The SEC Halts Fraudulent Bond Offerings in Harvey, Illinois.

A Chicago suburb is under investigation for allegedly diverting at least $1.7 million in bond proceeds meant for a new hotel to instead pay for the municipality's operating costs including wages, the Securities and Exchange Commission announced Wednesday.

The SEC has filed fraud charges in U.S. District Court for the Northern District of Illinois against the city of Harvey, Ill., and its comptroller, Joseph Letke, who the SEC says received approximately $269,000 in undisclosed payments from the bond proceeds. The commission also halted a planned bond offering by the city this week via an emergency court order.

"We moved quickly to stop this city and its comptroller from issuing more bonds under false pretenses," Andrew Ceresney, director of the SEC's Division of Enforcement, said in an issued statement. "We will continue to aggressively pursue municipalities and public officials who raise money through fraudulent bond transactions that harm both investors and residents."

In 2008, 2009 and 2010, Harvey issued limited obligations bonds that were to be repaid from dedicated tax revenue streams such as Harvey's hotel-motel tax, sales tax or incremental tax from the Tax Increment Financing District created for the planned Holiday Inn development. The payback structure meant that it was vitally important to bond investors that the money raised in the bond offering was actually used to fund the hotel development. That's because the amount of funds available to repay the bonds were derived from tax revenues collected by the project — and those revenues would be materially affected by the funding and progress of the project.

However, the SEC alleges that Harvey's bond investors were misled about the purpose and risks of the bonds they purchased from the city. The SEC's release cited news reports that described the Holiday Inn hotel and conference center as "a decrepit shell" with a façade pocketed with holes and a gutted interior with dangling wires and exposed studs.

"As Harvey and Letke perpetrated the scheme to divert bond-related proceeds," the commission said, "the hotel redevelopment project turned into a fiasco for bond investors and city residents."

The SEC action comes as part of increased enforcement by the commission on municipalities and states. Last year, the commission reached independent settlements with the Illinois and Harrisburg, Pa. The commission had accused both governments of securites fraud. It said Illinois had misled investors about the poorly funded state of its pensions while accusing Harrisburg of misleading investors by not reporting important city financial data. Both governments reached financial settlements with the SEC and did not have to admit to wrongdoing.

This is the first fraud charge by the SEC this year against a government. The commission has hinted at more to come. This spring, the Enforcement Division announced a self-reporting offer, encouraging "issuers and underwriters of municipal securities to self-report certain violations of the federal securities laws rather than wait for their violations to be detected." In exchange, the SEC is promising "standardized, favorable settlement terms," but did not specify what those terms could be. The offer stands until Sept. 10.

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