Bond Case Briefs

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Serving the Public? SEC Charges Two Municipalities and Their Leaders with Bond Fraud.

I have written previously about the recurring problem of fraudulent financial information used to market and sell municipal securities. See my Sept. 22, 2020, Blog "SEC Focus on Municipal Securities: Disclosure and Enforcement – the Peculiar Structure of the Municipal Securities Disclosure Regime"; my March 2, 2021, Blog "Being Held Accountable: The 'Education' of KPMG at the College of New Rochelle"; and by April 28, 2022, Blog "Failing Grades: School District and Auditor Earn SEC Discipline."

Indeed, the problems in municipal finance had proven so endemic by the first decade of the 21st century that in 2010, the U.S. Securities and Exchange Commission ("SEC") created a specialized group within its Division of Enforcement to deal with these matters. The work of the Public Finance Abuse Unit has become key to the commission's overall efforts to regulate capital markets and protect investors. On Oct. 13, 2016, the then director of the SEC's Division of Enforcement, Andrew J. Ceresney, gave the keynote address at the 2016 Securities Enforcement Forum, focusing entirely on problems arising in the then $ 3.7+ trillion municipal securities market and emphasizing the importance of the Public Finance Abuse Unit in dealing with them. There is a tendency, as noted in my "Failing Grades" Blog, to see municipal finance as low risk, because) it does not offer the same sort of outsized earnings and personal gains as do other parts of the capital market, and ii) the people involved are typically "ordinary citizens" on school boards or government councils. Unfortunately, that misplaced optimism frequently proves to be insufficiently skeptical. Both of the following cases were brought by the Public Finance Abuse Unit when optimism failed.

On Thursday, June 2, 2022, the SEC charged the town of Sterlington, Louisiana, a population of approximately 2,600, and its former mayor, as well as the town's unregistered municipal advisor, with misleading investors in the sale of $5.8 million of municipal revenue bonds in 2017 and 2018. The bond proceeds were to finance the development of a water system and the improvement of the existing sewer system. As required by law, Sterlington applied to the Louisiana State Bond Commission ("SBC") for approval of the offerings, including both detailed information about the costs of the projects and projections of revenue from the improved system. Those projections foresaw usage by some 2,200 customers when actual use was only a little over 1000. They also claimed an existing customer base of some 1,500, when in fact there were only 960 customers prior to the improvements. Absent the fraudulent projections, the system would not bring in enough revenue to support the bond payments. In addition, submissions to the SBC failed to disclose that some $3 million from earlier bond issues was used to fund improvements to a sports complex, municipal legal fees, and municipal payroll, notionally to the political benefit of the former mayor. Sterlington cooperated with the Public Finance Abuse Unit investigation and agreed to a cease-an--desist order. The unregistered municipal advisor and its principal consented to judgments enjoining them from future violations, disgorgement of all fees received together with interest, and a civil penalty to be set by the court. The former mayor resigned on Oct. 1, 2018, and is litigating the SEC's charges against him.

On Tuesday, June 14, 2022, the SEC filed charges in the U.S. District Court for the Western District of New York against the City of Rochester, its former finance director, and the former Rochester School District CFO, as well as the city's municipal advisor, with misleading investors in an August 2019 $119 million bond offering consisting of a $69 million bond anticipation note ("BAN") and a $50 million revenue anticipation note ("RAN"). The purpose of the BAN was to provide financing for the School District and for other city projects. The RAN was to finance cash flow for the District for the 2020 fiscal year. The former finance director and the district CFO failed to disclose, in the financial information used to inform a credit rating agency and to market the $119 million bond offering, that the district was facing at least a $25 million shortfall in its existing budget, primarily due to overspending on teacher salaries.

In fact, things turned out to be much worse. In September 2019, 42 days after the bond offering was sold, the district's outside auditors informed district leadership that the district had overspent its budget by some $30 million. This, in turn, led to a rating downgrade for the city's bonds and a voluntary disclosure filing on Oct. 3, 2019, on the Municipal Securities Rule Making Board's Electronic Municipal Market Access system. The district's CFO resigned on Oct. 10, 2019. When outside auditors completed the audit of the district's 2019 financial report on Dec. 3, 2019, it showed a $42 million operating deficit ($27.6 million more than had been budgeted), which consumed all the district's financial reserves. In May of 2020, the State of New York granted the district a $35 million, 30-year, interest-free loan and appointed a State Commission of Education monitor for three years to provide oversight of the district's finances. The former district CFO consented to the entry of a court order barring him from future violations and from participating in future municipal securities offerings and requiring him to pay a $25,000 civil penalty. The SEC charges remain pending against the other parties.

These cases reveal both greed (for political approval, especially by the former mayor) in small-town Louisiana and willful blindness in a major New York City. In both, the investing public, seeking the supposed safety (and tax benefits) of putting money in municipal securities, was deceived to its detriment. The work of the Public Finance Abuse Unit continues.

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