Ballard Spahr LLP

2014 YEAR IN REVIEW

SEC Municipal Market Enforcement

WINTER 2015

The most significant enforcement strategy the U.S. Securities and Exchange Commission (SEC) employed in 2014 followed a well-worn path: through its Municipalities Continuing Disclosure Cooperation Initiative (MCDC Initiative), the SEC sought to regulate issuers by leveraging its authority over underwriters. Announced on March 10, 2014, the MCDC Initiative encouraged municipal securities issuers and underwriters to self-report possible securities law violations related to inaccurate representations in offering documents concerning an issuer's prior compliance with its continuing disclosure obligations. The deadline for underwriters to self-report was September 9, 2014. Issuers, having the benefit of knowing whether their underwriters had reported any misrepresentations, had until December 1, 2014, to self-report.

Both underwriters and issuers had to decide whether to self-report based on little SEC guidance. In particular, the SEC declined to provide any framework related to which statements concerning past continuing disclosure compliance it considered to be material under the federal securities laws. On July 8, 2014, the SEC announced that it had brought an enforcement action against a school district in its first MCDC cease-and-desist order. The order provided little precedent for underwriters and issuers to consider: it gave little detail regarding how the alleged misrepresentations were material, and statements by LeeAnn Gaunt, Chief of the SEC Enforcement Division's Municipal Securities and Public Pensions Unit, suggested that the school district already was under investigation. In the absence of materiality guidance from the SEC, and due to the penalty cap provided to underwriters, it now appears that both underwriters and issuers over-reported under the MCDC Initiative. Stated differently, it is unclear whether the SEC could prove liability in these cases if it were required to do so.

One tangible result of the MCDC Initiative is an increase in the number of continuing disclosure filings submitted by municipal securities issuers to the Municipal Securities Rulemaking Board's (MSRB) Electronic Municipal Market Access (EMMA) website. When compared to the same time period in prior years, EMMA statistics show a notable spike in the filing of failure-to-file notices, which are required when an issuer misses a filing deadline, following the announcement of the MCDC Initiative. In June 2013, the number of notices of failures by municipal securities issuers and obligated persons to file annual financial information totaled 154. In June 2014, these notices totaled 718.

SEC 2014 ENFORCEMENT FOCUS:

- **Municipal securities issuers and their officials**
- **Individual liability of transaction participants**
- **Secondary market disclosure**
- **Public pension accounting and disclosure**
- **Recidivist bad behavior**
- **Disclosure related to tax law violations**

IN THIS ISSUE:

Another result of the MCDC initiative is an increased focus by municipal market participants on the manner in which secondary municipal market disclosures from municipal securities issuers are achieved. The SEC's regulation of issuers' secondary market disclosure continues to be accomplished through enforcement actions as well as through the SEC's regulation of brokers, dealers, and municipal securities dealers under SEC Rule 15c2-12.

In response to the SEC's November 2014 request for comment on the existing collection of information under SEC Rule 15c2-12, the Securities Industry and Financial Markets Association (SIFMA) submitted comments noting the "unnecessarily confusing, burdensome and complicated" requirements of Rule 15c2-12 and the increasing costs to underwriters under the SEC's broad interpretations of underwriters' duties under the Rule. SIFMA also noted that the Rule was adopted and amended before publicly-available information was widely available about municipal securities issuers, including on issuers' websites. In its response to the SEC's request for comment, the MSRB stated that its costs are also increasing due "in part to the increase in the number of filings with EMMA and the increased attention being paid to compliance with the disclosure requirements of Rule 15c2-12 following the SEC's National Examination Risk Alert issued in March 2012 and as a result of the MCDC Initiative."[i]

The SEC's efforts to regulate issuers indirectly through its ability to regulate underwriters directly appear to be its response to the denial of its request in its 2012 Report on the Municipal Securities Market, in which it sought authority to regulate directly the secondary market disclosures of municipal securities issuers. This would have all but required a repeal of the "Tower Amendment." In that report, and among other things, the SEC sought legislation authorizing it to set timing, form, content, and financial audit requirements for continuing disclosures and providing the SEC with "tools" to enforce such requirements, and to be granted the authority to require trustees to enforce continuing disclosure agreements. Congress did not grant any of these requests, and consequently the SEC has again resorted to indirect regulation, such as that through the MCDC Initiative.

