

A Year in Review for Municipal Securities: SEC Enforcement Highlights

By Kit Addleman and Sarah Mallett



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The Securities and Exchange Commission (“SEC”) touted 2014 as a record year for its enforcement program and noted cases that spanned the spectrum of the securities industry.¹ Actions against municipal securities issuers and underwriters particularly stand out among the many areas of aggressive enforcement in 2014.

Since establishing the Office of Municipal Securities in 2012 as required by the Dodd-Frank Act, the SEC has intensified its scrutiny of municipal securities issuers and underwriters, particularly in the context of disclosures. In 2013, the Division of Enforcement charged more issuers with securities fraud than it had in the previous 10 years combined. In 2014, the SEC continued its aggressive stance, which resulted in a banner year of “firsts”—the first injunction to halt a municipal bond offering (*City of Harvey*); the first settlement under its targeted cooperation initiative (*Kings Canyon*); and the first “control person” case against a municipal elected official (*Burtka*). In calendar year 2015, however, the SEC’s enforcement program has yet to bring an action involving municipal securities.

This article reviews the 2014 municipal securities enforcement actions and analyzes what the municipal securities industry might expect in 2015 and beyond.

Overview of 2014 Enforcement Actions

A Year of Enforcement “Firsts”

First Injunction to Halt a Bond Offering – SEC v. City of Harvey

The SEC obtained its first injunction to halt a bond offering when it learned during an investigation of the City of Harvey’s (the “City”) past bond offerings that the City intended to issue new limited obligation bonds in the Summer of 2014 despite a purported scheme between the City and its comptroller, Joseph T. Letke, to divert bond proceeds for improper and undisclosed uses.² The SEC filed a complaint in federal court in Chicago requesting emergency injunctive relief to halt the

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bond offering, which was scheduled to occur later that week. Following an emergency hearing, the court issued a temporary restraining order preventing the City from offering or selling any bonds through the next month.

The complaint further alleged that city officials diverted at least \$1.7 million of bond proceeds from past bond offerings to pay the City's operational costs and that Letke received approximately \$269,000 in undisclosed payments derived from bond proceeds.³ Alleging that the City's bond investors were materially misled about the purpose and risks of the bonds they purchased, the SEC charged

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the City and Letke with violations of Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5.⁴

The City of Harvey quickly settled with the SEC and consented to entry of a final judgment, which required certain undertakings, but no monetary penalty.⁵ The City agreed to retain an independent consultant and audit firm, and was prohibited from engaging in the offer or sale of any municipal securities for three years unless it retained independent disclosure counsel. The Court later entered default judgment against Letke, enjoining him from future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, barring him from participating in any municipal securities offerings as an adviser or consultant, and ordering him to pay disgorgement of \$164,375, prejudgment interest of approximately \$22,740, and a civil penalty of \$30,000.⁶

The City of Harvey case signals an increase in the SEC's aggressiveness against municipal issuers. In particular, the enforcement staff employed the litigation tactic of seeking an emergency motion for a preliminary injunction—an approach typically limited to Ponzi schemes and unregistered offerings. The Harvey case should serve as a well-heeded warning to issuers and their employees that the enforcement staff can and will seek immediate action to stop perceived fraud and misconduct.

First Control Person Case – City of Allen Park, Gary Burtka, and Eric Waidelich

The SEC brought fraud charges against the City of Allen Park, Michigan (the "City") and two of its leaders in connection with a movie studio project municipal bond offering that allegedly contained false and misleading statements about the scope and viability of the project and the City's overall financial condition and ability to service the bond debt. The two city officials charged were former Mayor Gary Burtka, and former City Administrator Eric Waidelich. This was the first time the SEC charged a municipal official for "control person liability" under Section 20(a) of the Exchange Act.⁷

The SEC claimed that by the time the bonds were issued, the studio project plans had deteriorated dramatically, yet these changes were not reflected in the offering documents or other public statements.

The City also allegedly used outdated budget information in bond offering documents.⁸ According to the SEC's complaint, Burtka was an active champion of the project and in a position to control the actions of the city and Waidelich with respect to the fraudulent bond issuances.⁹ Based on this control, Burtka was charged with liability for violations committed by the City and by Waidelich.¹⁰

Because Waidelich reviewed and approved the offering documents, he was charged with violating Section 17(a)(2) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5(b).¹¹ Actions against both individuals were brought in federal district court in Michigan. Burtka and Waidelich settled with the SEC without admitting or denying the charges. Waidelich agreed to a bar prohibiting him from participating in any municipal bond offerings and enjoining him from future violations. Burtka agreed to a \$10,000 penalty and a similar bar. The City of Allen Park settled with the SEC without admitting or denying the charges, agreed to cease and desist from future violations, and undertook certain remedial actions.

