



Insights

A Sea Change in the Municipal Industry

Article

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The Municipal Continuing Disclosure Cooperation (“MCDC”) initiative, as named by the Securities and Exchange Commission (“SEC”) in March, 2014, has attracted much attention in the municipal industry and with good reason — during the first phase of MCDC that ended in February 2016 and focused on underwriters, the SEC levied \$18 million in fines against 72 underwriters, comprising 96 percent of the market share for municipal underwritings. MCDC was the first market-wide SEC enforcement action that offered underwriters and issuers the opportunity to self-report potential misrepresentations in municipal bond offering documents regarding compliance by issuers with prior continuing disclosure obligations under Rule 15c2-12 of the Securities Exchange Act of 1934. The SEC has now begun the second phase of MCDC. In August 2016, the SEC announced what is expected to be the first wave of enforcement actions against municipal issuers when the SEC entered into settlements with 71 varied municipal issuers and obligated persons located throughout the country. Industry professionals and issuers alike have spent countless hours and incurred great expense responding to MCDC.

But MCDC, while top of mind in the municipal industry, is not the most important recent development for issuers of municipal bonds. The more significant change is the increased activity of the SEC Enforcement Division and, in particular, its Public Finance Abuse Unit. This entity, which was previously known as the Municipal Securities and Public Pension Unit, specifically targets potential violations of federal securities laws in connection with abuses in municipal securities. The Public Finance Abuse Unit has brought numerous first-of-its kind enforcement actions against governmental entities and levied civil penalties against public officials

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throughout the country. This is the real sea change to the municipal industry that began in earnest three years ago.

The statistics illustrate the sea change. As noted by Robert Doty in *The Bond Buyer* on July 12, 2016, since early 2013, the SEC has brought enforcement actions against 18 state or local governmental entities and against 16 issuer officials. In contrast, in the 14 years from the beginning of 1999 through 2012, the SEC resolved disclosure actions against only 11 state or local entities and 10 officials. Since early 2013, the SEC has also levied \$180,000 in civil penalties on eight officials. In contrast, five officials (in only two actions) paid \$85,000—less than half as much—in civil penalties in the 15 years from 1998 through 2012.

The Official Statement (the document prepared by an issuer in connection with a primary offering of its bonds) is the source of most of the anti-fraud liability in a municipal transaction. Section 17 of the Securities Act of 1933 includes the core anti-fraud provisions of federal securities law. Section 17(a)(2) makes it unlawful “in the offer or sale of any securities . . . directly or indirectly . . . to obtain money or property by means of any **untrue statement of material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.**” Under current case law, negligence is sufficient to establish a violation of Section 17(a)(2) and no finding of intentional wrongdoing is required. Furthermore, the SEC has held that the “knew or should have known” standard is appropriate to establish negligence.

Perhaps the most eye-opening enforcement action to date occurred in April 2016, when the SEC charged Ramapo, New York, its local development corporation and four town officials with fraud for allegedly not properly disclosing a deteriorating financial situation in its general bond offering documents. The SEC alleged that Ramapo officials resorted to fraud to hide the strain in the town’s finances caused by the financing of a controversial minor league baseball stadium and by the town’s declining sales and property tax revenues. In a joint effort with the SEC, the U.S. Attorney’s office for the Southern District of New York, aided by the FBI, also brought criminal charges against two of the town officials. This was the first criminal securities fraud prosecution involving municipal bonds in the country. Andrew J. Ceresney, Director of the SEC Enforcement Division provided the following: “We won’t stand for public officials and employees who resort to alleged accounting trickery to mislead investors who are investing in their financial futures as well as the future betterment of our communities.”

And very recently, on September 14, 2016, the SEC achieved another first in a securities fraud trial against the City of Miami and its former budget director—the first federal jury trial by the SEC against a municipality or one of its officials for violation of federal securities laws. Mr. Ceresney had this to say, in part, about the jury’s verdict (emphasis added):

“We are very pleased by today’s jury verdict holding the City of Miami, a recidivist violator of the federal securities laws, and its former Budget Director ... liable for multiple counts of antifraud violations of the federal securities laws. ... [T]he jury took less than a day to decide that the City and [the Budget Director] had committed securities fraud in connection with their disclosures concerning the deteriorating financial condition of the City during 2007 and 2008 and in three separate offerings of municipal securities in 2009. ... **We will continue to hold municipalities and their officers accountable, including through trials, if they**

engage in financial fraud or other conduct that violates the federal securities laws.”

In response to the recent activity of the Public Finance Abuse Unit, an issuer and its finance officials should strongly consider adopting a thorough continuing disclosure policy to ensure compliance with their responsibilities under federal securities laws, including the issuer’s continuing disclosure undertakings and SEC statements in its numerous recent enforcement actions. Adopting appropriate disclosure policies and procedures is recognized as a best practice for issuers and is required by the SEC in all MCDC issuer settlements.

A growing number of issuers are also engaging Disclosure Counsel for their transactions. Disclosure Counsel provides formal comfort as to the accuracy and completeness of an issuer’s Official Statement. This comfort does not act as a guarantee by Disclosure Counsel to the issuer or finance officials of the accuracy of the Official Statement, but does help establish that the issuer took reasonable care to produce accurate and reliable information.

Incorporating disclosure practices and procedures, hiring Disclosure Counsel and demonstrating a solid disclosure track record will benefit an issuer and the market for its bonds, especially in these transformational times. We must all recognize that SEC and Justice Department actions will continue and that they will affect both big and small issuers, without regard to credit rating or level of sophistication of the issuers’ officials. Being prepared and in compliance with federal securities laws will help steer officials through this recent wave of change in the municipal industry.

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