The MCDC Initiative was not the SEC's only enforcement effort in 2014. As in recent years, the SEC continued to aggressively pursue enforcement actions against state and local governments. In June 2014, the SEC obtained an emergency court order to prevent the City of Harvey, Illinois, from selling bonds in the municipal market amid allegations the City engaged in fraudulent market transactions. Without admitting or denying the allegations, the City settled in December 2014. In August 2014, the SEC announced a settled action against the State of Kansas. The SEC alleged the State failed to disclose a significant unfunded liability in its pension system in any of eight series of bonds offered over an 11-month period. These two actions foreshadow two possible enforcement focuses in 2015: secondary market disclosures and pension disclosures.

"Pay-to-play" violations also are likely to remain a focus of SEC enforcement actions. In June 2014, the SEC announced its first enforcement action under investment adviser pay-to-play rules. In September 2014, a federal district court dismissed on procedural grounds a challenge to the rule brought by the state Republican parties of New York and Tennessee. The Republican parties are appealing the court's ruling.

The prohibitions of the SEC's investment adviser pay-to-play rule do not apply to "regulated persons," which require such persons be subject to substantially equivalent or more stringent restrictions on political contributions than under the SEC's rule. For this reason, the Financial Industry Regulatory Authority requested comment on its own pay-to-play rule, modeled after the SEC's, in November 2014. Comments were due December 15, 2014.

Concerning municipal advisors, the SEC's final registration rules went into effect July 1, 2014. In August 2014, the SEC announced an initiative by its Office of Compliance Inspections and Examinations to examine a large number of these newly regulated municipal advisors over a period of two years. The SEC identified compliance with the municipal advisor's federal fiduciary duty to municipal entity clients as an area of potential scrutiny as well as compliance with requirements related to books and recordkeeping, disclosure, fair dealing, supervision, and employee qualifications and training. The MSRB has adopted, or is in the process of adopting, municipal advisor rules related to the areas identified by the SEC. Ms. Gaunt has made statements suggesting that the SEC may be poised to bring municipal advisor enforcement actions alleging breach of a fiduciary duty.

Another area of regulation addressed in the SEC's 2012 Report on the Municipal Securities Market that the SEC will likely continue to pursue in 2015 is improved price transparency for retail investors. In December 2014, the SEC approved the MSRB's adoption of a "best execution" rule. MSRB Rule G-18 provides that "[o]ne of the areas in which a dealer must be especially diligent in ensuring that it has met its best-execution obligations is with respect to customer transactions involving securities for which there is limited pricing information or quotations available." In November 2014, the MSRB issued a proposal to require dealers to disclose certain reference information in customer confirmations related to pricing. Given the SEC's focus on price transparency, it will likely undertake additional related initiatives in 2015.

Finally, in November 2014, the SEC demonstrated that it is also monitoring uniform practice standards for dealers. The SEC levied financial penalties against 13 dealer firms it alleged engaged in uniform practice violations by selling Puerto Rico high-yield bonds to investors below set minimum denominations.

OFFERING AND DISCLOSURE

MCDC Initiative

The MCDC Initiative, announced by the SEC on March 10, 2014, is a self-policing enforcement program for municipal securities issuers and underwriters to self-report possible securities law violations related to misrepresentations in offering documents concerning an issuer's prior compliance with its continuing disclosure obligations.

Under the MCDC Initiative, the SEC's Enforcement Division will recommend standard settlement terms upon self-reporting of possible securities law violations by municipal securities issuers, other obligated persons, and underwriters. The self-reporting deadline for underwriters was September 10, 2014. The self-reporting deadline for issuers was December 1, 2014.

Before 2013, despite reports of widespread issuer noncompliance with at least some continuing disclosure obligations, the SEC had not brought a related enforcement action against an issuer or emphasized SEC Rule 15c2-12 in its enforcement actions against underwriters. In July 2013, the SEC set groundbreaking precedent by undertaking enforcement actions against Indiana's West Clark Community Schools and the school district's underwriter. These actions were based on statements in offering documents that the school district was compliant with its previous continuing disclosure agreement.

The school district had, in fact, not submitted any of the required annual financials or event notices. The SEC alleged that the underwriter's due diligence efforts were inadequate as the underwriter failed to discover that the school district was not compliant with its prior continuing disclosure obligations. Neither the school district nor its underwriter challenged the SEC's findings, and the actions were settled through cease-and-desist orders.