SEC leadership has been candid about their desire to hold more individuals accountable for violations of the securities laws. This trend has been growing across many types of investigations and is expected to increase dramatically in enforcement actions in the municipal securities industry. The Division of Enforcement has been reluctant to seek or impose monetary penalties against municipal issuers, likely because

of the potential harm to taxpayers. In fact, the sanctions imposed against municipalities are relatively “light” when compared to similar allegations against non-municipal issuers. To balance this perception, the SEC likely will increase the number of actions it brings against individuals, who will face much harsher penalties, in order to deter misconduct by others working in the industry.

First MCDC Settlement - In the Matter of Kings Canyon

In March 2014, the SEC announced the “Municipalities Continuing Disclosure Cooperation (MCDC) Initiative” to encourage issuers and underwriters to self-report possible violations involving materially inaccurate statements related to prior compliance with the continuing disclosure obligations specified in Rule 15c2-12 under the Exchange Act.¹² Rule 15c2-12 generally prohibits any underwriter from purchasing or selling municipal securities unless the issuer has committed to providing continuing disclosures regarding the security and issuer, including information about its financial condition. The Rule also requires that any final Official Statement prepared for a primary offering contain a description of any instances in the last five years where the issuer failed to comply with any previous continuing disclosure obligations. The SEC can file enforcement actions under Section 17(a) of the Securities Act or 10(b) of the Exchange Act against municipal issuers for making misrepresentations in bond offerings about their prior compliance and against underwriters for failing to exercise adequate due diligence regarding the truthfulness of representations in the issuer’s official statement.¹³

In return for self-reporting under the MCDC Initiative, the Enforcement Division promised to recommend standardized, favorable settlement terms.¹⁴ For issuers, the Division would recommend: (1) a cease and desist proceeding in which the issuer neither admits nor denies the findings, (2) that the issuer undertake certain remedial and compliance measures, and (3) no payment of any civil penalty. For underwriters, the Division would recommend a similar settlement but require capped civil penalties based on the size of the offering or the underwriter’s annual revenue. Notably, however, there is no protection under the MCDC for individual liability.

The first and only issuer to settle under the MCDC Initiative in 2014 was Kings Canyon Joint Unified School District in California.¹⁵ The SEC alleged Kings Canyon’s 2010 bond offering falsely represented to investors that the District had

complied with its prior and continuing disclosure obligations when in fact, it had failed to submit contractually required disclosures relating to past offerings.¹⁶ Kings Canyon’s settlement terms fell well within the parameters indicated by the SEC in announcing its MCDC initiative.

The MCDC self-reporting deadlines expired in 2014 and it is unclear whether the SEC will renew this initiative or enact a similar one for 2015. Only one issuer – and no underwriters – settled publicly under the MCDC in 2014. The number of entities that self-reported is not known, but given only one announced settlement, the number likely was not very high. That is not surprising when comparing previous issuer and underwriter settlements to the dubbed “favorable terms” offered by the SEC through the MCDC initiative. In reality, the MCDC terms do not vary greatly from litigated settlements and thus do not provide a significant advantage to self-reporters. However, because few issuers and underwriters chose to self-report, it is likely that the SEC will conduct an aggressive review of the past offering activity and that any violators who failed to make reviews and self-report may face harsher penalties than those offered under the MCDC settlement terms.

Other Notable 2014 Enforcement Actions

Charter School’s Conflict of Interest – SEC v. UNO of Chicago

The SEC charged UNO Charter School Network Inc. (“UNO”), a charter school operator, and its affiliate, United Neighborhood Organization of Chicago, with defrauding investors by making materially misleading statements about transactions that presented a conflict of interest in a \$37.5 million bond offering for school construction.

According to the SEC’s complaint, filed in federal court in Chicago, UNO entered into two grant agreements with the Illinois Department of Commerce and Economic Opportunity (IDCEO) in June 2010 and November 2011.¹⁷ Each grant agreement contained a conflict of interest provision requiring UNO to (i) certify that no conflict of interest existed at the time it signed the agreement and (ii) immediately notify IDCEO in writing of any actual or potential conflicts of interest that subsequently arose.¹⁸ During 2011 and 2012, the SEC alleged that UNO violated the conflicts of interest provisions and failed to notify IDCEO despite issuing an Official Statement in connection with its \$37.5

million bond offering that affirmatively touted the strength of its Conflicts Policy.¹⁹ Given UNO's affirmative assurances in its Official Statement, the SEC claimed that reasonable investors would have wanted to know about the following undisclosed facts: (i) the engagement of a window subcontractor owned by a brother of UNO's COO; (ii) that UNO had already breached the conflict of interest provision in one of its grant agreements without notifying IDCEO; and (iii) the significant consequences that could result from UNO's conflicted transactions, including IDCEO's right to recoup all of its grant money.²⁰

Without admitting or denying liability, UNO settled the SEC's charges of violations of Section 17(a)(2) of the Securities Act. UNO faced no monetary penalties, but agreed to comply with certain undertakings to improve its internal procedures and training and retained an Independent Monitor charged with detecting and preventing conflicted transactions.

