

SEC Charges the City of Rochester and Its Former Finance Director, the Former Chief Financial Officer of the Rochester City School District, and a Municipal Advisory Firm and Its Two Co-Principals with Fraud in Connection with a Bond Offering

July 25, 2022

On June 14, 2022, the Securities and Exchange Commission (the “SEC”) charged the City of Rochester, New York (the “City”), Rosiland Brooks-Harris (“Brooks-Harris”), the former finance director of the City, Everton Sewell (“Sewell”), the former chief financial officer of the Rochester City School District (the “District”), and Capital Markets Advisors (“CMA”) and its principal Richard Ganci (“Ganci”) with fraud in connection with the 2019 sale of \$119 million in municipal bonds. The SEC alleged the City, Brooks-Harris, CMA, Ganci and Sewell violated multiple provisions and rules contained within Section 17(a) of the Securities Act of 1933 (the “Securities Act”) as well as Section 10(b) of the Securities Exchange Act of 1934 (the “Exchange Act”) and Rule 10b-5 thereunder by misleading investors with outdated financial statements. The SEC also alleged that CMA, Ganci and CMA’s other principal, Richard Tortora (“Tortora”), violated multiple rules of the Municipal Securities Rulemaking Board (“MSRB”) and Section 15B(c)(1) of the Exchange Act by breaching fiduciary obligations and concealing conflicts of interests.

Of the charged parties, all are contesting the allegations, other than Sewell (who, as described below, has agreed to settle the SEC’s charges), and as such, federal securities law violations by the City, Brooks-Harris, CMA or Ganci have not been established. Nonetheless, even as against the contesting parties, this action provides valuable information concerning the enforcement positions of the SEC.

Background

The District is located in the City and serves approximately 30,000 students. The District is dependent upon the City to issue debt and to levy taxes on its behalf. The District is also the largest component of the City’s overall budget.

The various fraud charges are based on the following facts, as alleged by the SEC. In August 2019, the City sold a \$68,905,000 bond anticipation note (“BAN”) and a \$50,000,000 revenue anticipation note (“RAN” and, together with the BAN, the “Notes”). The BAN provided financing for the District and for various City projects. The City issued the RAN “to finance cash flow requirements for the District purposes in anticipation of the receipt of State aid.” The Notes were offered pursuant to a Preliminary Official Statement, a Supplemented Preliminary Official Statement and a Final Official Statement (collectively, the “Offering Documents”). Brooks-Harris managed the City’s bond program and reviewed, edited and ultimately signed the Offering Documents on behalf of the City. She also reviewed and signed two closing certificates attesting to the accuracy of the Offering Documents. CMA and Ganci facilitated the bond offering process for the City. Under CMA’s municipal advisory contract with the City, CMA was required to prepare the Offering Documents and to participate in all working group meetings and conference calls to “help ensure compliance with the legal requirements” of a note issuance. CMA’s contract also required CMA to “advise on and coordinate the credit rating process,” including addressing any questions the rating analyst may have.

The City did not hire disclosure counsel to assist with the preparation or review of the Offering Documents.

The Notes were fully and timely paid.

Summary of Allegations

The SEC alleged that the financial information contained in the Offering Documents materially misled investors because such information was outdated and concealed the District's financial distress that came about as a result of overspending on teacher salaries. After the Offering Documents were circulated, the District revealed that it had overspent its budget for fiscal year 2019 by \$27.6 million, which required the State to intervene in the form of a \$35 million loan and also required the State to appoint a monitor for the District.

The SEC alleged that the City knew about the District's financial situation yet made no effort to investigate the extent of the overspending and made no effort to inform investors of the risks the overspending posed to either the District's or the City's finances. The SEC further alleged that the City and Brooks Harris were aware of the budget shortfalls, and CMA and Ganci specifically warned that it could become worse.

In addition, the SEC alleged that CMA, Ganci and Tortora concealed from the City and nearly 200 other CMA clients material conflicts of interest arising from its compensation arrangements that were contingent on the size and/or closing of the clients' bond offerings. The SEC further alleged that in many cases, CMA, Ganci and Tortora falsely stated that CMA had no undisclosed material conflicts of interest.