The MCDC Initiative encouraged issuers that may have made materially inaccurate statements in offering documents regarding their prior continuing disclosure compliance, and the underwriters of such offerings, to self-report through the submission of a questionnaire. The questionnaire requires the submitter to identify transaction participants—including the issuer, the underwriter, the municipal advisor, bond counsel, underwriter's counsel, and disclosure counsel, if any.

For eligible self-reporters, the Enforcement Division will recommend settlement through cease-and-desist proceedings that do not require an admission of liability. The Enforcement Division will recommend not levying a financial penalty against issuers. Issuers will be required to take remedial actions, including:

- Establishing compliance policies and procedures
- Complying with prior and existing continuing disclosure obligations
- Cooperating with subsequent SEC investigations
- Disclosing the terms of the settlement in its official statement for five years
- Providing a compliance certificate to the SEC regarding the above actions one year from the date on which the cease-and-desist proceeding is instituted

The Enforcement Division will recommend tiered financial penalties against underwriters, however. The civil penalties are based on a three-tiered approach. For underwriters with 2013 reported total annual revenue of more than $100 million, a maximum fine of $500,000 will be imposed. For underwriters with 2013 reported total annual revenue between $20 million and $100 million, a maximum fine of $250,000 will be imposed. Finally, for underwriters with 2013 reported total annual revenue of less than $20 million, a maximum fine of $100,000 will be imposed.

Underwriters will be required to take remedial actions including:

- Retaining an independent consultant to undertake a compliance review and provide recommendations regarding the underwriter's due diligence process and procedures
- Taking steps to implement the consultant's recommendations
- Cooperating with subsequent SEC investigations
- Providing a compliance certificate to the SEC regarding the above actions one year from the date on which the cease-and-desist proceeding is instituted

Critically, individuals may not self-report through the MCDC Initiative. The SEC's Enforcement Division will determine whether municipal officials and underwriting firm employees should be the subject of an SEC enforcement action on a case-by-case basis, considering such factors as the individual's level of intent and cooperation with the SEC.

The Enforcement Division has indicated that the remedies it seeks will be more severe for eligible issuers, other obligated persons, and underwriters who fail to self-report through the MCDC Initiative. The Division stated that it will likely recommend financial penalties for such non-reporting issuers and financial penalties higher than those set forth in the MCDC Initiative for such non-reporting underwriters. Notably, however, the SEC has never assessed a financial penalty against a municipal issuer where the penalty would be paid from taxpayer funds.

The SEC recognizes the limitations in auditing continuing disclosure compliance prior to the EMMA system becoming the single, official repository for continuing disclosure information on July 1, 2009. The former Nationally Recognized Municipal Securities Information Repositories (NRMSIR) system was a decentralized and unreliable source of continuing disclosure information. If the SEC identifies securities law violations after the MCDC Initiative self-reporting deadline, it stated that it will consider good faith efforts to discover violations that occurred pre-EMMA in determining whether to recommend an enforcement action or the type of relief sought if an enforcement action is undertaken.

Failure to Disclose Conflicts of Interest

On June 2, 2014, the SEC charged a Chicago charter school operator with defrauding investors in a $37.5 million bond offering by failing to disclose transactions that presented conflicts of interest.[ii] According to the SEC's complaint, UNO Charter School Network, Inc. (UNO) failed to disclose a multimillion-dollar construction subcontract with a company owned by a brother of UNO's Chief Operations Officer, as well as the potential impact of this transaction on UNO's ability to repay its bond obligations. This announcement was notable both in itself and for what may be forthcoming: SEC officials have stated that the agency may bring charges against individuals in the ongoing investigation.

In 2010 and 2011, according to the complaint, UNO entered into two grant agreements totaling $78 million with the Illinois Department of Commerce and Economic Opportunity to build three charter schools. Both agreements contained a lengthy conflict of interest policy. The policy required UNO to certify that no conflicts of interest exist and immediately notify the Department of "any actual or potential conflicts of interest, as well as any actions that create or which appear to create a conflict of interest." If UNO breached this provision, the Department was entitled to suspend any future grant payments as well as recover grant funds already paid to UNO.

According to the SEC, in 2011, UNO contracted with two companies owned by its COO's brother, agreeing to pay one company approximately $4 million to supply and install windows at the schools it was constructing and the other approximately $500,000 to serve as UNO's representative during construction. Although both transactions qualified as conflicts of interest under the grant agreements, UNO allegedly failed to disclose them to the Department.

