Bond Case Briefs

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Brace for More SEC Muni Advisor Antifraud Actions.

SEC hasn't taken enforcement action against a municipal advisor in over a year, but that situation could change very soon.

As we approach the 10-year anniversary of Dodd-Frank's municipal advisor antifraud and registration provisions, which takes place on Oct. 1, several trends are converging that may put municipal advisors in the SEC's crosshairs.

Historically, the SEC's enforcement actions against issuers of municipal bonds often look very similar to the actions brought against issuers of other securities.

So, for example, a few years ago, the New York and New Jersey Port Authority paid $400,000 to settle SEC claims the Port Authority violated the antifraud provisions of the federal securities laws in connection with a $2.3 billion bond offering.

The Port Authority admitted failing to disclose to investors known material risks surrounding the potential lack of legal authority to fund the projects described in the bond offering documents. This and dozens of other, similar SEC cases are fairly routine stuff as against securities issuers.

However, in 2010 the Dodd-Frank Wall Street Reform and Consumer Protection Act contained a municipal advisor antifraud provision that for the first time specifically applied to the many advisors who assist municipal entities with bond offerings, reinvestment of bond proceeds, and structuring and pricing of related products.

It took the SEC six years after Dodd-Frank became effective before it used its new tool to bring an enforcement action for the first time against a municipal advisor.

'Opening of Floodgates'

The SEC's first case applying the municipal advisor antifraud provision involved a small, California-based advisor to several school districts who allegedly shared confidential information with financial professionals being considered by the school districts for certain advisory contracts. The advisory firm paid a small fine to settle the matter.

But the floodgates opened: since that first 2016 case, the SEC has brought several more enforcement actions against municipal advisors. Until the middle of 2019.

In June of last year, the SEC brought an action against a municipal advisor for breaching its fiduciary duties to its client: a small public library district in Illinois.

According to the SEC, the advisor (among other things) "did not provide the Library District with the information and advice needed to determine whether the price of the bonds was fair and reasonable . . . and the mispricing of the bonds will cause the Library District to pay more than $500,000 in additional interest over the life of the bonds."

The municipal advisor paid a $50,000 penalty to settle.

But the SEC hasn't brought any enforcement actions against a municipal advisor in over a year. Current volatile market conditions and the unprecedented precarious fiscal posture of many municipalities create a unique set of risks that may cause the SEC to end its drought.

Coronavirus Climate

News reports in the spring painted a dire picture of the impact COVID-19 would have on municipal bond issuers: "Delinquencies in the municipal market — already on the rise as counties and cities get squeezed by the coronavirus crisis — are likely to worsen amid soaring unemployment, rising alarm about stressed municipalities, and Federal conflict about aid," according to a Barron's report in April.

More recent reports note that the Federal Reserve's $500 billion Municipal Liquidity Facility — open to states and cities and counties that meet population thresholds — have calmed the municipal bond markets. Ironically, even municipalities that qualify aren't using the federal backstop in large numbers because bond issuance is way up.

"In all, about $201.5 billion in municipal bonds were issued during the first half of the year, up from $173.3 billion during the first half of 2019," according to the Fed.

Against this backdrop, the SEC put out a public statement in May with an explicit (and verbose) headline: "The Effects of COVID-19 Have Raised Uncertainties Regarding Financial Status of State and Local Governments and Special Purpose Entities; Municipal Securities Issuer are Encouraged to Provide Updated Financial and Other Disclosures; Financial Professionals are Encouraged to Discuss These Matters with Main Street Investors."

The SEC emphasized the types of information that it views as critical to municipal bond investors:

- The impact of COVID-19 on operations and financial condition;
- Sources of liquidity availability of federal, state and local aid; and
- Reports prepared for other governmental purposes.

The municipal bond market is booming; the risks faced by that market are enormous and unprecedented; the SEC is hyper-focused on ensuring that retail muni-investors receive adequate disclosures; and municipalities will rely in no small part on financial advisors to successfully navigate this high wire.

Expect the SEC to spend the next several years forensically pouring over the events of the next several months to find its next case against a municipal advisor.

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