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SEC Raises Pressure on Borrowers as Leniency Ends: Muni Credit.

Just before speculation mounted four years ago that defaults would soar in the U.S. municipal-bond market, a school system in California's San Joaquin Valley assured investors that it was making adequate financial disclosures.

It wasn't. The Kings Canyon Unified School District hadn't filed or was late in disclosing a half-dozen financial statements, a lapse it didn't report in documents used to market about $7 million of bonds in November 2010.

The district in July became the first municipality to accept the U.S. Securities and Exchange Commission's offer of leniency for borrowers that report by today any failures in providing adequate documentation to investors. It's part of a push by the agency to pressure localities to comply with the laws in the $3.7 trillion market, where disclosure rules are more lax than they are for companies selling stocks and bonds.

"We've got to put municipals on the same level of disclosure that you have in other markets — and that's what this is really all about," said Richard Ciccarone, the chief executive officer of Hiawatha, Iowa-based Merritt Research Services LLC, which analyzes municipal finance.

Default Call

As the leniency program ends, borrowers may face fines if they're charged with fraud.

The SEC has increased its focus on the municipal market since the credit crisis and 18-month recession that ended in June 2009. Those events helped push Jefferson County, Alabama, Detroit and three California cities into bankruptcy and left government pension plans reeling from investment losses. In a December 2010 interview on CBS Corp.'s "60 Minutes," banking analyst Meredith Whitney forecast that there would be widespread defaults, a prediction that didn't materialize yet helped trigger months of sales by individual investors.

The agency has settled with the governments of New Jersey, Illinois and Harrisburg, Pennsylvania, for misleading investors about their financial state. Last year, in a case against an agency in Washington state, the SEC levied its first fine against a municipal issuer that misled investors.

SEC enforcement director Andrew Ceresney told a meeting at the Securities Industry and Financial Markets Association in New York last month that the agency plans to impose fines more often in fraud cases against states and cities.

Bankers Too

The leniency program introduced in March is aimed at municipalities that fail to file timely reports on rating changes and other information of interest to investors, while claiming in bond documents that they do. It's also open to the bankers who underwrote the debt. The SEC said borrowers could settle without fines if they turn themselves in. Banks’ penalties are capped at $500,000.

Elaine Greenberg, the former head of municipal enforcement at the SEC, said the program reflects regulators’ view that borrowers routinely neglect to disclose required information.

“There has been a perception at the SEC that there has been widespread failure by issuers as well as underwriters with regard to continuing disclosure obligations,” she said.

The SEC has limited power to compel states and cities to disclose information to investors because of curbs on its power that have been in place since the 1970s. It imposes the rules indirectly by forbidding underwriters from selling securities unless governments agree to provide investors ongoing financial updates.

Company Contrast

Analysts, investors and others told the SEC that some municipalities don’t report pertinent information or take months to do so, according to a 2012 report from the agency.

While corporations must file quarterly financial statements and have four business days to report information relevant to investors, municipalities only submit annual reports and agree to disclose material events within 10 business days.

Michael Decker, who follows municipal-bond regulation for Sifma, which represents banks, said dozens of underwriters have sought leniency under the SEC offer. The institutions had until Sept. 10 to do so.

“I haven’t talked to a firm that hasn’t participated,” he said.

Kevin Callahan, an SEC spokesman in Washington, declined to comment on how many submissions the agency has received. The SEC’s Ceresney said during the November Sifma panel that the agency had received a “tremendous number of submissions.”

South Dakota

Mitchell, South Dakota, a city of 16,000 people about 70 miles (113 kilometers) west of Sioux Falls, is among them. It reported that it filed an annual financial report late after being told of the breach by its underwriter, Dougherty & Co., said Marilyn Wilson, who handled the city’s finances until her retirement last month. Pam Ziermann, the chief compliance officer for the Minneapolis-based underwriter, declined to comment.

“We are clearly not the only one who is going to do this,” Wilson said.

Greenberg, the former SEC official, who’s now a partner at Orrick, Herrington & Sutcliffe LLP in Washington, said the program is making public officials scrutinize whether they’ve been flouting the law.

“It has caused all of the market participants to look seriously at their continuing disclosure obligation,” she said. “This is already leading to change.”

Staffing Turnover

Regulators have taken other steps to improve the flow of information to investors in the municipal market. Since 2009, issuers have filed documents to a centralized, public website run by the

Municipal Securities Rulemaking Board, instead of private vendors. The SEC in 2012 issued guidance to banks instructing them to review the disclosure practices of governments whose bonds they underwrite.

"Things have improved considerably in the muni market in the last couple of years in terms of the amount of information that is available," said Gary Pollack, the New York-based head of fixed-income trading at Deutsche Bank AG's private-wealth management unit, which manages $7 billion of munis. "Anything that improves the issuers' timeliness in terms of disclosure of their financial well-being is positive."

The SEC program may push the market further in that direction. When the Kings Canyon district settled with the SEC, it agreed to comply with disclosure rules within 180 days and make sure it doesn't break the law again.

John Quinto, the district's business manager, said the failures resulted from staff turnover, not an effort to deceive.

"We weren't out to purposely mislead or do any harm," he said. "That doesn't relieve us of the responsibility."

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