Bond Case Briefs

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Municipal Enforcement, What Direction Under SEC Chairman Clayton?

Enforcement Forecast

Each September brings a flood of Securities and Exchange Commission announcements of enforcement actions as it approaches the September 30 end of its fiscal year. The announcements include Orders Instituting Administrative Proceedings (including Cease and Desist Proceedings and Notice of Hearing), settled Administrative Proceedings and accompanying Orders, and complaints filed in federal court, some announcing settlements, others initiating litigation in federal court. Looking back at such announcements over the past year, it is fair to say that the days of the "broken windows enforcement" policy of former Chair Mary Jo White are past. For the municipal securities market, this policy played out in the form of the Municipalities Continuing Disclosure Cooperation Initiative, or MCDC, in which the SEC filed and settled actions against 72 municipal underwriting firms and an equal number of issuers and obligated persons of municipal securities. So what can issuers, obligated persons, municipal advisors, underwriters and other municipal market participants expect from the SEC?

SEC Chairs set Commission priorities and under SEC Chairman Jay Clayton, SEC enforcement resources now have turned to "bad actors," protection of retail investors (including the elderly and "Mr. and Mrs. 401K"), and cybersecurity as stated in his Senate nomination hearing and in a later speech by his appointed Co-Directors of the SEC's Enforcement Division. In the new paradigm, the SEC continues to focus on individual officials as well as the municipalities, corporations, or firms releasing materially misleading disclosure. Likewise the Department of Justice continues the policy of holding individuals responsible for corporate wrongdoing. However, the focus appears to be less on putting numbers of enforcement actions up on the board and more upon the significance of cases brought with regard to Commission priorities. Along with policy direction, the SEC requires staff to carry out its mission, particularly in enforcement. Staff resources available to address Commission priorities have been limited by a hiring freeze in effect in place since mid-2016 and the SEC's Division of Enforcement has replaced only of its 37 departures since 2017.5 In such a context, quality matters more than quantity, and efficient use of all available resources is necessary. For the SEC, this means increased coordination with FINRA, the Financial Industry Regulatory Authority, and its own Office of Compliance Inspections and Examinations, or OCIE. So how is this playing out?

What we are seeing in our Municipal Securities Regulatory Investigations and Enforcement Defense practice reflects these adjustments. For example, we are familiar with non-public ongoing enforcement matters in areas relating to issuer disclosure and potential corruption affecting financial reporting, interest in pricing and allocation matters by underwriters in offerings as well as interest in sales involving potential "flipping," and municipal advisor conflict of interest and fiduciary duty breach, as well as basic record-keeping concerns. OCIE and FINRA are more active and aggressive on municipal securities related matters, resulting in some instances with referrals for enforcement to either the SEC's Enforcement Division or FINRA Enforcement, with subsequent opening of an enforcement investigation. Municipal advisors, brokers, dealers, and municipal securities dealers are registered and subject to inspection and examination by OCIE, FINRA and

certain banking regulators, while municipal issuers are only subject to investigation in the context of an antifraud investigation by the SEC's Enforcement Division. As a result, investigations with a focus on municipal advisors or brokers, dealers and municipal securities dealers may likely exceed those focused on issuers. However, once an investigation begins, all parties involved in a transaction may be required to produce emails and other documents and may be required to provide testimony. What remains to be seen as a factor generating enforcement inquiries is whether the combination of extensive municipal advisor record keeping requirements and the periodic inspection of those records leads to inquiries of the conduct of a municipal advisor's client as well as the municipal advisor.

Recently, we successfully concluded representation of a city in the Southwest in a post MCDC enforcement investigation of its offering disclosures and compliance with its continuing disclosure agreements, or CDAs, including purported amendment of its CDAs. While MCDC is now in the past, potentially misleading offering disclosure about continuing disclosure compliance may still attract the interest of the SEC and potentially lead to allegations of securities law violations by parties other than the issuer or underwriter.

Overall, under the new paradigm, we anticipate an increase in municipal market investigations and enforcement actions emanating from OCIE and FINRA examinations of municipal advisors and brokers, dealers, and municipal securities dealers, while investigations of municipal securities issuers and their officials arising from instances of alleged issuer official misconduct or corruption affecting issuer financial reporting and disclosure will continue. In some instances, such as described below, the investigations may be joint or parallel efforts by the SEC and the Department of Justice and FBI.

Recent Noteworthy Enforcement Activity

Issuers

The SEC and Department of Justice worked in tandem in a recent investigation, with the SEC bringing securities fraud charges against the Town of Oyster Bay, N.Y. and several of its officials while the DOJ brought charges including multiple counts of wire fraud related to securities offerings against the town supervisor. We previously published advisories on these actions.6 Likewise working in tandem with DOJ, the SEC recently brought antifraud charges against the former mayor of Markham, Illinois relating to an undisclosed pay-to-play scheme in which he allegedly solicited bribes from a construction contractor. Simultaneously, the mayor pleaded guilty to criminal charges for the pay-to-play scheme. We previously published an advisory on this matter as well.

