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U.S. Strikes Deal with Chicago Suburb of Harvey Over Bond Fraud.

Dec 5 (Reuters) – The Chicago suburb of Harvey has settled civil charges in an unusual case where federal regulators had rushed to obtain an emergency restraining order against a planned bond sale, the Securities and Exchange Commission said on Friday.

Under the settlement reached with the SEC on Thursday, Harvey will be required to obtain an independent consultant and undergo an audit, and the city faces certain restrictions on selling new debt.

In a complaint filed in June against the city and its comptroller, the SEC asked the U.S. District Court for the Northern District of Illinois to prevent Harvey from selling bonds and also demanded a jury trial.

Both were unusual requests in the commission's current crackdown on the $3.7 trillion municipal bond market. By law, municipal bond issuers do not have to involve federal regulators in planned debt sales.

As part of the settlement, Harvey agreed to a final judgment forcing it to stop selling municipal bonds for three years unless it retains independent bond counsel. The litigation against the comptroller, Joseph Letke, is pending, the SEC said.

"These measures are designed to prevent future securities fraud by Harvey and to enhance transparency into Harvey's financial condition for future bond investors," the agency said in announcing the deal.

Starting in 2008, the city sold $14 million in bonds for the construction of a Holiday Inn that would be repaid from dedicated hotel-motel and sales tax revenues. It then diverted at least $1.7 million to fund its daily operations and also made $269,000 in undisclosed payments to Letke, the SEC alleged.

The SEC has described the city of 30,197 people as "in a desperate financial condition" and the hotel project as a "fiasco."

Over the last two years, the SEC has tightened the vise on the municipal bond market, rapping cities, individuals and even states for not properly informing investors of the risks involved with certain municipal bonds.

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By Lisa Lambert and Sarah N. Lynch

(Editing by Susan Heavey)