some money. The BFA is required to establish policies and procedures and training for securities law and CDA compliance, and for accounting and record-keeping for bond proceeds. BFA is also required to bring all existing CDA filings up to date if not in compliance. These sanctions are similar to but a little more detailed than

those applied in the 71 MCDC issuer settlements. A new requirement for BFA (which previously applied to underwriters under MCDC but not issuers) is to engage an independent consultant to provide a review and recommendations to the BFA on the matters subject to new policies and procedures. BFA must comply with such independent consultant's recommendations, subject to appeal to the SEC. As with the MCDC settlements, BFA must disclose this settlement in its OS's for five years.

This action reinforces the importance for all issuers to make sure that they have policies and procedures in place to comply with their continuing disclosure agreements.

2. Alan Kapanicas was sued in Federal District Court based on the facts described above, alleging violations of Sections 17(a)(2) and (3). The SEC only released the Complaint in the action, but its press release indicated that, without admitting or denying the charges, Kapanicas agreed to the entry of permanent injunctions against violating Sections 17(a)(2) and (3) and against participating in any offering of municipal securities. He also agreed to pay a civil fine of $37,500.

This post-MCDC action is significant in that no individual officials were included in any of the 71 issuer settlements. This is consistent with recent SEC policy in which individual officials are included in virtually every new enforcement action involving issuers, and who are usually required to pay some civil fine. Also, as noted above, the sanctions against the issuer entity were somewhat more severe and costly than the issuer would have faced if it had reported under MCDC.

3. O'Connor and its lead underwriter, Anthony Wetherbee, settled administrative proceedings brought under Sections 17(a)(2) and (3), several MSRB Rules, and a section of the 1934 Act which prohibits licensed dealers from violating MSRB Rules. Without admitting or denying the SEC's charges, which were based on failure of adequate diligence in determining if the BFA's description of its CDA compliance was accurate, the following sanctions were imposed:

A. O'Connor is required to engage an independent consultant to review its policies and procedures, and comply with its recommendations. This is similar to the MCDC settlements. O'Connor agreed to a cease and desist order, was censured and was required to pay a civil fine of $150,000, which is larger than it would have paid under MCDC.

B. Weatherbee agreed to cease and desist from violating Section 17(a)(2) or (3), and is barred for 6 months from association with any municipal dealer, any investment company, or participating in any issuance of penny stocks. He also has to pay a civil fine of $15,000. None of the 72 underwriter settlements in MCDC included any individuals.

II. Municipal Financial Services, Inc.; Rick A. Smith; and Jon G. Wolff (August 24, 2017)

The SEC brought an administrative action against Municipal Financial Services, Inc. (MFS), a registered municipal advisor (MA) based in Oklahoma, and two of its principals, Smith and Wolff. MFS was hired by an unidentified city in 2011 (City) to act as its MA and to be responsible for preparing the City's OS's for bond offerings, reviewing and commenting on all legal documents for bond issuances, and for assisting the City in compliance with its CDAs.

The City had three bond issues from 2005, 2008 and 2012 which all required annual reports to be filed within 180 days of the end of its fiscal year. In a 2013 bond issue, the City's bond counsel (a sole practitioner now retired) wrote a CDA providing for a 360 day deadline to file its CDAs, and which purported to amend the three prior CDAs to move to a 360-day reporting deadline.

The SEC alleged that MFS violated its fiduciary duty to the City by failing to advise the City that moving to the new 360-day reporting deadline violated the provisions of the 2005, 2008 and 2012 CDAs and that it did not advise the City until three years later to notify bondholders of those prior issues that the CDA deadline had been changed. These actions (carried out by Smith and Wolff) violated Section 15B(c)(1) of the 1934 Act which requires MAs to act in a fiduciary capacity with their clients, and to use reasonable care to avoid misleading clients.**[iii]**

MFS was censured, agreed to cease and desist from further violations of Section 15B(c)(1), and paid a civil fine of $50,000. MFS was also ordered to establish written policies and procedures and periodic training on the fiduciary obligations owed to municipal clients. Smith and Wolff each agreed to pay a civil fine of $8,000.

There are a couple of interesting points in this case. One is that the SEC pointed out that based on advice given in a 1995 letter to the National Association of Bond Lawyers, it is very difficult for an issuer to unilaterally amend a CDA. The SEC strongly implied (although it did not say expressly) that this City's retroactive amendment of its 2005, 2008 and 2012 CDAs was improper, substantively as well as procedurally, since the City's bond counsel did not follow the provisions in those CDAs to make an amendment. Essentially, MFS was sanctioned for failing to tell the City that it could not make such amendments.

Another point to note is that this case was based on the fact that MFS's failure to properly advise the City was serious because investors in the three older bond issues were harmed by not getting their CDAs in the time frame originally promised to them. One commentator raised the question of whether the SEC was trying to do another "round-about" regulation by suggesting that an MA owed a duty to investors, but others point out that since in this case MFS had an express contractual duty to the City to help it with CDA compliance, the outcome was not surprising.

by Roger Davis, Robert Feyer, and Alison Radecki

September 27, 2017

Orrick, Herrington & Sutcliffe LLP

[i] Under MCDC, issuers and underwriters were given the opportunity to voluntarily report to the SEC instances in which the issuer erroneously stated in an Official Statement that it had materially complied with all of its obligations under continuing disclosure agreements for the past five years. The SEC offered a pre-arranged suite of sanctions, relatively mild, for those who participated in the program, but promised harsher penalties for those who did not. Ultimately the SEC settled with 72 underwriting firms and 71 issuers under the MCDC program.

[ii] For more background on the SEC's municipal enforcement activities, please access the recent Orrick – Bond Buyer Webinar.

[iii] This action was based solely on the statutory provision enacted by the Dodd-Frank Act. Subsequent to the time covered by this action, the Municipal Securities Rulemaking Board enacted Rule G-42 which spells out in more detail the duties and responsibilities of municipal advisors to their clients.