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The SEC Crackdown on Municipal Bond Fraud & The Increased Risk for Municipal Officials

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Summary

In recent years, the Securities and Exchange Commission (SEC or Commission) has sunk its enforcement teeth deeper into the $3.7 trillion municipal bond market. In some of its most recent enforcement actions, the SEC has even taken a bite from the personal finances of municipal officials from cities, both large and small.

The Commission's recent tactics reflect a shift in its enforcement against municipal bond fraud. Previously, the Commission would prosecute only the bond counsel, underwriters, and/or the municipal attorneys involved in the issuance of bonds. However, within the past five years, the Commission has settled fraud cases with states, restricted municipalities' ability to issue bonds, and secured financial penalties from individual municipal officials.

The message is loud and clear: the ink on municipal officials' rubber stamps has run dry when it comes to issuing bonds. City mayors, their councils, and administrators and staff must now take on a more active role to ensure they are acting in good faith to provide accurate and up-to-date information to the investing public.

This report will briefly track the history and background behind the SEC's enforcement in the municipal bond market, give recent examples of cases involving states, municipalities, and individual municipal officials, and provide common sense advice for municipal officials to do their due diligence when issuing bonds.

Background

The municipal bond market is crucial to building and upgrading the infrastructure of the country, and it is the primary vehicle available for municipalities to execute significant projects and capital improvements. As of the end of 2011, the SEC reports that, "there were over one million municipal bonds outstanding, in the total aggregate principal amount of more than $3.7 trillion." [1]

Due to the importance of municipal bonding, it is unavoidable for the variety of governments (cities, townships, counties, etc.) in the United States. In addition, municipal bonds have historically lower rates of default compared to corporate and foreign government bonds.[2]

In 2012, the SEC issued its "Report on the Municipal Securities Market," which described the market as too opaque for investors to make fully inform decisions about what they are purchasing.[3] The SEC outlined several recommendations to improve the liquidity and transparency in the market, with the overall goal of protecting investors.[4] Many of the core recommendations were directed toward Congress and asked that they grant the Commission power to require greater disclosure requirements of municipal bond issuers as it related to relevant financial information.[5]

In the absence of legislative prescriptions, the Commission has taken actions on its own that are purportedly aimed to increase the liquidity of the municipal bond market and accomplish their primary goal of offering better protection to the investing public.[6] Since 2010, these actions have resulted in a string of firsts for the Commission in the area of municipal bond fraud.

In short, the bond counsel, underwriters, and municipal attorneys are no longer the only individuals under the SEC microscope. While those individuals were once the only ones at risk of being dealt charges by the SEC, municipal officials must also act in good faith to furnish accurate and up-to-date financial and budgetary information. In addition, changes in the scope, or even the entire feasibility, of the project for which a municipality is issuing a bond, or bonds, must also be reported to the necessary individuals.

A New Era of SEC Enforcement Against Municipal Bond Fraud

The SEC has taken action over the past five years against large and small municipalities, and states. While collecting fines have not been the primary result of many of these actions, as fining a state or municipality would only pass the consequences on to the taxpayers, individual officials themselves have *not* been immune to the SEC's enforcement. In addition, the SEC has extended its reach to holding municipalities accountable for misrepresenting information outside of its securities disclosure statements.

New Jersey – 2010

In August 2010, New Jersey became the first ever state charged with breaking federal securities laws for misleading investors about the financial condition of two major pension funds for teachers and public employees. New Jersey sold more than $26 billion of municipal bonds in 79 offerings between 2001 and 2007.[7]

The state concealed the fact that they were unable to make contributions to the funds without raising taxes, cutting services, or otherwise affecting the state budget, which meant investors were not able to adequately judge the state's financial condition. The SEC's order found that New Jersey misrepresented and omitted such financial information in their bond documents, including preliminary official statements, official statements, and continuing disclosures. The state further failed to disclose pertinent legislation that affected the pension funds to investors.[8]

San Diego, CA (population 1,356,000) – 2010

In October 2010, the SEC fined municipal officials in a municipal bond fraud case for the first time in a case involving former San Diego city officials. At issue were five municipal offerings – including revenue bonds and tax anticipation notes (TANs) – totaling over $260 million between 2002 and 2003.[9]

The settlement required the four officials – the former City Manager, Comptroller, Deputy City Manager, and Treasurer – to pay a collective total of $80,000 in fines.[10] The SEC alleged that the city intentionally failed to disclose to the municipal investors, or was reckless in not knowing, its significant pension and retiree health care liabilities, and the difficulty the city would have in funding those liabilities. This information was not reflected in the bond disclosure statements.[11]