UNO subsequently conducted a $37.5 million bond offering in October 2011 to finance the construction of the three charter schools. The bonds were to be repaid using the revenues UNO received from the Chicago Public School system for operating the charter schools. In connection with the offering, UNO issued an Official Statement to investors that devoted an entire section to UNO's "Conflicts Policy." In addition to affirming to investors that UNO followed a policy that was more robust than required for nonprofit organizations, UNO also disclosed that it had engaged a company owned by its COO's brother to serve as UNO's construction representative.

Nevertheless, the SEC alleged that the disclosures in the Official Statement were deficient due to UNO's failure to disclose that UNO had entered into a $4 million window installation contract with a company owned by another of its COO's brothers, and that UNO was in breach of the conflict of interest provisions in the grant agreements due to its failure to disclose the conflicted transactions. Most egregiously, according to the SEC, UNO failed to disclose that due to its breach, the Department was entitled to suspend and/or recoup all the grant funds. Because the bonds were to be repaid with funds UNO received from the Chicago Public School system for operating the charter schools, a breach of the conflicts policy and resulting potential repayment of the grants could have put the primary source of repayment funds at risk.

The SEC alleged that UNO's negligence violated Section 17(a)(2) of the Securities Act of 1933. Without any admission of wrongdoing, UNO agreed to settle the SEC's charges by undertaking measures to improve its internal procedures and training. Among those measures is the appointment of an independent monitor for one year, at a cost of $100,000 to UNO, with the authority to prohibit UNO from expending significant funds or engaging in any transaction deemed to be a conflict of interest.

The complaint notably does not include any charges against UNO's CEO, who allegedly approved the conflicted transactions, signed the Official Statement, and allegedly falsely stated, on an investor call, that the grants did not subject UNO to any guidelines on conflicted transactions. Peter K. M. Chan, then assistant regional director of the SEC's Chicago Regional Office, stated, however, that the SEC is "not finished" with its investigation and intends to "look into all parties and individuals who contributed to UNO's violations." This further review is consistent with the SEC's recent focus on pursuing individuals responsible for securities law violations, a primary focus of SEC Chair Mary Jo White's enforcement agenda.

Misuse of Bond Proceeds

On June 24, 2014, the SEC filed a complaint against the City of Harvey, Illinois, and its comptroller—who also served as the City's financial advisor—alleging material misrepresentations were made regarding the use of bond proceeds in official statements for offerings sold by the city in 2008, 2009, and 2010.[iii]

The City stated in its offering documents that the bond proceeds would be used to fund the development and construction of a hotel. The bonds were to be paid from pledged revenue streams including hotel, sales, and incremental tax revenue. According to the SEC, bond proceeds were instead deposited into the City's general fund and used for payroll and other operational expenses. Further, the SEC alleges that the City's comptroller received approximately $269,000 in undisclosed payments, and a firm controlled by the comptroller received $547,000 in compensation as the City's financial advisor in the 2008, 2009, and 2010 public offerings.

The SEC's complaint alleges that, for the purpose of building a grocery store, the City planned to issue new bonds in 2014 in accordance with an offering memorandum that failed to disclosed the City had previously misused municipal bond proceeds. Accordingly, the SEC took an unprecedented step in seeking and obtaining an emergency order preventing the City from selling its bonds. Among other relief, the SEC requested that the City and its officials be prohibited from offering any municipal securities for five years unless it retained a court-appointed independent consultant to review the City's disclosure policies and procedures and make recommendations for improvement, which would be implemented by the City. The SEC's Complaint also seeks disgorgement by the comptroller of ill-gotten gains and civil monetary penalties.

The SEC's action was filed in U.S. District Court for the Northern District of Illinois. On December 10, 2014, a final judgment against the City was entered. The City did not admit or deny the SEC's allegations. The final judgment enjoins the City from violating Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder as well as Section 17(a) of the Securities Act. The City must retain an independent consultant to recommend changes to the City's policies and procedures related to its financial reporting, use of bond proceeds, and primary market disclosures. In addition, the City must retain an independent auditor. Finally, the City is prohibited from offering or selling municipal securities for a period of three years unless it hires independent disclosure counsel to help ensure offering documents are accurate and complete, and the final judgment is disclosed. A default judgment was entered against the former City comptroller on January 27, 2015, enjoining him from future securities law violations, barring participation in any municipal securities offering, and requiring payment of disgorgement and a civil penalty totaling more than $200,000.

