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SEC Focus on Municipal Securities: Disclosure and Enforcement – The Peculiar Structure of the Municipal Securities Disclosure Regime

When the two key Federal Securities Laws (the Securities Act of 1933 [the "33 Act"] and the Securities Exchange Act of 1934 [the "34 Act"]) were enacted, municipal securities (the bonds, notes, etc., issued by states, counties, municipalities, and municipal authorities) were exempt, both from the registration requirement of the 33 Act and from the oversight under the 34 Act of the professionals who underwrote and dealt in the purchase and sale of these securities. These exemptions resulted from policy (municipal securities were generally seen as more secure than those issued by corporations and other private sector entities) and political considerations. More individual investors sought to buy municipals by the early 1970s to reduce federal and state tax liabilities, at a time of ever-increasing inflation. This in turn led to an extraordinary proliferation of municipal security products. Then Congress passed the Securities Act Amendments of 1975, creating the Municipal Securities Rule Making Board ("MSRB") as a self-regulatory body subject to the oversight of the U.S. Securities and Exchange Commission ("SEC").

The Peculiar Structure of the Municipal Securities Disclosure Regime

In 1978, the MSRB adopted rules governing underwriting practices, urging "market participants" (i.e., broker/dealers, investment advisers, and the like) to comply with disclosure obligations consistent with those that the SEC required in connection with the registration and sale of securities under the 33 Act. It should be noted that, unlike the registration process (where the disclosure obligations fall on the issuer), in the case of municipal securities those obligations fall on market professionals. Disclosures concerning a municipal security (both as to the issuing entity and the terms of the security) are typically found in a Preliminary Official Statement ("POS"), followed at the time of issuance with an Official Statement ("OS"). The POS and OS are usually prepared by the underwriters in conjunction with the issuing entity and are expected to be reviewed by any broker/dealer involved in selling the security and by any investment adviser recommending the security. This somewhat "Rube Goldberg" disclosure structure reflects continuing political decisions to eschew direct federal regulation of municipal security issuers, including disclosure of material developments following issuance.

In 1989, the SEC adopted Rule 15c2-12 under the 34 Act, which requires an underwriter of municipal securities to obtain a written agreement from the issuer requiring the issuer (and any related obligor, as in the case of conduit issuers), to deliver an OS within seven days of issuance. Under the Rule, underwriters are also required to review the POS and the OS for the adequacy and completeness of the disclosures. In 1994 the SEC amended Rule 15c2-12 to also require the underwriter to obtain a written agreement (a Continuing Disclosure Agreement ["CDA"]) from an issuer of a municipal security, under which the issuer (and any related obligor) commits to provide annual updates on the issuer's financial condition. In addition, both the Rule and the CDA require the issuer to file "timely reporting of material events" affecting the issuer (or any related obligor). Originally both the OS and disclosures under the CDA were filed with designated depositories. In

2002 the MSRB required that these filings be done electronically. In 2008, the MSRB launched the Electronic Municipal Market Access ("EMMA") website. All OS's and CDA disclosures are now filed on EMMA. Any market professional dealing in municipal securities is required to review those filings prior to effecting transactions.

Increasing SEC Enforcement Activity

In January 1996, the SEC brought an enforcement action against the principal officials of Orange County, California (ironically including its Treasurer, Robert Citron, whose last name is the French word for "lemon") for massive misstatements and omissions in disclosure documents covering 11 bond offerings from July 1, 1993, to September 28, 1994, which raised over $2.1 billion. In addition to material errors about the tax treatment of some of the offerings and continuing failures to disclose the deteriorating financial condition of the county, there was a failure to disclose that the county tried to greatly increase revenues by attempting to hedge payment obligations on the bonds with "earnings" on short-term reverse repurchase agreements. When interest rates went against the county's "bets," the County experienced such great financial losses that it was forced to file bankruptcy under Chapter 9 of the Federal Bankruptcy Act. The county filed on December 9, 1994, and made its final payment under the court-approved reorganization plan on July 1, 2017.

In 2010, the SEC brought its first-ever enforcement action against a state – New Jersey. The SEC asserted that the POS's and OS's used for the offer and sale of over $26 billion of bonds in 79 separate bond offerings from August 2001 through April 2007 contained material misrepresentations and omissions about the underfunding of New Jersey's two largest pension plans (one for teachers, the other for State employees). There had been no payment default on any of the bonds (a situation that continues to date). New Jersey consented to a settlement in which it accepted a cease and desist order; it was not subjected to a civil penalty. Illinois suffered a similar fate in 2013 for failing to adequately disclose pension shortfalls in connection with the sale of over $2.2 billion in bonds from 2005 to early 2009.

Beginning in 2014, the SEC undertook an initiative to identify material misstatements and omissions in municipal security offering documents from 2011 on. As a result, the SEC found that 71 issuers (and in some cases, related obligated persons) had inadequate POS's and OS's relating to new securities issuances. In some cases, they also found that the issuers had not met their obligations under the CDA's related to those or previously outstanding issuances. All 71 issuers eventually settled with the SEC and accepted cease and desist orders. On September 14, 2016, the City of Miami and its former budget director were found liable for securities fraud in connection with the sale of $153.5 million of bonds. The offering documents failed to disclose that the value of the city's reserves were materially overstated (by illegally transferring capital funds to the city's General Fund), resulting in significantly higher ratings from bond rating agencies. Both the city and the former budget director were permanently enjoined from engaging in securities fraud. The city settled the case by paying $1 million; the former budget director, whom the court found did not personally profit from the fraud, was ordered to pay $15,000.