In a SEC press release, Rosalind Tyson, Director of the SEC's Los Angeles Regional Office stated, "Municipal officials have a *personal obligation* to ensure that investors are provided with complete and accurate information about the issuer's financial condition" (emphasis added).[12]

Despite not admitting or denying the allegations, the former City Manager, Comptroller, and Deputy City Manager each paid $25,000 in fines, and the former City Treasurer paid $5,000 in fines.[13]

Illinois - 2013

The 2013 Illinois's case is similar to New Jersey's. Illinois sold over $2.2 billion in bonds from 2005 to 2009. In this case, the state did disclose pension holidays and other legislative amendments to their pension plan. However, the SEC took issue with Illinois's misleading investors on the *effect* of legislative changes on the contribution schedule and its ability to meet pension obligations.[14]

According to the SEC, Illinois disclosure failures stemmed from its own structural deficiencies. For example, the state lacked or failed to implement the proper controls, policies, and procedures to ensure that information about Illinois's pension plan was communicated to individuals responsible for bond disclosures. Further, as the SEC alleged in the New Jersey case, the state failed to adequately train individuals involved in the bond disclosure process or to retain disclosure counsel.[15]

Harrisburg, PA (population 48,000) – 2013

In May 2013, SEC charges against Harrisburg, PA marked the first time that a municipality was charged for misleading statements made *outside* the bond disclosure documents. By March 2013, Harrisburg had missed approximately $13.9 million in debt service payments on general obligation bonds, while also failing to disclose relevant information pertaining to the City's financial health in previous years.[16]

An investigation uncovered misleading statements in the city's budget report, annual and mid-year financial statements, and even a State of the City Address. Harrisburg was charged with securities fraud for its misleading public statements in regards to the deteriorating financial state of the city, and it provided incomplete or outdated information to investors.[17]

In a SEC press release, George S. Canellos, Co-Director of the SEC's Division of Enforcement, said, "Statements that are reasonably expected to reach the securities markets, *even if not prepared for that purpose*, cannot be materially misleading" (emphasis added).[18]

Allen Park, MI (population 27,600) – 2014

A recent case against former Allen Park City Officials marked the first time the SEC charged a municipal official under a federal statute that provides for "control person" liability. Allen Park's offering documents given to investors for two general obligation bonds, totaling $31 million, contained misleading financial and budget information. The SEC alleged that the former Mayor of Allen Park was in a position to control the activities of those engaged in fraudulent bond issuances, namely the City Administrator at the time. Once again, without admitting or denying to the charges, the case was settled and the Mayor agreed to pay $10,000 in fines.[19]

Further, the Commission alleged that the $146 million film studio project had greatly shrunk in size and scope by the time the bonds were issued in November 2009 and June 2010, yet that deterioration was not reflected in the bond documents either.[20]

The Allen Park case, which has yet to fully conclude, shows that even smaller municipalities are not out of reach from the SEC's enforcement.

Harvey, IL (population 25,300) - 2014

Earlier this year, the SEC also took action against the small town of Harvey, IL, which marked the first time the Commission filed an emergency court order to keep a municipality's bonds off the market. Harvey issued three limited obligation bonds from 2008 to 2010 totaling $14 million, which were supposed to be repaid from dedicated revenue streams and not the City's general funds.[21]

The city issued bonds to supposedly rebuild a large Holiday Inn near a busy stretch of highway in an effort to spur job growth. However, rather than renovating the hotel, Harvey siphoned some of the funds to meet its payroll obligations and other general city operations. In addition, the City Comptroller received and failed to disclose $269,000 in bond proceeds while working for both the city and the developer on the project.[22]

The SEC's complaint asks the court to stop Harvey and its officials from offering any municipal bonds for five years unless it retained a court-appointed independent consultant. It also asked the court to make the Comptroller forfeit the bond proceeds and pay unspecified civil penalties.[23] The case has yet to conclude.

Those Who Don't Know History Are Doomed to Repeat It – Key Take-Aways

Valuable insights can be gleaned from the handful of examples provided in the previous section. As seen in the aforementioned cases, penalties range from a censure from the SEC, which negatively impacts an issuer's credibility with the investing public, to individual fines on municipal officials, and even potentially a prohibition on issuing bonds.

In light of these actions taken by the SEC, municipal officials should be on alert. They can no longer simply rubber stamp projects and then turn a blind eye to realities on the ground. In order to act in good faith when issuing bonds, municipal officials must take on a more active role than what was previously deemed acceptable.

Here are some key take-aways:

- Provide accurate, up-to-date information in the bond documents. If budgetary projections have changed, then those changes must be communicated to the proper individuals and reflected in the bond documents. This is particularly the case with revenue streams, which can be subject to greater flux for municipalities.

