# Bond Case Briefs

*Municipal Finance Law Since 1971*

---

## Expanding Municipal Securities Enforcement: Profound Changes for Issuers and Officials.

While many in the municipal securities market have been preoccupied with the Securities and Exchange Commission's Municipalities Continuing Disclosure Cooperation Initiative, other significant developments have been occurring in the SEC's municipal regulation through enforcement.

Since early 2013 alone, apart from the MCDC Initiative, there have been enforcement actions brought against 18 state or local governmental entities and against 16 issuer officials. In contrast, in the 14 years from the beginning of 1999 through 2012, the commission resolved disclosure actions against only 11 state or local entities and 10 officials. There is a definite change in tone.

Municipal securities enforcement has experienced a number of significant firsts in the 3½ years since early 2013. Most, if not all, of those measures follow the SEC's expansion of the role of its Public Finance Abuse Unit (formerly, Municipal Securities and Public Pensions Unit).

At about the time the SEC's more aggressive activity began, Mary Jo White, a former federal criminal prosecutor, became chair of the commission. White defined a priority of enforcement against the full range of securities law violations, even minor ones involving only negligence, as opposed to intent or recklessness. White described this as "Broken Windows" enforcement.

The commission's reliance on enforcement is not a surprise. Indeed, it is the market discipline contemplated in 1975 with the enactment of the Securities Acts Amendments of 1975. These included the Tower Amendment prohibiting the SEC from requiring pre-sale review of municipal official statements.

As a part of the bargain, Congress also amended the definition of "person" in Section 3(a)(9) of the Securities Exchange Act of 1934 to include "a government or political subdivision thereof." That seemingly minor statutory change gave affirmative congressional authority — a green light — to the SEC for post-offering pursuit of state and local entities and officials not only for acts of fraud in violation of SEC Rule 10b5, but also pursuant to Section 17(a)(2) and (3) of the Securities Act of 1933 for negligence.

To summarize the outcome in 1975, there are no pre-sale SEC reviews of municipal issuers' official statements and little in the way of pre-offering SEC disclosure mandates (other than in the definition of "final official statement" in SEC Rule 15c212), but post-offering review through SEC enforcement was clearly contemplated by Congress.

Importantly, the commission's change of direction from its prior reliance almost solely upon deferential cease-and-desist orders against municipalities and public officials has far-reaching implications.

In the past 3½ years, the SEC has asserted its enforcement role considerably. It is not unfair to describe this approach as a form of direct regulation of issuers.

The MCDC Initiative is only one SEC enforcement undertaking, albeit against multiple parties. The SEC has embarked on a much larger journey. This is not good news for issuers or officials (or others). Instead of SEC guidance through regulation in advance of bond issues, the enforcement approach provides after-the-fact guidance to which bond lawyers and others pay significant attention. Enforcement may provide a very rough form of post-offering guidance indeed for the particular issuers and officials (and others) affected directly. Yet enforcement does provide helpful information for the balance of the market.

As discussed below, the Commission has achieved the following examples of "firsts" since early 2013:

- Collected its first civil penalties from issuers;
- Obtained its first emergency court order against an issuer to halt an offering in progress;
- Prohibited issuers from issuing municipal securities in the future without first satisfying specific conditions precedent;
- Determined "control person" liability for key issuer officials—mayors—without alleging that the officials acted with fraudulent intent or even with negligence;
- Ordered the first bars of municipal officials from participation in future offerings, effectively preventing the officials from exercising significant official responsibilities (or from working with underwriters);
- Ordered an issuer official to pay a civil penalty and barred the official from future bond offerings, although the official was alleged only to have been negligent due to a failure to read an official statement he signed;
- Taken its first action against a municipality for violations in public statements by the mayor — political speech — appearing together with annual financial reports on the issuer's website; in other words, held an issuer liable for information provided outside of official statements or continuing disclosure documents filed with the MSRB;
- Taken action against a municipality in connection with tax certifications to bond counsel and a pooled bond issuer, i.e., documents that investors never saw nor could be expected reasonably to see;
- Received the benefit of District and Appellate Court decisions that a municipal official is not entitled in securities law enforcement proceedings to qualified immunity in the performance of discretionary official duties;
- Taken its first action, based upon information relating to a private conduit borrower, against a governmental issuer providing credit enhancement for the borrower's payment obligations;
- Ordered an issuer to employ an independent monitor to review transactions for conflicts of interest;
- Taken its first action against local issuer counsel;
- And taken an action in coordination with a Justice Department criminal action in a municipal disclosure case pursuant to an announced policy of cooperation.

