HAWKINS ADVISORY

MUNICIPAL MARKET REGULATORY UPDATE

Proposed Amendments to Rule 15c2-12

The Securities and Exchange Commission (the "SEC") on March 1, 2017, published for comment proposed amendments to SEC Rule 15c2-12 (17 CFR § 240.15c2-12).[1] Those amendments would add the following two events to be reported in a timely manner, not in excess of ten business days after the occurrence of the event, with respect to the securities being offered:

1. Incurrence of a financial obligation of the [issuer or] obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the [issuer or] obligated person, any of which affect security holders, if material; and

2. Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the [issuer or] obligated person, any of which reflect financial difficulties.

The deadline for comments on the proposed amendments is 60 days following publication of the proposing release in the Federal Register. If the proposed amendments are approved, the new events would only apply to "continuing disclosure agreements that are entered into in connection with primary offerings occurring on or after the compliance date of such proposed amendments." [2]

The term "financial obligation" is defined as follows:

> The term financial obligation means a (i) debt obligation, (ii) lease, (iii) guarantee, (iv) derivative instrument, or (v) monetary obligation resulting from a judicial, administrative, or arbitration proceeding. The term financial obligation shall not include municipal securities as to which a final official statement has been provided to the Municipal Securities Rulemaking Board consistent with this rule.

Ch-Ch-Ch-Changes at the SEC

The SEC currently has only two Commissioners, one Republican and one Democrat. Commissioners are appointed by the President and with the advice and consent of the Senate.[3] Not more than three Commissioners may be members of the same political party, and in making appointments members of different political parties are required to be appointed alternately as nearly as may be practicable.[4] Thus, it can be expected that the SEC will have a Republican Chairman,[5] two other Republican Commissioners, and two Democratic Commissioners. How, if at all, will such composition of the SEC change the ongoing operation and focus of the SEC's Public Finance Abuse Unit and of the Office of Municipal Securities?

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1 SEC Rel. No. 34-80130 (Mar. 1. 2017).

2 Although there is some ambiguity created by tying the effective date to the "offering," the SEC staff, when the same language was employed in connection with the 2010 amendments to the Rule, clarified that the effective date was tied to the date the continuing disclosure agreement was executed, i.e., the settlement date.

3 Section 4(a) of the Securities Exchange Act of 1934.

4 *Id.*

5 President Trump has nominated Jay Clayton to be Chairman of the SEC. Mr. Clayton identifies himself as an Independent.

Arthur Levitt, as Chairman of the SEC, oversaw the creation in 1995 of the SEC's Office of Municipal Securities, with the Director of that Office reporting directly to the SEC Chairman. It was during Levitt's tenure as Chairman (July 1993 – February 2001) that SEC enforcement in the municipal arena gained attention, with the enforcement actions against Orange County, CA (Jan. 1996), Maricopa County, AZ (Sept. 1996), and the City of Syracuse, NY (Sept. 1997). Of particular import, the SEC released the Orange County Report (Jan. 1996), which cautioned that "[i]n addition to the governmental entity issuing municipal securities, public officials of the issuer who have ultimate authority to approve the issuance of securities and related disclosure documents have responsibilities under the federal securities laws as well." In addition, it was during Chairman Levitt's tenure that the continuing disclosure provisions of Rule 15c2-12 were approved by the SEC.

Arthur Levitt was succeeded as Chairman by a Republican appointee, Harvey Pitt. Chairman Pitt, who had served as General Counsel of the SEC, concluded that the Office of Municipal Securities should report to the Director of the Office of Market Supervision, an office within the Division of Trading and Markets.[6] At that time, it was reported that "[m]unicipal securities oversight – a top priority for former SEC chairman Arthur Levitt – is not even on the radar screen of Harvey Pitt, Levitt's successor, and is in danger of falling off the SEC's agenda entirely."[7] Chairman Pitt's tenure was from August 2001 to February 2003. The Office of Municipal Securities did not get re-established as a stand-alone office until the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (July 21, 2010), which required that the Director of such Office report directly to the Chairman.

The new Administration has advised that it intends to revise or repeal much of the statutory and regulatory structure established by the Dodd-Frank Act. On February 3, 2017, President Trump issued an Executive Order entitled "Core Principles for Regulating the United States Financial System." In connection with such Executive Order, the Administration's Press Secretary advised that it was being released because "[t]he Dodd-Frank Act is a disastrous policy that's hindering our markets, reducing the availability of credit, and crippling our economy's ability to grow and create jobs." Legislation to repeal many of the provisions of the Dodd-Frank Act is expected to be similar to HR 5983, the "Financial Choice Act of 2016," which was introduced by Rep. Hensarling in the last session of Congress (114th Congress, 2nd Session). HR 5983 would have amended the Dodd-Frank Act to have the Office of Municipal Securities report to the Director of the Division of Trading and Markets rather than directly to the Chairman.