Thirteen Dealers and Underwriters Sanctioned for Improper Sale of Junk Bonds

The SEC investigated the improper sales of bonds below a \$100,000 minimum denomination in a \$3.5 billion offering of Puerto Rican junk bonds and instituted an enforcement action against 13 firms, including such notable names as Charles Schwab, J.P. Morgan Securities, and TD Ameritrade.²¹ The enforcement action was the SEC's first under MSRB rule G-15(f), which establishes the minimum denomination requirement. Each firm agreed to settle the charges on a

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neither admit nor deny basis, paid penalties ranging from \$54,000 to \$130,000, and undertook a review of its policies and procedures to ensure future compliance.

Actions Against States Continued – In the Matter of the State of Kansas

The SEC continued its enforcement initiative against states in 2014 when it brought securities fraud charges against Kansas. The SEC's cease and desist order alleged the state's offering documents failed to disclose that Kansas's pension program was significantly underfunded.

Kansas ultimately agreed to settle with the SEC and implemented remedial actions.²²

The scrutiny on states began several years ago when the SEC conducted a nationwide review of state bond offering documents. The SEC's first enforcement action was against New Jersey in 2010 and it later also sanctioned Illinois in 2013. States can expect continued scrutiny, particularly with regard to inadequate disclosures regarding underfunded pension programs, which SEC Commissioner Gallagher recently called "an unpardonable sin."²³

Future Outlook

The 2014 enforcement actions indicated that municipal securities enforcement activity was on the rise. The SEC's year-end report explicitly included municipal securities as an enforcement priority for FY 2015.²⁴ Enforcement Director Andrew Ceresney also promised more enforcement activity and greater penalties in the future during a Securities Industry and Financial Markets Association ("SIFMA") conference last fall.²⁵ That means the industry will likely see an increase in actions brought against individuals. Indeed, Mr. Ceresney stated "the most effective deterrent is individual liability, so we need to be focused on that."²⁶

Although issuers remained a primary target in 2014, it is likely that future actions will also focus on underwriters and advisors. In fact, in August 2014 the SEC announced a Municipal Advisor Exam Initiative²⁷ directed at newly regulated municipal advisors. Over the next two years, the Office of Compliance Inspections and Examinations ("OCIE") plans to examine many of these advisors and focus its exams on: the advisor's fiduciary duties to its municipal clients, books and recordkeeping obligations, disclosure, fair dealing, and supervision. The SEC is also working with the MSRB and FINRA to facilitate a coordinated approach to the oversight of municipal advisors.

Additionally, Commissioner Gallagher spoke in March 2015 about his concerns regarding transparency in the municipal bond market.²⁸ He acknowledged the agency's limited enforcement authority under the Tower Amendment but applauded and encouraged the efforts of the SEC to use their existing authority—mainly antifraud provisions and Rule 15c2-12—to enforce and improve municipal disclosure practices.

Conclusion

The SEC's enforcement program in 2014 showed an intensified scrutiny of municipal securities issuers and underwriters, particularly in the context of disclosures. While no actions involving municipal securities offerings were filed in the first five months of 2015, it is unlikely that the SEC has dropped

its focus and emphasis in this area. Municipal issuers and their underwriters should increase their diligence for complete and accurate disclosures, including continuing disclosure obligations and changes in circumstances leading up to offerings, to avoid SEC investigations and enforcement actions. Experienced issuer's disclosure counsel and underwriters' counsel are critical to avoiding the need for experienced SEC defense counsel.

ENDNOTES

* Kit Addleman is also co-head of the firm's Crisis Management Practice Group. Kit uses the extensive experience she gleaned at the SEC to provide vigorous representation to advance her clients' interests. Kit defends companies and their executives and directors against charges of civil and criminal misconduct, particularly investigations and litigation by the Securities and Exchange Commission and Department of Justice. She also counsels public companies, investment advisors, hedge funds and broker-dealers concerning compliance with the securities laws and SEC rules.