In another "first," the SEC is seeking potentially harsh monetary remedies in a pending action against a city that already is subject to a cease-and-desist order from a prior enforcement action.

Although the imposition of civil penalties on municipal officials is not a "first," previously the SEC imposed civil penalties only in a few instances. More recently, the commission has followed a pattern of imposing significant civil penalties on municipal officials in several separate actions within a brief period. Since the beginning of 2013, the Commission has levied $180,000 in civil penalties on eight officials. In contrast, five officials (in only two actions) paid $85,000—less than half as much—in civil penalties in the 15 years from 1998 through 2012. In pending actions, the SEC is seeking to levy civil penalties on five additional governmental entities and an additional six officials.

In connection with its increasing penalties, the commission is seeking, among other things, to place a greater emphasis on the responsibilities of individual officials, in addition to organizations for which the officials act.

Sometimes, in acting against municipal officials, the commission alleges control person and aiding and abetting liability. For example, in one settled action, for the first time, the SEC asserted that a former mayor "controlled" the actions of the city administrator and the city.

In a recent settled action against a sitting mayor the SEC alleged only that the mayor was a control person in relation to the city and the city's comptroller, that the mayor signed official statements and bond closing certificates, and the city and its former comptroller (as opposed to the mayor) had committed fraud. The commission made no explicit allegation that the mayor knew of disclosure violations, or even that he was reckless or negligent. The commission did not allege that the Mayor promoted or was involved in the project financed through the issuance of bonds. The commission did allege that the mayor asserted his Fifth Amendment privilege against self-incrimination during his investigative testimony before the commission in response to all substantive questions regarding the events at issue. Therefore, one is left to infer that the mayor did not have a good faith defense to overcome the commission's control person liability charge. Yet, that inference is part of the point. The burden of proof on the issue of good faith rested on the mayor, not the SEC. The remedies included a civil penalty and a bar against participation in future bond issues—a difficult outcome requiring a delicate balancing act for a sitting mayor, bond professionals working with the city, and investors purchasing the city's bonds. This approach may prove challenging for community leaders elsewhere in the future.

In another action against a former charter school CEO, the commission imposed a $10,000 civil penalty and barred the CEO from future bond issues for failing to read an official statement he signed. Despite the harsh remedies, the SEC did not charge the former CEO with fraud, only negligence. In the commission's press release regarding the action, David Glockner, regional director of the SEC's Chicago Regional Office, stated: "This kind of negligent behavior is unacceptable in the securities markets."

Perhaps as an indication of things to come in more egregious fact settings, another "first" includes the first time that the SEC has announced an intention to coordinate with the Justice Department regarding misconduct in the municipal bond market. One recent coordinated effort led to the indictment of municipal officials in a pending action in connection with alleged disclosure violations.

Reviewing the past 3½ years, in circumstances involving carelessness, the SEC has recognized issuer efforts to improve practices by adopting policies, assigning responsibility, and training staff, and has imposed less exacting remedies structured to provide future assistance to the issuers. The commission's message is heavily underscored, however, in more egregious circumstances by remedies that drive the message home with an emphasis that issuers, officials and the market should not mistake.

It is likely that those changes in enforcement will result in significant alterations in the behavior of the vast majority of market participants.

**The Bond Buyer**

By Robert Doty

July 12, 2016

*Robert Doty is president and proprietor of AGFS, a municipal securities litigation consulting firm in Annapolis, Md. This commentary is excerpted from his forthcoming book, "Expanding Municipal Securities Enforcement: Profound Changes for Issuers and Of icials," to be published by the International Municipal Lawyers Association.*