MCDC Enforcement Action

On July 8, 2014, the SEC announced its first cease-and-desist order under its MCDC Initiative. Without providing detailed analysis, the SEC found that the Kings Canyon Joint Unified School District of California (District) made a material misstatement in a 2010 official statement.[iv]

The SEC alleged that the District represented that it had not failed to comply in all material respects with its continuing disclosure agreements in the previous five years. According to the SEC, the District failed to provide "some" of the disclosure between 2008 and 2009 required by continuing disclosure agreements. The SEC did not provide further detail about the nature of the District's noncompliance, and largely appears to have assumed that the fact of the District's noncompliance was material to investors.

The SEC's action was significant in a second respect. It is widely known that, at the time of some of the District's noncompliance, investors had limited access to continuing disclosure before the SEC designated the Electronic Municipal Market Access (EMMA) system as the sole, official repository for continuing disclosure, effective July 1, 2009. In its adopting release approving EMMA, the SEC stated: "Specifically, we believe that municipal securities disclosure documents should be made more readily and more promptly available to the public and that all investors should have better access to important market information." Although the apparent expectations of a "reasonable" investor regarding continuing disclosure may have changed substantially post-EMMA, the SEC's order does not draw a pre- versus post-EMMA line to determine the materiality of a misstatement.

Ms. Gaunt has stated that future MCDC cease-and-desist orders will provide more detail than the District order.

Fraud Liability of Mayor as Control Person

On November 6, 2014, the SEC announced fraud charges against the City of Allen Park, Michigan,[v] and two of its former officials—the former City Mayor[vi] and former City Administrator.[vii] It is the first time the SEC has imposed "control person" liability on a mayor, or any municipal official, under Section 20(a) of the Securities Exchange Act of 1934 (Exchange Act), which provides that a control person may be held jointly and severally liable for the securities law violations of the persons over which it exercises control.

While unprecedented, the SEC's action was not unexpected. In the May 2013 Section 21(a) Report it issued following its investigation of the City of Harrisburg, the SEC warned:

> *The statements by the Harrisburg public officials were part of, and could have altered, the total mix of information available to the market. There is a substantial likelihood that a reasonable investor would consider the financial condition of the City important in making an investment decision, and there were no other disclosures made by the City as part of the total mix of information available to enable investors to consider other information. These public officials' statements were the principal source of significant, current information about the issuer of the security and thus could reasonably be expected to influence investors and the secondary market. Because statements are evaluated for antifraud purposes in light of the circumstances in which they are made, the lack of other disclosures by the municipal entity may increase the risk that municipal officials' public statements may be misleading or may omit material information.*

The Allen Park matter accordingly demonstrates the resolve the SEC warned about in the City of Harrisburg matter.

The facts in Allen Park frequently coincide with the economic conditions many municipalities face, and with the optimistic statements many public officials typically make in connection with economic development projects. In 2008, the City initiated plans for an economic development project consisting of a $146 million movie studio with eight sound stages. The studio was to be financed and operated by a public-private partnership (PPP) consisting of a limited liability company, a producer, and a private developer. The City planned to acquire the land for the project using municipal bond proceeds and subsequently donate the land to the PPP. The bonds were to be initially repaid from revenues generated by the City from leases with media-related entities. In April 2009, the City issued a press release covering the project that included a statement from the former City Mayor characterizing the project as an "economic development blockbuster" and emphasizing the job opportunities created by the project.

In May 2009, the producer committed to pay up to $2 million to cover the City's budget deficit. The payment was contingent upon the land being donated by the City to the PPP. Shortly thereafter, the City entered into an agreement—signed by the former City Mayor—with the producer and the developer under which the developer pledged $20 million for the first phase of building the studio, according to the SEC. The SEC alleged that the PPP collapsed after the City was informed in July 2009 by its bond counsel that it was prohibited from using bond proceeds to purchase land that would be donated to the PPP. By August 2009, plans for the project had deteriorated into leasing a piece of the property for the operation of a movie production vocational school.

Despite the knowledge of the former City Mayor, the SEC alleged he made false statements to the public and the City Council about the timing and scope of the project in a press release and public meeting. The SEC also alleges that neither the former City Mayor nor former City Administrator disclosed to the City Council any of the negative developments affecting the project prior to the issuance of the municipal bonds. Although the former City Mayor was alleged to have promoted the underlying project, the SEC's action does not rest on that fact alone.

