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SEC’s Gaunt Sees Fines for Muni Bond Breaches: Five Questions.

The head of the U.S. Securities and Exchange Commission’s unit overseeing municipal bonds and pensions is urging local governments to come clean if they failed to keep investors informed about the state of their finances.

If they do: Localities can escape fines, while Wall Street firms that sold their bonds would see them capped at $500,000. If not: “They absolutely should be expecting harsher sanctions.”

Gaunt took over in November, policing a $3.7 trillion market coping with record bankruptcies, depleted pension funds and new rules aimed at protecting localities from banks and once-unregulated financial advisory firms.

The unit has charged New Jersey, Illinois, and Harrisburg, Pennsylvania, with fraud for misleading investors about deteriorating finances. In November, it took a new tack, fining a Washington authority that defaulted on hockey-rink bonds after hiding misgivings, marking the first financial penalty against an municipal issuer.

Following is condensed from a recent telephone interview about her priorities as the market’s top enforcement official:

Q: In March, the SEC offered leniency to municipalities and underwriters in cases where buyers were told that a borrower had been providing adequate updates on their financial affairs, even when they weren’t. They have until September to report violations. What has the response been?

A: On the one hand, it’s a little disturbing that they don’t know whether they have been in compliance. On the other hand, it’s great that people are trying to get their houses in order. We certainly hope that if they find problems, they take advantage of the initiative. They absolutely should be expecting harsher sanctions if they elect not to.

Q: Since last year the agency has been scrutinizing the disclosures of distressed borrowers. Can we expect enforcement actions to result?

A: We certainly are seeing situations where issuers would have strong incentives to be less than fully candid. We’re going to be prepared to bring enforcement actions when we find the right kind of cases. We are actively monitoring distressed issuers, including whether they are continuing to comply with their disclosure obligations. Our Harrisburg case was particularly instructive. Harrisburg had not been complying, creating a kind of information vacuum, which is particularly dangerous for an issuer that’s in distress.

Q: During the financial crisis, municipalities were hurt by complex transactions. Since Dodd-Frank, the Municipal Securities Rulemaking Board has updated its rules to put added requirements on underwriters’ dealings with municipalities. What is the agency’s approach toward enforcing regulations aimed at protecting issuers?

A: We're looking at the conduct of banks as it relates both to issuers and investors. What you sometimes see is that conduct that hurts issuers also hurts investors. We're investigating cases where the posture is issuer as victim, as distinct from issuer as perpetrator. Are they being dealt with fairly? Are they getting competent advice from their advisers? Are these sensible structures? Are they getting the lowest possible borrowing costs? What are the risks? Are they getting unconflicted advice? That's a very high priority for us. That's a core focus.

Q: Are there areas of the municipal market where you feel there aren't sufficient regulations?

A: There's a lot of work to be done around issues associated with markups in the secondary market, just in terms of ensuring there's adequate disclosure to investors about what markups they're paying.

Q: Your division also oversees pensions. What is the agency's focus there?

A: There's a substantial intersection between underfunded pension funds and municipal securities issuers. Accurately reporting the extent of the underfunding is important, and the failure to do so could be materially misleading to investors.

Separately, we're focused on instances where pension funds have been victimized by bad behavior by other participants. We always have a very healthy stable of pay-to-play investigations. As we're seeing more pensions investing in alternative investments, we're interested in fee disclosures. Many pension funds are sophisticated. Many are not — and we're interested in whether they're receiving adequate disclosure about the fees associated with those types of investments.

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