

# **Bond Case Briefs**

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## **Regulators Way Too Easy On Muni Bond Fraudsters.**

In business, when an employee diverts money it is a crime. When they attempt to make things seem other than they are—cooking the books—it is a crime. So why are municipal bond regulators lax in initiating punitive actions against municipalities for diverting funds and cooking the books? Whether it's a state misleading investors, or a municipality whose officials divert funds, a rap on the knuckles only hurts investors and taxpayers, not those perpetrating the crime.

An example of such light punishment occurred in Harvey, Ill. where its comptroller—Joe Letke—was found to have diverted millions in bond proceeds to other projects and to his own pocket. His punishment was merely to pay a fine that appears to be a fraction of what he stole and be barred from ever participating in a municipal bond offering again.

For their role in this fraud, the city of Harvey agreed to stop violating federal securities law and to hire a different consultant other than the one who was caught with his hand in the cookie jar. Oh, and the city was allowed to neither admit nor deny any wrongdoing.

Municipal bond fraud seems to be on the rise. In the recent past the SEC slapped a civil fraud on the State of Illinois for lack of disclosure on its public pensions. New Jersey was charged with fraudulent bond offerings. The court order states that New Jersey has a significant disregard...for the principles of fair and accurate disclosure.

On a smaller scale, Grossmont Union High School District in San Diego County was found to have diverted monies from a voter-approved measure and into non-authorized projects—a classic bait and switch scheme.

When we investors read what the uses of money are for and the issuer does not adhere to that specified project, why aren't the people involved sent to jail? In the case of Grossmont High Schools, once they had the money in their hot little hands they thought they could do whatever they wanted with it rather than what they promised the taxpayers who voted for the bond issue.

As you might guess, Grossmont is seeking to resolve its financial woes in court. However, in such an action, only the lawyers win, not the taxpayers. Consider the audacity of Grossmont in issuing another \$60 million in bonds over the next few months. Why would any bond investor trust a word Grossmont's, Harvey's, or the States of Illinois or New Jersey officials say? We don't.

During the legal process of putting together a municipal bond offering, the most important document is the Official Statement. This identifies how and where the monies are spent once the bonds are issued. Those responsible to the bond investors sign off on the Official Statement attesting to the validity of the financial statements, sources and uses of funds, debt service coverage calculations, and cash reserves. Investors rely on the Official Statement.

When the issuers lie about the facts or don't execute what the Official Statements says they will—as in the case of Harvey, Ill, the state of Illinois and the state of New Jersey—the entire issuers integrity craters into a morass of incredulity. That's when the regulators must step in—with an Abrams tank

rather than their usual fly swatter that does little in the way of deterring others.

Underwriters, lawyers, regulators and issuers should all abide by and comply with the rules. It's the retail investors who need their protection. As a bond manager, it is frustrating to get only half-truths or worse—outright lies—while the culprits live large without a hint of remorse or consideration toward the bondholders or voters.

There should be significant punishments for those who break securities laws. Investors beware. Always study compliance with an issuer's past bonds and the promises made. Ask, did they execute what they said they would? Did they deliver? Finding even one instance of noncompliance with the Official Statement is one too many. As with the cockroach theory—there's never just one.

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