The City issued $31 million in municipal bonds in November 2009 and June 2010. According to the SEC, the City Administrator provided information used in drafting the offering documents, reviewed the offering documents, and providing certification that the information contained therein was true, correct, and complete. According to the SEC, the offering documents failed to disclose the negative developments concerning the project. The SEC further alleged the offering documents contained material misstatements about the projected lease revenue available to pay bondholders as well as the City's financial health.

The SEC charged the City and the former City Administrator with violating Section 17(a)(2) of the Securities Act and Section 10(b) of the Securities Exchange Act and Rule 10b-5(b). Without admitting or denying the findings of the SEC, the City consented to a cease-and-desist order and the City Administrator consented to a final judgment barring him from participating in municipal bond offerings and enjoining future securities law violations.

The SEC charged the former City Mayor under Section 20(a) of the Exchange Act based on his position as a controlling person of the City and the City Administrator at the time the alleged fraud was committed. The former City Mayor consented to a final judgment barring him from participating in municipal bond offerings and enjoining him from committing future securities law violations without admitting or denying the SEC's findings. The former City Mayor also agreed to pay a $10,000 financial penalty. In November 2014, the court vacated the settlement agreements due to the concerns of U.S. District Judge Avern Cohn that more sophisticated transaction participants had not been included in the SEC's enforcement efforts. On December 23, 2014, the SEC filed a declaration by Mark Zehner,[viii] Deputy Chief of the SEC's Municipal Securities and Public Pensions Unit, stating that:

> *Prior to filing of the instant actions and submitting the proposed consent judgments, the SEC conducted a thorough investigation into the circumstances of the 2009 and 2010 Allen Park Bond offerings. The SEC considered the possible liability of multiple participants in light of the law and evidence. Based on the evidence, the SEC made its best determination in the public interest as to which parties should be charged.*

Regarding the underwriter's role, Mr. Zehner stated that "[t]he bonds involved in this case were sold by means of competitively bid underwritings . . . with respect to the alleged fraudulent statements in this case, the Underwriters were privy to little, if anything, more than were the investors." The court accepted the settlement agreements and final judgments were entered on January 28, 2015.

The SEC's action against the former City officials is consistent with its increased focus on individual liability. In the SEC press release announcing its charges, Ms. Gaunt stated that "[w]hen a municipal official like [the City Mayor] controls the activities of others who engage in fraud, we won't hesitate to use every legal avenue available to us in order to hold those officials accountable."

PAY-TO-PLAY AND PUBLIC CORRUPTION

Receipt of Advisory Fees from Pension Funds Following Ban on Business

On June 20, 2014, the SEC announced its first enforcement action under "pay-to-play" rules for investment advisers.[ix] TL Ventures Inc., a Philadelphia-area private equity firm, agreed to pay nearly $300,000 in disgorgement and penalties to settle the charges that it continued to receive advisory fees from city and state pension funds after making mayoral and gubernatorial campaign contributions.

TL Ventures is an advisor to venture capital funds that invest in early-stage technology companies. In 1999, the Pennsylvania State Employees' Retirement System (SERS) invested $35 million of public pension funds in one of the company's funds, TL Ventures IV. In 2000, SERS invested $40 million of public pension funds in another of TL Ventures' funds, TL Ventures V. Also in 2000, the City of Philadelphia Board of Pensions and Retirement (the Retirement Board) invested $10 million of its public pension funds in TL Ventures V. Although the funds have been in wind-down mode in recent years, both SERS and the Retirement Board have remained investors in the funds.

On April 12, 2011, a TL Ventures executive made a $2,500 contribution to the campaign of a candidate for Mayor of Philadelphia. Later that year, the executive made a $2,000 campaign contribution to the Governor of Pennsylvania. Both are officials covered by the pay-to-play rules—the Mayor appoints three of the nine Retirement Board members, and the Governor appoints six of the 11 SERS members. The contributions triggered a two-year ban on business under SEC Rule 206(4)-5 prohibiting TL Ventures from providing advisory services to those government entities. Nevertheless, TL Ventures continued to receive advisory fees from SERS and the Retirement Board attributable to the prior investments in TL Ventures IV and TL Ventures V.