- If legislative or statutory changes are going to affect a government's financial condition, ability to pay debt service on the bonds, or another portion of the budget, that legislative or statutory change *and* the effect of that change must be reported and explained to the investing public.

- If the scale of the project for which you are bonding materially changes, that must also be communicated to the proper individuals and reflected in the bond documents. Indeed, this may impact the viability of the project, which is why solid preparation beforehand is important.

- Cover all your bases. As seen in the Harrisburg case, if information can be reasonably expected to reach the investing public, it must be accurate. This includes providing accurate, up-to-date information in public statements, publicly available documents, and even speeches (e.g. State of the City).

- Municipal officials should also take an active role to ensure their staff are doing their jobs properly. And they are also responsible for seeking the appropriate counsel and ensuring that their staff are properly trained in communicating information to bond counsel and other individuals who may be involved in the issuance of bonds. As seen in the Allen Park case, the SEC went after the person "in control" (the Mayor) of the actions of personnel (the City Administrator).

Conclusion

The SEC's actions in recent years send a clear message that municipal officials – no matter the size of their city or town (or state) – should be on alert. In order to act in good faith when issuing bonds, municipal officials are required to do more than was previously acceptable to ensure the investing public is receiving accurate and up-to-date information on the financial state of the municipality. The consequences of the SEC enforcement could very well include taking a bite out of the pocketbook of municipal officials.

This increased responsibility for individual officials includes ensuring that changes in budgetary projections are communicated to the proper individuals, actively working to provide accurate financial and project information in the bond documents, and providing accurate financial and project information in all communication to the public (not just the *investing* public).

The SEC's recent tactics represent a series of firsts in terms of their enforcement against municipal bond fraud. These actions are part of an effort to strengthen the $3.7 trillion municipal bond market and better protect investors. And, from the 5,000-foot-view, these efforts reflect a greater movement to strengthen accountability and transparency at all levels of government and rout out potential corruption and fraud. In short, the time for passivity on the part of municipal officials has come to an end.

Acknowledgment

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Footnotes

1. U.S. Securities and Exchange Commission. "Report on Municipal Securities Market." July 31, 2012. p. i-ii.

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3. Ibid., p. vi.

4. Ibid. p. viii-X.

5. Ibid.

6. ElBoghdady, Dina. "SEC cracks down on disclosure in municipal bond sales." The Washington Post, June 28, 2013. Accessed Tuesday, November 25, 2014, http://www.washingtonpost.com/business/economy/2013/06/28/8d608dbe-df8e-11e2-963a-72d740e88c12_story.html.

7. U.S. Securities and Exchange Commission. "SEC Charges State of New Jersey for Fraudulent Municipal Bond Offerings." August 18, 2010. Accessed Tuesday, November 25, 2014, http://www.sec.gov/news/press/2010/2010-152.htm.

8. Ibid.

9. Securities and Exchange Commission cease-and-desist order in the matter of City of San Diego, California. Securities Act of 1933 Release No. 8751, November 14, 2006, and Securities and Exchange Act of 1934 Release No. 54745, November 14, 2006.

10. U.S. Securities and Exchange Commission. "Former San Diego Officials Agree to Pay Financial Penalties in Municipal Bond Fraud Case." October 27, 2010. Accessed Tuesday, November 25, 2014, http://www.sec.gov/news/press/2010/2010-204.htm

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13. Ibid.

14. U.S. Securities and Exchange Commission. "SEC Charges Illinois for Misleading Pension Disclosures." March 11, 2013. Accessed Wednesday, November 26, 2014, http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171513202#.VH3i0THF8dd.

15. Ibid.

16. Securities and Exchange Commission cease-and-desist order in the matter of The City of Harrisburg, Pennsylvania. Securities and Exchange Act of 1934 Release No. 69515, May 6, 2013.

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18. Ibid.

19. U.S. Securities and Exchange Commission. "SEC Charges Allen Park, Mich. and Two Former City Leaders in Fraudulent Muni Bond Offering for Movie Studio Project." November 6, 2014. Accessed Wednesday, November 26, 2014, http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543373355#.VH3kDzHF8dd.

20. *U.S. Securities and Exchange Commission v. Gary J. Burtka* (2014). Complaint filed by the SEC in the U.S. District Court, Easter District of Michigan, Southern Division.

21. *U.S. Securities and Exchange Commission v. City of Harvey, Illinois and Joseph T. Letke* (2014). Complaint filed by the SEC in the U.S. District Court, Northern District of Illinois, Eastern Division.

22. Walsh, Mary Williams. "S.E.C. Stops City in Illinois From Selling Municipal Bonds." June 25, 2014. Accessed Tuesday, November 25, 2014, http://dealbook.nytimes.com/2014/06/25/s-e-c-stops-harvey-ill-from-selling-municipal-bonds/?_r=3.

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