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SEC Brings First Charges Against Muni Market Underwriters Alleging Failure to Meet Requirements for Limited Offering Disclosure Exemption: Ballard Spahr

Summary

The Securities and Exchange Commission (SEC) recently announced enforcement proceedings against four municipal market underwriters for alleged violations of municipal bond disclosure requirements. Three of the four underwriters have settled with the SEC.

The Upshot

- The four underwriting firms allegedly sold new issue municipal securities in primary offerings intended to meet the limited offering exemption to broker-dealers and investment advisers without a reasonable belief that the entities were making purchases for their own accounts or without a view to distribute the securities.
- The underwriters allegedly failed to ascertain for whom the broker-dealers and investment advisers were purchasing the securities and were unable to form a reasonable belief that the purchases were for investors who possessed the necessary knowledge and experience to evaluate the investments.
- The three underwriters that settled with the SEC agreed to disgorgement and penalties ranging between \$100,000 and \$300,000. In pending charges against the fourth underwriter, the SEC alleges the underwriter “made no inquiry to determine if those entities were buying on behalf of their customers and/or clients and, if so, whether such investors met the exemption criteria.”

The Bottom Line

The pending complaint identifies certain matters that the SEC believes underwriters should consider in determining compliance with the limited offering exemption requirements. But the SEC provides no guidance on how such inquiries should be undertaken or whether investor letters can be used for this purpose. The SEC said it is investigating whether other firms are properly relying on the limited offering exemption and is encouraging firms that believe they may have not complied with the exemption requirements to self-report possible violations.

On September 13, 2022, the Securities and Exchange Commission (SEC) announced enforcement proceedings against four municipal market underwriters for alleged violations of municipal bond offering disclosure requirements under SEC Rule 15c2-12. The SEC rule establishes certain requirements in connection with primary market and continuing disclosures to be provided to investors, unless an exemption applies. Three of the underwriters settled with the SEC while charges are pending against the fourth underwriter.

Under federal securities law, a limited offering exemption is available for offerings sold in \$100,000 authorized denominations if the securities are sold to no more than 35 persons who the underwriter reasonably believes (i) have such knowledge and experience in financial and business matters that

they are capable of evaluating the merits and risks of the investment (the “sophisticated investor clause”) and (ii) are not buying the securities for more than one account or with a view to distributing the securities (the “investment purpose clause”).

According to the SEC, the four underwriting firms sold new issue municipal securities in primary offerings intended to meet the limited offering exemption to broker-dealers and investment advisers without a reasonable belief that the entities were making purchases for their own accounts or without a view to distribute the securities, as required by the investment purpose clause. The SEC asserts that, because the underwriters failed to ascertain for whom the broker-dealers and investment advisers were purchasing the securities, the underwriters were unable to form a reasonable belief that the broker-dealers and investment advisers were purchasing the securities for investors who possessed the necessary knowledge and experience to evaluate the investments, as required by the sophisticated investor clause.

The SEC’s pending complaint against the underwriter that did not settle provides more details about the alleged violations. In that complaint, the SEC observes that some broker-dealers and investment advisers purchasing securities in the primary offerings from the underwriter shortly thereafter resold the securities to multiple brokerage customers or allocated the securities to multiple advisory clients. The SEC alleges that the underwriter “made no inquiry to determine if those entities were buying on behalf of their customers and/or clients and, if so, whether such investors met the exemption criteria.” The SEC argues that the underwriter “did not reasonably believe the broker-dealers were buying the securities for their own accounts because the broker-dealers that were buying the securities were in the business of servicing brokerage customer accounts” and also “did not reasonably believe the investment advisers were buying the securities for their own accounts because these investment advisers were in the business of managing accounts for their advisory clients.”

The SEC notes in the pending complaint that the underwriter did not inquire whether the broker-dealers or investment advisers were purchasing on behalf of their customers or clients. Further, in cases where the broker-dealers or investment advisers may have been purchasing on behalf of their customers or clients, the SEC states that the underwriter “neither requested nor received information from the broker-dealers [or investment advisers] about: how many customers [or clients] would receive the securities; how much each customer [or client] was investing; each customer’s [or client’s] level of financial experience; or whether each customer [or client] was buying for a single account.” The SEC concludes that, without this information, the underwriter could not have formed the requisite reasonable belief that the broker-dealers or investment advisers, or the customers or clients on whose behalf they may have been buying, were sufficiently sophisticated and buying for their own account, as the limited offering exemption requires. The SEC also alleges that the underwriter violated MSRB Rule G-17, which requires fair dealing, by deceptively representing to municipal market issuers that it complied with the limited offering exemption requirements.

While the pending complaint identifies certain matters that the SEC believes underwriters should consider in determining compliance with the limited offering exemption requirements, the SEC provides no guidance on how such inquiries should be undertaken or whether investor letters can be used for this purpose. As a matter of practice, investor letters are often used by municipal market underwriters to confirm the sophisticated status and investment intent of municipal securities purchasers.

The SEC further alleges that the four firms also violated Municipal Securities Rulemaking Board (MSRB) Rule G-27, which requires municipal market underwriters to put in place sufficient supervisory policies and procedures to ensure compliance with federal securities laws.

The three underwriters that settled with the SEC agreed to disgorgement and penalties ranging between \$100,000 and \$300,000. The case against the fourth underwriter is pending. The SEC stated in its news release that it has started investigating whether other firms are properly relying on the limited offering exemption. The SEC is encouraging firms that believe they may have not complied with the exemption requirements to self-report possible violations to the SEC at: LimitedOfferingExemption@sec.gov. The SEC did not provide a form for self-reporting or standard settlement terms.

by Teri Guarnaccia, Ernesto Lanza, Kimberly Magrini, William Rhodes, Tesia Stanley

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Ballard Spahr LLP

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