To settle the SEC's charges, TL Ventures, without admitting or denying any wrongdoing, agreed to cease and desist from future violations of the law, and further agreed to pay disgorgement of $256,697, prejudgment interest of $3,197, and a civil penalty of $35,000 to the SEC.

The SEC's pay-to-play rule is modeled after the MSRB's pay-to-play rules for dealers, Rules G-37 and G-38. The MSRB recently announced it is planning to extend the rules to apply to municipal advisors. As the SEC and MSRB have publicly stated, pay-to-play rules are designed to prevent corruption by breaking the link between business generation and political contributions.

The rules are applied formulaically: they do not require that an advisor intend to influence the government official to award the advisor business or any evidence that the contribution generated business from the recipient. Further, the rules broadly define a political "contribution" as including any gift, subscription, loan, advance, or deposit of money, or anything of value. This action, while the first against an investment adviser, is the second the SEC recently has brought relating to pay-to-play; in 2012, the SEC settled its first action for pay-to-play violations under MSRB Rule G-37 involving "in-kind" non-cash political contributions by an underwriter.

In adopting the release of SEC Rule 206(4)-5, the SEC stated: "Public pension plans are particularly vulnerable to pay-to-play practices." In its press release announcing the enforcement action, the chief of the SEC's Municipal Securities and Public Pensions Unit warned: "Public pension funds are increasingly investing in alternative investment vehicles such as hedge funds and private equity funds. When dealing with public pension fund clients, advisers to those kinds of investment vehicles should be mindful of the restrictions that can arise from political contributions."

PUBLIC PENSION ACCOUNTING AND DISCLOSURE

Failure to Disclose Pension Plan Underfunding

On August 11, 2014, the SEC issued a cease-and-desist order to settle charges that the State of Kansas defrauded investors in eight bond offerings totaling $273 million in 2009 and 2010 by failing to disclose to investors in the offering documents that the State's pension system was significantly underfunded.[x] This is the third SEC action directly against a state for allegations of fraud related to public pension plan disclosure.[xi]

According to the SEC's order, the Kansas Public Employees Retirement System (KPERS), which covers most of the State's public employees, was significantly underfunded. The SEC alleged the State's maximum annual contribution rates fell short of covering the costs of earned pension benefits as well as the unfunded actuarial accrued liability. At the close of 2008, this liability was approximately $8.3 billion and the plan's funded ratio was less than 60 percent. The SEC alleged that because the 2009 and 2010 official statements failed to disclose such information about the financial health of KPERS and the risks associated with the underfunding by the State of its pension obligations, the official statements contained material omissions. In each transaction, the Kansas Department of Administration certified that the information about the State contained in the offering documents was true in all material respects.

In consenting to the SEC's order, the State did not admit or deny the SEC's findings, and a financial penalty was not levied. In settling the charges, the State took a number of remedial actions, including adopting new disclosure policies and procedures. The SEC's action demonstrates its continued focus on disclosures regarding public pension plan funding.

UNIFORM PRACTICE STANDARDS

Bonds Sold Below Minimum Denominations

On November 3, 2014, the SEC announced sanctions against 13 securities firms relating to their executions of transactions with investors in Puerto Rico high-yield bonds.

Under MSRB Rule G-15(f), a dealer may not effect a customer municipal securities transaction in an amount lower than the issue's minimum denomination. The SEC alleged that the 13 firms sold the Puerto Rico bonds to investors below the set minimum denomination of $100,000 in 66 transactions.

Without admitting or denying the SEC's finding, the 13 firms agreed to financial penalties ranging from $54,000 to $130,000. The firms further agreed to review and strengthen their policies and procedures to ensure future compliance with MSRB Rule G-15(f).

In the SEC's press release announcing the enforcement actions, Andrew J. Ceresney, Director of the SEC's Division of Enforcement, stated that "[t]hese actions demonstrate our commitment to rigorous enforcement of all types of violations in the municipal bond market."

2014 UPDATE ON PRIOR ENFORCEMENT ACTIONS

Multimillion-Dollar Kickback Scheme

In March 2014, the SEC obtained favorable judgments against various individuals, including Henry Morris,[xii] whom the SEC alleges engaged in a fraudulent scheme involving undisclosed kickback payments made by investment management firms in order to obtain New York Common Retirement Fund business. The SEC filed its complaint against Mr. Morris in 2009.