The establishment in 2010 of the Office of Municipal Securities as a separate office reporting (once again) directly to the SEC Chairman, the creation of the Public Finance Abuse Unit in the Enforcement Division, the announcement of the MCDC Initiative, and the numerous and precedent-setting SEC enforcement actions in the municipal arena over the last eight years, all occurred during President Obama's term in office. If history is a guide, the appointment by President Trump of three new Commissioners, with one as Chairman, may result in the focus of the SEC turning away from the municipal market, as occurred during Chairman Pitt's tenure.

Recent Municipal Enforcement Actions

Chair White noted that during her tenure the SEC brought a "bolder and more unrelenting approach to enforcement to change industry behavior." This is reflected in SEC remedies in recent municipal securities enforcement actions.[8] Of particular note are the following:

- Using "control person" liability to target municipal officials who did not have direct knowledge of misrepresentations in offerings, but who had control over the entities or individuals involved in the misconduct and the bond offerings[9]
- Obtaining an emergency court order to halt an allegedly misleading bond offering[10]

[6] The Office of Municipal Securities, starting in late 2000, had been reporting to the Director of the Division of Trading and Markets. "Muni Office Languishing under Pitt," THE BOND BUYER, June 6, 2002.

[7] *Id.*

[8] See speech of Andrew J. Ceresney, former Director of the SEC's Division of Enforcement, "The Impact of SEC Enforcement on Public Finance." (Oct. 13, 2016)

[9] *In re* City of Allen Park, Michigan, SEC Rel. Nos. 33-9677, 34-73539 (Nov. 6, 2014).

[10] SEC Press Rel. 2014-122, *SEC Obtains Court Order to Halt Fraudulent Bond Offering by City of Harvey, Ill.* (June 25, 2014).

- Holding individuals liable, and seeking both personal financial penalties and industry bars from the municipal finance business
- Imposing significant fines on municipal issuers (not simply disgorgement)
- Corresponding criminal indictment in connection with municipal bond offerings[11]
- Bringing first jury trial against a municipality for securities law violations[12]
- Requiring a municipal issuer to admit wrongdoing in an SEC enforcement action[13]
- Imposing remedies on both municipal securities underwriters and issuers in connection with the Municipalities Continuing Disclosure Cooperation Initiative
- Bringing enforcement actions against municipal advisors, both for failure to register and for violating an antifraud provision that is applicable solely to municipal advisors[14]

In addition, preceding Chair White's tenure, the SEC had established in January 2010 a separate group in the SEC's Enforcement Division, the Municipal Securities and Public Pensions Unit (now the Public Finance Abuse Unit), which consists of approximately 30 professionals (attorneys, accountants, and financial analysts) across the SEC's home and regional offices. The focus of this Unit is "misconduct in the large municipal securities market and in connection with public pension funds."[15]

This Advisory reviews the SEC's municipal securities enforcement actions during calendar year 2016 and 2017 to date. Such actions are summarized, in outline format, below:

1. *In re The Port Authority of New York and New Jersey* (Jan. 10, 2017)

    a. First municipal issuer to admit wrongdoing in an SEC enforcement action[16]

    b. Settlement was based on 17(a)(2) and 17(a)(3) [negligence]

    c. Port Authority provided its own validity opinion, without outside bond counsel, for the bond offerings that were the subject of the order

    d. Port Authority internal draft legal memoranda raised concerns that the use of bond proceeds for certain NJ projects was invalid - "legislative authorization for Port Authority participation in the Projects is lacking"

    e. Upon further review, the Port Authority lawyers produced a revised memorandum in which they advised that "we can link the Projects to the existing authority under the Lincoln Tunnel legislation"

        (i) In doing so, the memorandum cautioned that "The Port Authority engineering department will perform a traffic study to bolster the statutory conclusion," but "it is important to note that this statutory construction is not without doubt and may raise questions in the minds of some."

    f. SEC based the securities law violation on a finding that "The Port Authority knew, or should have known, that known but undisclosed risks surrounding the Roadway Projects were material to potential investors is making investment decisions."

[11] *Town of Ramapo, New York*, at item 7 below.

[12] *SEC v. City of Miami and Boudreaux*, Civil Action 13-22600 (S.D. Fla., verdict rendered Sept. 14, 2016).

[13] *Port Authority of New York and New Jersey*, at item 1 below.

[14] *In re School Business Consulting*, at item 6 below.

[15] SEC Press Release 2010-5 (Jan. 13, 2010).