Charges

The SEC charged the City, Brooks-Harris, Sewell, CMA and Ganci with violating Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder for fraud in the offer or sale of securities. The SEC also charged CMA, Ganci and Tortora with violating MSRB Rules G-17, G 42 and G-44 for engaging in a deceptive, dishonest or unfair practice, breach of duties of non-solicitor municipal advisor and breach of supervisory and compliance obligations of municipal advisors. Finally, the SEC charged CMA, Ganci and Tortora with violating Section 15B(c)(1) of the Exchange Act for breach of fiduciary duties and for acts in contravention of MSRB rules.

Sewell has agreed to settle the SEC's charges by consenting, without admitting or denying any findings, to a court order prohibiting him from future violations of the antifraud provisions and from participating in future municipal securities offerings, and to pay a \$25,000 penalty. The settlement is subject to court approval.

Considerations for Market Participants

Issuers and their finance officials must understand that material misstatements or omissions in financial documents, including those containing future projections, carry potential securities law antifraud liability whether in connection with a primary offering of municipal securities or disclosures made pursuant to continuing disclosure agreements. In addition, any issuer issuing on behalf of another entity should conduct its own due diligence during the disclosure process and understand its related liabilities under the law. To mitigate the potential for liability, issuers should (i) adopt thorough disclosure policies and procedures for primary and secondary market disclosures related to municipal securities, (ii) carefully review disclosures made in connection with offerings issued on behalf of other entities, if applicable, and (iii) hire disclosure counsel.

Municipal advisors often play a significant role in the successful issuance and sale of municipal bonds, including, in many engagements, providing assistance to issuers in the preparation and review of offering documents. This enforcement action highlights that, in the view of the SEC, a municipal advisor's involvement cannot be divorced from potential liability associated with the non-disclosure of material information to investors. Municipal advisors should work closely with issuers, especially during the due diligence process, to ensure that material information is included in offering documents.

This issue is not the first time the SEC has brought an enforcement action involving inadequate disclosure of an issuer's deteriorating financial position. On June 22, 2001, a cease-and-desist order was entered into against the City of Miami because of the omission of information that would have shown a trending deterioration of the City's cash balances after the end of the fiscal year. The related administrative proceeding is available here <https://www.sec.gov/litigation/aljdec/id185bpm.htm>. On September 27, 2021, the SEC charged Sweetwater Union

High School District and its former chief financial officer with making material misstatements and omissions in connection with a bond issue by failing to accurately account for an approved salary increase in its budget and related projections. Our client alert on the Sweetwater enforcement action is available here <https://www.chapman.com/publication-SEC-School-District-CFO-Materially-Misleading-Investors>.

The SEC's Enforcement Division's Public Finance Abuse Unit continues to be very active in the municipal disclosure space. This SEC action was the third municipal enforcement in June of this year. On June 2, 2022, the SEC charged the Town of Sterlington, Louisiana, its former mayor and the Town's unregistered municipal advisor and its owner with fraud in connection with the sale of \$5.8 million in municipal bonds sold in two private placements in 2017 and 2018. Our client alert on the Sterlington enforcement action is available here <https://www.chapman.com/publication-sec-charges-louisiana-town-its-former-mayor-and-unregistered>. On June 16, 2022, the SEC charged the former chief administrative officer and city secretary of Johnson City, Texas, with securities fraud for creating and causing to be distributed falsified financial statements and a falsified audit report for the Johnson City's 2016 fiscal year. The SEC press release detailing the charges dated June 16, 2022, is available here <https://www.sec.gov/litigation/litreleases/2022/lr25426.htm>.

For More Information

If you would like further information concerning the matters discussed in this article, please contact a member of our Public Finance Group or visit us online at chapman.com.

This document has been prepared by Chapman and Cutler LLP attorneys for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice and no attorney-client relationship is created. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material.

To the extent that any part of this summary is interpreted to provide tax advice, (i) no taxpayer may rely upon this summary for the purposes of avoiding penalties, (ii) this summary may be interpreted for tax purposes as being prepared in connection with the promotion of the transactions described, and (iii) taxpayers should consult independent tax advisors.

© 2022 Chapman and Cutler LLP. All rights reserved. Attorney Advertising Material.