Material Misstatements in Official Statements Related to Construction and Management Fees

In April 2013, the SEC filed a complaint against an underwriter, two investment bankers, a developer, the City of Victorville, the director of economic development for the City, and an airport authority, alleging fraud related to tax increment bonds issued by the authority in 2006, 2007, and 2008.[xiii] Proceeds from the bonds were used to fund redevelopment projects on a former Air Force base in San Bernardino County, California. The case is pending in the U.S. District Court for the Central District of California. In the initial stages of the litigation, the City of Victorville moved to dismiss certain of the SEC's fraud claims and claim for relief based on allegations of aiding and abetting violations of Rule Section 10(b) of the Exchange Act and Rule 10(b)-5 promulgated thereunder. The City's motion was denied. As of January 12, 2015, a final pretrial conference is scheduled for September 30, 2015, with a jury trial set for October 13, 2015.

Material Misstatements and Omissions in Official Statement and Annual Financials Related to Interfund Transfers

In July 2013, the SEC filed an enforcement action in federal court against the City of Miami and its former budget director alleging securities fraud related to the City's 2007 and 2008 annual financials and subsequent 2009 bond offerings.[xiv] The

SEC's complaint against the City focused on alleged improper conduct—and the consequent annual financials and bond offering disclosures—involving interfund transfers by the City.

The SEC alleged that, from 2007 to 2009, the City made transfers from capital project funds (which comprised monies restricted to specific purposes) to a general use fund to mask deficits in the general fund. The case is pending in the U.S. District Court for the Southern District of Florida. The action has been stayed pending the appeal of the district court's denial of the former budget officer's motion to dismiss based upon the defense of qualified immunity.

Ballard Spahr's Municipal Securities Regulation and Enforcement Group helps municipal market participants navigate a rapidly evolving regulatory, investigative, and enforcement environment, enabling them to anticipate and address compliance issues and respond effectively to investigations when necessary.

Our attorneys provide representation in proceedings involving the SEC, the Municipal Securities Rulemaking Board (MSRB), the U.S. Department of Justice (DOJ), the Financial Services Regulatory Authority (FINRA), and state securities commissions.

For further information, please contact **John C. Grugan** at 215.864.8226 or gruganj@ballardspahr.com, or **Tesia N. Stanley** at 801.517.6825 or stanleyt@ballardspahr.com.

ENDNOTES

i. In the MSRB's response to the SEC's request for comment, it also suggests expanding the categories of disclosure information required under Rule 15c2-12 to include an event notice for the "Creation of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement of a Registrant." On January 29, 2015, the MSRB published an advisory alert urging market participants to voluntarily disclose bank loan information on EMMA.

ii. *SEC v. United Neighborhood Organization of Chicago and UNO Charter School Network, Inc.*, Case No. 1:14-cv-04044 (June 2, 2014).

iii. *SEC v. City of Harvey, Illinois and Joseph T. Letke*, Case No. Case: 1:14-cv-04744 (June 24, 2014).

iv. *In the Matter of Kings Canyon Joint Unified School District*, Admin. File No. 3-15966 (July 8, 2014).

v. *In the Matter of Allen Park, Michigan*, Admin. File No. File No. 3-16259 (Nov. 6, 2014).

vi. *SEC v. Gary J. Burtka*, Case No. 2:14-cv-14278-AC-DRG (Nov. 6, 2014).

vii. *SEC v. Eric C. Waidelich*, Case No. 2:14-cv-14279-TGB-MJH (Nov. 6, 2014).

viii. Declaration of Mark R. Zehner, Case No. 2:14-cv-14278-AC-DRG [Dkt. 12-1] (Dec. 23, 2014).

ix. *SEC v. TL Ventures, Inc.*, Admin. File No. 3-15940 (June 20, 2014).

x. *SEC v. State of Kansas*, Admin. File No. 3-16009 (Aug. 11, 2014).

xi. The SEC's first action directly against a state was in *SEC v. State of New Jersey*, Admin. File No. 3-14009 (Aug. 18, 2010). The SEC's second action directly against a state was in *SEC v. State of Illinois*, Admin. File No. 3-15237 (March 11, 2013).

xii. *SEC v. Henry Morris et al.*, Case No. 09-CV-2518 (Mar. 19, 2014).

xiii. *SEC v. City of Victorville, Cal. et al.*, Case No. EDCV13-0776 (Apr. 29, 2013).

xiv. *SEC v. City of Miami, Florida et al.*, Case No. 1:13-cv-22600-CMA (July 19, 2013).