Bond Case Briefs

Municipal Finance Law Since 1971

SEC: RIEDC, Wells Fargo Defrauded Investors In 38 Studios Deal.

WASHINGTON – The Securities and Exchange Commission on Monday charged a Rhode Island agency, its underwriter, and three individuals associated with $75 million of 2010 bonds for a startup video game company with defrauding investors by not revealing the complete financial status of the company or the extent of the compensation arrangement with the underwriter.

The commission also settled related charges against First Southwest, the agency's financial advisor at the time, for failing to document its advisory relationship with the agency for seven months. First Southwest, without admitting or denying the findings, agreed to disgorge $120,000 of ill-gotten gains plus pay prejudgment interest of $22,400 as part of the settlement.

The SEC filed its complaint alleging fraudulent disclosures related to privately-placed bonds for the now-bankrupt video game company 38 Studios in a federal district court in Providence, R.I. The complaint names the Rhode Island Economic Development Corp., now called the Rhode Island Commerce Corp., Charlotte-based underwriter Wells Fargo Securities, as well as Peter Cannava, who the SEC said was Wells Fargo's lead banker on the deal. The litigation against these parties is ongoing with the SEC seeking injunctions against future violations and civil penalties of unspecified amounts for each defendant.

Gabriel Boehmer, a spokesperson for the firm, said Wells Fargo disputes the SEC's allegations in connection with the placement of the municipal bonds and will respond to the specific allegations in the complaint in court.

Two other individuals, former RIEDC executive director Keith Stokes and former RIEDC deputy director James Michael Saul, already settled charges and agreed to each pay $25,000 without admitting or denying the allegations that they were responsible for the RIEDC not making complete and truthful disclosures in the bond placement memo — the key disclosure document for potential investors. The two former RIEDC executives are also barred from participating in future muni offerings.

The charges stem from the $75 million of muni bonds that the RIEDC privately placed in November 2010 to help finance a project being developed by 38 Studios, whose board chair and majority shareholder was former baseball player Curt Schilling. The funding for the project was part of a Rhode Island program intended to spur economic development and promote job growth. The RIEDC loaned 38 Studios $50 million in bond proceeds and used the remaining funds to pay related bond offering expenses and establish a reserve fund and a capitalized interest fund.

The loan was meant to be repaid with revenues 38 Studios generated from a multi-player video game project code-named Project Copernicus. However, the bond placement memo failed to disclose to investors that Massachusetts-based 38 Studios needed at least $75 million to produce the game and even more money to relocate to Rhode Island. The video game company did not obtain the extra financing and eventually defaulted on its loan in 2012.

“Municipal issuers and underwriters must provide investors with a clear-eyed view of the risks involved in an economic development project being financed through bond offerings,” said Andrew Ceresney, director of the SEC’s enforcement division.

The SEC included evidence in its complaint against the RIEDC, Wells Fargo and the three individuals that the defendants either knew or should have known, about the company’s financing issues before moving forward with the private placement. The company had made clear throughout its negotiations with the RIEDC that it would require $75 million and it was clear from discussions and documents at the time that the company would only receive $50 million from the RIEDC loan, the SEC said.

Both Stokes and Saul reviewed the bond placement memo, as well as other financial documents, for the RIEDC. The SEC alleged Cannava had primary responsibility for Wells Fargo on the 38 Studios bond offering as well as the authority to sign contracts and agreements on behalf of Wells Fargo.

The SEC complaint also alleges that Wells Fargo misled investors by not informing them that the firm had a side deal with 38 Studios that allowed it to receive almost double the amount of compensation as was disclosed in the offering documents. The additional compensation created a conflict of interest, according to the commission.

“An underwriter’s ‘skin in the game’ is material information to investors,” said LeeAnn Ghazil Gaunt, chief of the SEC enforcement division’s municipal securities and public pensions unit.

When 38 Studios was first trying to get additional financing, it was considering both an RIEDC loan as well as funding from an equity private placement. Wells Fargo worked on both financing options during the spring of 2010, but ultimately did not find any investors for the equity private placement. The underwriter designed a $400,000 fee structure to insure it would be compensated for the work it did on both financings, even though one wasn’t chosen. Wells Fargo only disclosed that it would receive a $406,250 share of a $634,065 placement agents’ fee but not the additional $400,000, according to the SEC’s complaint.

The SEC said the actions by the RIEDC and Wells Fargo violated SEC rules that prohibit fraud in the offer or sale of securities while, Wells Fargo additionally violated MSRB rules on fair dealing and disclosure by municipal market professionals. The three individuals were found to have aided and abetted the violations of their employers.

Rhode Island general treasurer Seth Magaziner said in a statement that the fraud charges illustrate the urgent need for stronger debt management and oversight in Rhode Island.

“My office has taken action to strengthen debt management in Rhode Island, by replacing the financial advisor involved in the 38 Studios deal and introducing legislation to strengthen oversight of public borrowing at all levels of government,” he said. “I am committed to working with the General Assembly to reform Rhode Island’s system of debt management and oversight, to minimize the chance of a future public debt debacle.”

The Bond Buyer

By Jack Casey

March 7, 2016