In April, 2016, the DOJ unsealed an indictment of the Town Supervisor of Ramapo, N.Y. and the former Executive Director of the Ramapo Local Development Corporation (RLDC) with criminal charges alleging the officials had "lied about the Town's and RLDC's financial conditions in order to ensure successful sales of municipal bonds issued by the Town and the RLDC and to get better ratings on those bonds so that the Town and the RLDC would have to pay less interest on the bonds."8 Prior to trial, the former Executive Director pleaded guilty to one count of conspiracy and one count of securities fraud. At trial, the jury found the former Town Supervisor guilty of 20 counts of conspiracy, securities fraud, and wire fraud. The SEC charged the Town, the RLDC, the Town Supervisor, the former RLDC Executive Director, the Town Attorney, and the town's Deputy Finance Director with fraud charges involving the use of inflated general fund balances were used in offering materials for 16 municipal bond offerings by Ramapo or the RLDC to investors. All parties other than the Town Supervisor settled with the SEC. The SEC's litigation against the Town Supervisor continues. The federal trial judge issued lifetime bars prohibiting the former RLDC Executive Director, the Town Attorney, and the Town's Deputy Finance Director from participating in

municipal bond offerings, permanent injunctions from violating the antifraud provisions of federal securities law, fined the Deputy Finance Director $10,000 and the Town Attorney $25,000 and required their resignations from the Town and barred future employment by the Town for five and seven years respectively.9 The accounting firm and a senior partner at the firm agreed to settle charges that they issued fraudulent audit reports in connection with the municipal bond offerings by the Town and the RLDC. Without admitting or denying the findings, under an SEC Order, the firm agreed to forfeit approximately $380,000 in audit fees and interest and, pay a $100,000 penalty and engage an independent consultant. The order finds the partner violated the scienter based antifraud provisions and the negligence based prohibitions of federal securities law. The partner agreed to pay a $75,000 penalty and suspension from practicing public company accounting, and is prohibited from acting as the engagement partner or engagement quality control reviewer on any municipal audit for five years.10 The Town and the RLDC were permanently enjoined from violating the antifraud provisions of federal securities law and required to retain an independent consultant, independent auditor, and independent disclosure counsel not unacceptable to the SEC staff and unaffiliated with bond counsel.

Municipal Advisors

Whatever grace period municipal advisors enjoyed has ended, particularly for unregistered advisors contacted by the SEC regarding their failure to register. That would be the clear message from In the Matter of Eric Hall & Associates, LLC and Eric Hall,12 a Cease and Desist Order issued in a settled administrative proceeding in which the respondents, without admitting or denying the findings, consented to the order finding the firm willfully violated Securities Exchange Act Section 15B(a)(1))(B) by failing to register as a municipal advisor and that Hall was a cause of that violation, and by failing to disclose unregistered status to a client school district, each willfully violated their fiduciary duty under Exchange Act Section 15B(c)(1) as well as that same section by not dealing fairly with their school district client in violation of Municipal Securities Rulemaking Board Rule G-17. As a consequence, the firm was ordered to cease and desist from committing or causing any violations and any future violations of Sections 15B(a)(1)(B), 15B(c)(1) of the Exchange Act, and MSRB Rule G-17; censured; ordered to pay jointly and severally with Hall, disgorgement of $35,520 together with interest of $4,241.38; and ordered to pay, jointly and severally, a civil monetary penalty of $15,000. Hall was ordered to cease and desist from committing or causing any violations and any future violations of Sections 15B(a)(1)(B), 15B(c)(1) of the Exchange Act, and MSRB Rule G-17; barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter; and ordered to pay, jointly with the firm, the amounts described above.

On June 13, 2016, the SEC accepted the settlement offers made by two firms and three executives charged with using deceptive business practices in dealing with five school districts. As part of their settlements, School Business Consulting, Inc. (SBCI), SBCI's principal Terrance Bradley, Keygent LLC, and Keygent's associated individuals Anthony Hsieh and Chet Wang agreed to cease and desist from any further commission or facilitation of violations of certain provisions of the Securities Exchange Act and MSRB Rule G-17, censure, issue notices of the order to all existing clients and prospective clients, and pay monetary penalties. Further, Bradley was barred from association with any SEC-regulated entity. All respondents settled without admitting or denying the SEC's allegations.

SBCI is a consulting group for school districts on financial and budget matters, often providing them

with guidance when they seek to hire municipal advisors. Keygent is a registered municipal advisor that focuses on advising school districts and community colleges that issue bonds. Keygent analyzes outstanding bond and debt information to identify prospective school district clients and traditionally submitted unsolicited proposals aiming to refinance school district debt in order to attract new business. At issue in the case were five contracts for municipal advisor services between Keygent and California school districts, which SBCI assisted Keygent in obtaining.