In April of 2016, the SEC charged the town of Ramapo, New York, along with the town supervisor (who doubled as president of the municipality's Development Corporation ["RLDC"]), an assistant town attorney (who doubled as executive director of the RLDC), two other municipal officials, and the RLDC with securities fraud in connection with 16 bond offerings from 2010 to 2015, which raised over $300 million. The primary basis of the material misstatements in the offering documents was the failure to disclose the impact of the expenditure of over $58 million to construct a minor-league baseball park for the town's Ramapo Boulders – presciently-named, as this became the proverbial "millstone" around the necks of the defendants. The United States Attorney brought parallel criminal proceedings against the town supervisor and the assistant town attorney. In

October 2018, the town and the RLDC consented in the SEC lawsuit to injunctions; the town supervisor paid a $327,000 civil penalty; the two other municipal officials paid civil penalties of $25,00 and $10,000 respectively; and all four were collaterally barred from serving as officials of a municipal entity. The two other officials were able to apply for release from the bar after a term of years. The assistant town attorney pled guilty in the criminal action, was fined $10,000, sentenced to 18 months supervised release, and disbarred. The town supervisor was convicted by a jury on 20 counts and sentenced to serve 30 months in prison and pay a fine of $75,000.

In November 2017, the SEC brought a lawsuit against the Town of Oyster Bay ["TOBAY"] (a part of Nassau County, Long Island, New York, where the author of this blog grew up; TOBAY has a dedicated portion of Jones Beach set aside for TOBAY residents), and the town supervisor for failing to disclose in 26 offerings from August 2010 to December 2015 that the town had guaranteed four private loans totaling over $20 million to a restauranteur in connection with his operating restaurants and concession stands on town property (theoretically at TOBAY Beach). TOBAY was permanently enjoined. The town supervisor was acquitted in a criminal prosecution for official corruption; the resolution of the SEC's civil lawsuit against him was not reported.

The SEC Provides an "Education" in Disclosure Obligations

In March 2019, the SEC brought a civil lawsuit against the former controller of the College of New Rochelle, a non-profit college located in Westchester County, just north of New York City. The college was under financial duress due to declining enrollment and deteriorating collection of pledged donations. The controller created false financial records and failed to pay payroll taxes so that the college's financial statements for 2015 had overstated net assets by almost $34 million. He also certified those statements. What he failed to do was file timely disclosures under the CDA relating to an outstanding 1999 bond issue. Due to its self-reporting of the matter and exemplary cooperation, as well as its difficult financial condition, the college was not charged and no penalty was sought. The controller, who was also charged in a parallel criminal action for securities fraud, pled guilty in the criminal case and reached a partial settlement with the SEC that permanently enjoined him from future misconduct, with civil penalties to be determined by the court. Six months later the SEC brought suit in federal court in California against the former chief business officer and the superintendent of schools of a school district in connection with falsified disclosures relating to the 2016 offering of $100 million of the district's general obligation bonds. The district's independent auditor had repeatedly sought to investigate allegations of fraud and internal control issues. The district refused to pay the fees for that investigation, and instead terminated the auditor. The chief business officer used the prior year's clean audit as part of the 2016 offering documents and provided "deceptive updates" to the attorneys who worked on the disclosures for those 2016 documents. The district and the superintendent agreed to settle with the commission, consenting to the entrance of cease and desist orders. The superintendent, who signed the OS, was also ordered to pay a $10,000 civil penalty. The case against the former chief business officer seeks injunctive and collateral bars, as well as financial penalties, for his active misconduct.

This year brought an expanded scope of "educational" opportunities in the charter school context. First, in April 2020, the SEC charged the then chief executive officer AND the then director of finance of the Tri-Valley Learning Corporation, which operates two charter schools in Northern California, with misleading investors who purchased $25.54 million in bonds in a May 2015 offering. The two individuals helped prepare and signed the POS and the OS, which failed to disclose serious cash flow problems, inability to service payments on the bonds, delinquency on payables, non-payment of a term loan over one year overdue, and that the school had fully drawn on its bank line of credit. The same two signed demonstrably false certifications that the POS and OS contained no material misrepresentations or omissions. The individual defendants agreed, in a settlement with the

commission, to be permanently enjoined from securities law violations and from participating in future municipal securities offerings, and in addition, to pay a civil penalty of $20,000 and $15,000 respectively. Most recently on September 14, 2020, the SEC charged a state-funded nonprofit charter school in Arizona and its former president with misleading investors in a $7.6 million offering in April 2016. The charter school was experiencing significant operating losses and was "staying afloat" by making repeated unauthorized withdrawals from two reserve accounts to cover "routine" operating expenses, pay other debts, and transfer money to affiliated entities. The offering documents did not disclose this but instead contained profit and expense projections showing profitability in fiscal 2017 and a clear ability to repay the debt. Both the charter school and its former president agreed to settle with the commission, becoming subject to an injunction against future violations of the Federal Securities Laws. In addition, the individual defendant agreed not to be involved in any future issue of a municipal security.

Closing Observations

It seems quite clear that persons acting in the municipal securities markets, including public officials and local educators, are not all well-informed. "Educational" lessons from the SEC can prove costly and destructive of both careers and reputations, let alone possible exposure to criminal prosecution. The design, functioning, and assessments of municipal securities markets are necessarily critical to achieving both fairness and liquidity when raising private capital for public purposes. It behooves financial professionals and others to learn the disclosure rules, and even more importantly, to strive for clarity, completeness, and compliance.

The National Law Review

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September 22, 2020

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