** Sarah Mallett has extensive experience in SEC enforcement matters. She counsels clients through every stage of an SEC enforcement action including the investigation, Wells process, and litigation. She recently served as trial counsel in a multi-week SEC administrative proceeding, resulting in a complete victory for her client. Also, Sarah helped secure the dismissal with prejudice of all claims against the Board of Directors of a Fortune 20 company in a shareholder derivative lawsuit in Dallas County and defeated shareholder plaintiffs' motion for preliminary injunction on behalf of Independent Directors in the U.S. District Court for the Northern District of Texas.

¹ According to the U.S. Securities and Exchange Commission, Agency Financial Report Fiscal Year 2014 [hereinafter AGENCY FINANCIAL REPORT], available at <http://www.sec.gov/about/secpar/secafr2014.pdf>, the SEC's Division of Enforcement brought 755 enforcement actions yielding \$4.16 billion in penalties and disgorgements. *Id.* at 19. The Report also highlighted some "notable actions," including those in the municipal securities industry, which were characterized as "important, first-of-their kind enforcement actions." *Id.* at 25, 151.

² SEC Press Release, *SEC Obtains Court Order to Halt*

Fraudulent Bond Offering by City of Harvey, Ill. (June 25, 2014), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542163027>.

³ Complaint at 2-3, *SEC v. City of Harvey*, No. 1:14-cv-04744 (N.D. Ill. June 24, 2014), ECF No. 1.

⁴ *Id.* at 24-26.

⁵ SEC Litigation Release No. 23149, *City of Harvey Agrees to Settle Charges Stemming from Fraudulent Bond Offering Scheme* (Dec. 5, 2014), available at <https://www.sec.gov/litigation/litreleases/2014/lr23149.htm>.

⁶ Litigation Release No. 23180, *Court Enters Default Judgment Against SEC Defendant Joseph T. Letke, Bars Him from Participating in Municipal Securities Offerings, and Orders Him to Pay Over \$200,000* (Jan. 27, 2015), available at <https://www.sec.gov/litigation/litreleases/2015/lr23180.htm>.

⁷ SEC Press Release, *SEC Charges Allen Park, Mich. and Two Former City Leaders in Fraudulent Muni Bond Offering for Movie Studio Project* (Nov. 6, 2014), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543373355>.

⁸ See *In the Matter of City of Allen Park*, Securities Act Release No. 9677, Admin. Proc. File No. 3-16259 (Nov. 6, 2014).

⁹ See Complaint at 2, *SEC v. Burtka*, No. 2:14-cv-14278 (END. Mich. Nov. 6, 2014), ECF No. 1.

¹⁰ *Id.* at 13-14.

¹¹ See Complaint at 12-13, *SEC v. Waidelich*, No. 2:14-cv-14279 (E.D. Mich. Nov. 6, 2014), ECF No. 1.

¹² SEC Press Release, *SEC Launches Enforcement Cooperation Initiative for Municipal Issuers and Underwriters* (Mar. 10, 2014), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541090828>.

¹³ *Id.*

¹⁴ *Municipalities Continuing Disclosure Coopera-*

tion Initiative, SEC.gov, <https://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml> (last modified Nov. 13, 2014).

¹⁵ See *In the Matter of Kings Canyon Joint Unified School Dist.*, Securities Act Release No. 9610, Admin. Proc. File No. 3-15966 (July 8, 2014).

¹⁶ *Id.*

¹⁷ See Complaint at 1, *SEC v. United Neighborhood Org. of Chicago*, No. 1:14-cv-04044 (N.D. Ill. June 2, 2014), ECF No. 1.

¹⁸ *Id.* at 1-2.

¹⁹ *Id.* at 2.

²⁰ *Id.*

²¹ SEC Press Release, *SEC Sanctions 13 Firms for Improper Sales of Puerto Rico Junk Bonds* (Nov. 3, 2014), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543350368>.

²² See *In the Matter of the State of Kansas*, Securities Act Release No. 9629, Admin. Proc. File No. 3-16009 (Aug. 11, 2014).

²³ Daniel M. Gallagher, SEC Commissioner, *A Watched Pot Never Boils: the Need for SEC Supervision of Fixed Income Liquidity, Market Structure, and Pension Accounting* (Mar. 10, 2015), available at <http://www.sec.gov/news/speech/031015-spch-cdmg.html>.

²⁴ AGENCY FINANCIAL REPORT at 40, available at <http://www.sec.gov/about/secpar/secafr2014.pdf>

²⁵ William Segway, *SEC to Impose Penalties More Often in Municipal-Bond Securities Fraud Cases*, 46 SLUR 2197 (BNA) (Nov. 10, 2014).

²⁶ *Id.*

²⁷ SEC Press Release, *SEC Announces Municipal Advisor Exam Initiative* (Aug. 19, 2014), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542678782>

²⁸ Gallagher, *supra* note 23.

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