

Bond Case Briefs

Municipal Finance Law Since 1971

SEC Commish Praises Muni Bond Fraud Enforcement Push.

Law360, New York (March 10, 2015, 3:31 PM ET) — A top Republican on the U.S. Securities and Exchange Commission on Tuesday backed the agency's increased use of enforcement powers to clamp down on municipal bond fraud, and delivered a tough message to municipalities when he called a failure to adequately disclose pension shortfalls "an unpardonable sin."

In a speech before a Financial Industry Regulatory Authority conference in New York, SEC Commissioner Daniel Gallagher heaped praise on the efforts of the agency's specialized enforcement unit for municipal bonds and public pensions. He noted in particular the unit's emergency action last year to stop a bond offering by a Chicago suburb after finding evidence that some of its proceeds were going to be illegally diverted to the city's comptroller and bond adviser, Joseph Letke.

The city of Harvey in December reached a settlement with the SEC that imposed certain conditions on it for three years, while the agency also secured a default judgment against Letke himself.

"This case was an outstanding use of agency resources, and I fully support prohibiting municipalities that cannot or will not comply with the law from accessing the securities markets, as well as pursuing the culpable officials who perpetrate the fraud," Gallagher said.

His remarks come as the SEC continues to turn away from a historical reticence to bring enforcement actions against municipalities and government workers over alleged bond frauds and misconduct, even though its powers over the market are limited. For example, the so-called Tower Amendment prevents the SEC from requiring issuers to file offering documents ahead of an issuance, and the agency has no authority to directly regulate the content and form of municipal disclosures, Gallagher said.

However, the SEC's enforcement efforts appear to be improving transparency within the municipal bond market, he said.

For one, its Municipalities Continuing Disclosure Cooperation initiative, an effort the agency launched last year to get issuers and underwriters to come forward about possible disclosure violations in exchange for leniency, is perhaps the reason for a 40 percent bump in the number of financial and operating disclosures made publicly available last year compared to the previous year before, Gallagher noted.

The commissioner did not signal any new enforcement initiatives targeting failures to disclose unfunded pension liabilities, but it is an area in which the SEC has previously taken action in settlements with New Jersey, Illinois and, most recently, Kansas.

In addition to poor disclosure of pension shortfalls being an "unpardonable sin," Gallagher also said these liabilities amount to "a true systemic risk," particularly given recent changes to accounting for pension liabilities that has forced plan administrators to disclose a more realistic assessment of their shortfalls than they had before.

“But don’t hold your breath waiting for FSOC to address it,” Gallagher quipped, referring to the Financial Stability Oversight Council. “They are probably too busy with Level III assessments of lemonade stands anyway.”

Separately, Gallagher urged the bond industry to lead its own migration toward electronic or exchange-based trading of corporate bonds, saying it otherwise may face the prospect of Congress imposing its own solution on the industry if rising interest rates spark a liquidity crisis.

In his speech, the commissioner repeated warnings about storm clouds brewing over the corporate debt market, as dealer bond inventories shrink to record low levels and rising rates could force investors to flee riskier assets. Put together, these could put a freeze on the market’s liquidity, Gallagher said, a particular problem considering the degree to which mutual fund complexes and insurance companies have bulked up their reserves of these assets.

To address this, Gallagher repeated calls he made in the fall for the SEC to help spur electronic or exchange trading of corporate debt, which he said could help keep the marketplace flowing for these securities. But, he added, the process should not wait for issuers to start standardizing typically “bespoke” offerings that would be easier to trade.

Instead, it is the market’s infrastructure that could adapt to the challenges of trading corporate paper, he continued, noting that options exchanges regularly transact unique contracts.

If the industry doesn’t move, then Congress could step in with a “draconian” solution such as forcing all corporate bonds to be traded on an exchange, Gallagher added. “This is exactly what happened in another over-the-counter market, the swaps markets, in the Rube Goldberg invention known as Title VII of Dodd-Frank.”

By Ed Beeson

-Editing by John Quinn.