After investigation, the SEC accepted offers of settlement from the entities and associated individuals under the municipal advisor antifraud provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Section 15B(a)(5) of the Exchange Act. This action marks the first time the SEC has enforced that provision. The SEC also alleged violations of Section 15B(c)(1) of the Exchange Act and MSRB Rule G-17. Further, the SEC alleged that SBCI violated Section 15B(a)(1)(B) by failing to register as a municipal advisor, and that Bradley caused SBCI's violation.13

On June 29, 2018, judgments were entered in federal district court against Malachi Financial Products, Inc., and its president and sole shareholder, Porter B. Bingham, for alleged violations of the Exchange Act and MSRB Rule G-17. The judgments were entered in accordance with a consent agreement signed by the SEC, Bingham, and Malachi. Without confirming or denying the allegations, Bingham and Malachi agreed to being permanently enjoined from further violations of Sections 15B(a)(5) and 15B(c)(1) of the Exchange Act and MSRB Rule G-17; pay a joint and several disgorgement of $33,000 plus $2,858 of prejudgment interest; and pay civil penalties of $50,000 for Malachi and $25,000 for Bingham. On July 9, 2018 the SEC cited the final judgments in revoking Malachi's registration as a municipal advisor and barring Bingham from association with any "broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization," effectively prohibiting Malachi from engaging in municipal advisory activities and barring Bingham from engaging in activities that are regulated by the SEC.

On May 9, 2018, the SEC announced it charged a registered municipal advisor (the "MA Firm") and its owner (the "MA Owner") with defrauding their client, a Texas school district, in connection with multiple municipal bond offerings. This enforcement action brings attention to the obligations and duties that municipal advisors have to their clients.

The SEC's Order states that in connection with three municipal bond offerings the MA Owner and his wholly-owned MA Firm misrepresented their municipal advisory experience and failed to disclose to the school district that the MA Owner was employed by the attorneys who served as bond counsel for all three bond offerings. Specifically, the SEC stated that, in an attempt to gain municipal advisory clients, the MA Owner drafted and circulated a brochure to the school district and municipalities to market the MA Firm's municipal advisor experience. The SEC order states that the brochure created the misleading impression that the MA Owner and MA Firm had served as a municipal advisor on numerous municipal bond issuances and failed to disclose that the MA Owner had a financial interest in the school district's offerings.

By misrepresenting their municipal finance experience and failing to disclose the conflict of interest, the SEC concluded that:

- The MA Firm violated and the MA Owner willfully violated Section 15B(a)(5) of the Securities Exchange Act of 1934, which prohibits any fraudulent, deceptive, or manipulative act or practice while providing advice to a municipal entity with respect to municipal financial products [or] the issuance of municipal securities;
- The MA Firm breached and the MA Owner willfully breached their respective fiduciary duty to the

school district, as set forth in Section 15B(c)(1) of the Exchange Act; and
- The MA Firm and the MA Owner failed to deal fairly with the school district in violation of Municipal Securities Rulemaking Board Rule G-17.

The MA Firm and the MA Owner consented to the order and are jointly and severally liable for paying $362,606 in disgorgement and $19,514 in prejudgment interest. The MA Firm was also assessed a civil penalty of $160,000 while the MA Owner was assessed a civil penalty of $20,000. The MA Owner was also barred from association with various regulated entities, including municipal advisors.

On August 24, 2017, a municipal advisor, its president, and its vice-president were charged by the SEC with breach of their fiduciary duty to a client. According to the SEC's administrative summary,16 Municipal Finance Services Inc. ("MFSOK") served as municipal advisor to the client on a municipal bond offering in 2013, and as part of its advisory services, agreed to review legal documents related to the issuance of the bonds and to assist the client in complying with its continuing disclosure agreement requirements. According to the order, the continuing disclosure agreement for the 2013 offering contained an improper amendment to the client's prior continuing disclosure agreements for bond offerings in 2005, 2008 and 2012, unilaterally extending the deadline by which the client was to provide annual reports to investors for those prior offerings. The order states that MFSOK president Rick A. Smith and vice-president Jon G. Wolff each had concerns about the amendment, which was drafted by a now-retired bond counsel, but took no action. According to the order, Smith and Wolff did not advise the client of their concerns, did not comment on the draft amendment provisions, did not conduct further investigation, and did not seek further information from bond counsel or otherwise attempt to determine whether the amendment complied with the terms of the client's prior continuing disclosure agreements. The order found that Smith and Wolff also failed to advise the client of its obligation to notify prior bondholders of the amendment in a timely manner, as required by the client's prior continuing disclosure agreements. As a result, some investors in the earlier bonds engaged in transactions without the benefit of the updated financial information contained in the annual reports that had been promised in the continuing disclosure agreements for those bonds.

The SEC's order instituting settled cease-and-desist and administrative proceedings found that MFSOK willfully violated Section 15B(c)(1) of the Securities Exchange Act of 1934 and that Smith and Wolff caused MFSOK's violation. Without admitting or denying the SEC's findings, MFSOK agreed to a censure, to cease and desist from committing or causing further violations of Section 15B(c)(1) of the Exchange Act, and to pay a $50,000 penalty. Smith and Wolff agreed to cease and desist from committing or causing further violations of Section 15B(c)(1) of the Exchange Act and each agreed to pay an $8,000 penalty. Under the order, MFSOK is required to establish appropriate written policies and procedures and periodic training regarding the fiduciary duty owed by municipal advisors under the federal securities laws, including the provision of advice concerning an issuer's continuing disclosure obligations.

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