Bond Case Briefs

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SEC Steps Up Enforcement With Respect to Municipal Bond Offerings: ArentFox

In September 2022, the US Securities and Exchange Commission (SEC) announced that it had filed suit against one broker-dealer underwriter and entered into settlements with three other broker-dealer underwriters in cases alleging that the underwriters repeatedly violated the limited offering exemption rules applicable to municipal bond offerings.

Alleged Limited Offering Exemption Violations
In general, the limited offering exemption applies to primary offerings that are made to a limited number of sophisticated investors who are capable of evaluating the risks of the investment without aid of the disclosures that are normally required. In instances where an exemption does not apply, disclosures are made through public offering materials, Preliminary Official Statements in the municipal securities area, which, as is the case with corporate securities, are subject to SEC Rule 10b-5 disclosure standards.

Default Disclosure Requirements and the Limited Offering Exemption
The point of public disclosure in both corporate and municipal securities offerings is to ensure that investors can make informed investment decisions after full disclosure so that investors are protected from potential material misrepresentations and omissions.

This is particularly critical in the municipal area, where 45% of municipal securities are held directly by retail investors or indirectly by retail investors through mutual funds.[1] Many of these retail investors may not be sophisticated in complex financial products, hence the default requirement for comprehensive disclosure and the restricted scope of the limited offering exemption.

In a typical private placement of municipal or corporate securities to sophisticated investors, the broker-dealer obtains a certification that the purchaser is purchasing for its own account and not with the intent to resell, and that it understands the merits and risks of the investment. This certification is colloquially known as a “big boy” letter. It is then up to the sophisticated investor to determine whether it needs some disclosure, such as through a private placement memorandum.

The limited offering exemption to the default disclosure rules with respect to municipal securities is contained in SEC Rule 15c2-12(d), which was promulgated in consultation with the Municipal Securities Rulemaking Board (MSRB), which is a self-regulatory organization subject to SEC oversight. The rule provides an exemption from the public disclosure requirements applicable to underwriters offering municipal securities if the securities are offered in denominations of $100,000 or more and sold to no more than 35 persons. Rule 15c2-12(d) is parallel to SEC Rule 506(b) in the corporate securities context.

With respect to purchasers in limited offerings, Rule 15c2-12(d)(1)(i) also requires that the underwriter have a reasonable belief that each purchaser has “such knowledge or experience in financial and business matters that it is capable of evaluating the merits and risks of the prospective investment” and “is not purchasing for more than one account or with a view to distributing the

securities." It should be noted that, unlike with corporate securities, the SEC does not directly regulate municipal issuers due to concerns with respect to the Tenth Amendment of the United States Constitution. Instead, the SEC regulates the underwriters who offer municipal securities.

The Actions

Background

In each case brought by the Commission, the underwriters allegedly relied on the limited offering exemption in situations where the exemption requirements were not satisfied. In particular, the Commission alleged that the underwriters sold the securities to other broker-dealers and investment advisors without the requisite reasonable belief that those entities were purchasing the securities for their own investment, rather than purchasing the securities for resale to others. In addition, because the underwriters purportedly did not make any inquiries as to the identities of the customers for whom the broker-dealers and investment advisors were purchasing the securities, the Commission also asserted that the underwriters were unable to form the requisite reasonable belief that the purchasing broker-dealers or investment advisors were purchasing the securities for investors who possessed the requisite knowledge and experience to evaluate the investments—a factor the Commission asserts requires that a subjective determination be made with respect to each ultimate purchaser.

Finally, the Commission alleged that the underwriters violated MSRB Rule G-27(c) because they failed to have written supervisory procedures reasonably designed to ensure compliance with the limited offering exemption rules.

Underwriter Settlements; SEC Complaint

Three firms entered into cease and desist settlements with the Commission, where each agreed to disgorge the profits they made from the offerings that purportedly did not qualify for the exemption, along with the payment of prejudgment interest and civil monetary penalties. Those firms also agreed to cease and desist from future violations of the rules at issue and were censured. In each of the settlements, the Commission noted that the firms promptly took remedial action and cooperated with the Commission.

The remaining firm, Oppenheimer & Co., apparently was unable to reach a settlement with the Commission and the Commission filed suit in the U.S. District Court for the Southern District of New York. The complaint alleges Oppenheimer violated the exemption rules more often than the settling firms – in at least 354 municipal offerings – while also making deceptive statements to governmental issuers that it would comply with the limited offering exemption, in contravention of MSRB Rule G-17 (which prohibits deceptive practices). The Commission requests permanent relief enjoining Oppenheimer from future violations of the federal securities laws and MSRB rules, disgorgement of profits, prejudgment interest, and the imposition of a civil penalty. Although Oppenheimer will presumably assert that it acted reasonably and complied with the rules, the nature of Oppenheimer's factual and legal arguments is not yet known.

Although Oppenheimer is a mid-sized broker-dealer, its mutual fund affiliate is one of the largest institutional holders of municipal bonds in the country.

Takeaways

Although the Commission's litigation release noted that the four actions are the first time that it has pursued underwriters for failing to comply with the municipal bond offering disclosure requirements, the Commission also stated that it is actively investigating whether other underwriters complied with the exemption and it urged firms who believe they might have violated

those rules to self-report to the Commission. As a result, underwriters who are, or who have in the past, relied on the exemption should work with counsel to carefully evaluate both their conduct and their supervisory procedures to ensure that those procedures were sufficient for prior transactions and are adequate to avoid future violations. Depending on the results of such an evaluation, the prudent course might be to self-report any possible violations as a way of attempting to reduce the penalties that the Commission might later seek if it uncovers violations during the course of an investigation and institutes enforcement proceedings or files a civil action.

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[1] *See* 'How 2022 Volatility is Shifting Muni Ownership', The Bond Buyer (Jessica Lerner), September 23, 2022 (referencing Federal Reserve statistics).

[2] *See also* Client Alert entitled 'Intriguing FINRA Enforcement Action in the Bond Market: More to Come?', September 22, 2021, available here.

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