[16] As is the case in almost all SEC enforcement actions, debt service has been and continues to be paid in full when due.

g. The Order noted that the legal staff made no disclosure to the Port Authority Board, which approved the financings in question, regarding (i) "potential legal issues surrounding the Roadway Projects," and (ii) "nor was any disclosure made to the Board of Commissioners concerning the cited legal justification - that the Roadway Projects were linked to the Lincoln Tunnel - supporting the Port Authority's participation in the projects."

h. Settlement:

(i) SEC noted remedial actions already undertaken, including "retaining and using outside bond counsel for all bond offerings (at the time of the events at issue in this matter [Jan 2012 - June 2014], the Port Authority had no outside bond counsel)

(ii) Retain an Independent Consultant to review policies and procedures relating to disclosure

(iii) Pay a civil money penalty of $400,000

i. Analysis:

(i) The National Association of Bond Lawyers standard (Model Bond Opinion Project, 2003) for delivering a bond opinion is as follows:

> Bond counsel may render an "unqualified" opinion regarding the validity and tax exemption of bonds if it is firmly convinced (also characterized as having a "high degree of confidence") that, under the law in effect on the date of the opinion, the highest court of the relevant jurisdiction, acting reasonably and properly briefed on the issues, would reach the legal conclusions stated in the opinion.

(ii) It is unclear whether the internal Port Authority lawyers, in providing validity opinions, viewed themselves as guided by such standard. The settlement order is troublesome, however, if it can be read that even if bond counsel is able to satisfy the NABL standard for rendering a clean opinion, any internal draft documents analyzing preliminary concerns regarding validity should be disclosed.

2. *In re Consolo and O'Connor Davies* (Oct. 31, 2016)

a. Cease-and-desist order against the independent auditor for the Town of Ramapo, NY (see item 7 below) and the individual audit partner

b. Individual and firm knew that audit reports would be included in Official Statements of the Town

c. Allowed a $3M receivable for the sale of land to be booked even after learning sale had not been completed

(i) Without the receivable, the General Fund would have had a negative balance in the FY 2010-2014 financial statements

d. Town between FY 2009 and FY 2014 used transfers from the Ambulance Fund to overstate the balance of the General Fund. Transfers ranged from $1.3M to $2.4M annually, with a cumulative impact on the General Fund balance of more than $12M.

(i) Employees in the Town's finance department raised concerns to the audit engagement team relating to the propriety of the interfund transfers, but audit partner continued to rely on a false representation from Town management

(ii) FY 2014 audit report was issued after the audit firm had learned that the Town's financial statements were the subject of ongoing investigations by the FBI, the US Attorney's Office, and the SEC, and that the $3M receivable was a focus of these investigations

e. Audit firm found to have violated Rule 10b-5, and audit partner to have violated 17(a)(1) [device, scheme, or artifice to defraud], 17(a)(2) and 17(a)(3) [misstatement or omission of material fact]

f. Remedies:

(i) Individual not allowed to be engagement partner for any municipal client for a period of five years. Paid a $75K penalty.

(ii) Audit firm to retain an independent consultant, and must require each audit professional to complete 32 hours of audit-related training, including "professional skepticism in evaluating audit evidence" and "fraud prevention and detection training." Firm forfeited $380K in audit fees and paid a $100K penalty.

3. *MCDC Issuer Settlements* (Aug. 24, 2016)[17]

a. 71 Settlements with Issuers from 45 different States

(i) Municipal issuers that settled included: States, counties, cities, school districts, airport authorities, sanitary districts, fire protection district, power agency, housing authorities

(ii) Obligated Persons that settled included: Universities, hospitals, college foundation, retirement residence, health care corporation, waste management company

(iii) SEC staff advised on December 13, 2016, that no further actions against issuers that filed voluntarily under MCDC are expected, but that the SEC staff will focus its resources on those issuers that did not file

b. In most cases, issuers had affirmatively stated that they were in compliance with their continuing disclosure obligations when in fact there had been certain failures

(i) No statement in situations of non-compliance (Arkansas Tech University) was also the basis for one settlement

c. CDA violations included:

(i) Failure to file audited financial statements

(ii) Failure to file financial information and operating data

(iii) Failure to file material event notice (defeasance; Ascension Health Alliance)

d. The look-back period for the SEC's review

(i) In one instance (Delaware Trans. Auth.), the SEC cited 2012 and 2014 OSs that did not mention failure to file 2009 audited financials

[17] See HAWKINS ADVISORY, "MCDC Settlements with Issuers." (Aug. 24, 2016)

e. The settlement orders require the issuers to undertake certain actions to ensure future compliance with continuing disclosure obligations, namely:

(i) Establish appropriate policies and procedures and training regarding continuing disclosure obligations within 180 days of the date of the settlement order

(ii) Comply with existing continuing disclosure undertakings, including updating past delinquent filings, within 180 days of the settlement order

(iii) Cooperate with any subsequent investigation by the SEC's Division of Enforcement regarding the misleading statements, including the roles of individuals or other parties involved

(iv) Disclose the settlement terms in any OS for an offering by the issuer within 5 years of the date of the settlement order

(v) Provide to the SEC staff a compliance certification regarding the applicable undertakings by the issuer on the 1-year anniversary date of the settlement order

4. *SEC v. Rhode Island Commerce Corporation* (aka "38 Studios") (Mar. – Aug. 2016)

a. Complaint against the Issuer, two officials of Issuer, the investment banking firm, and the investment banker

b. Private placement of revenue bonds, secured by (i) loan repayments made by borrower (38 Studios) from revenues from selling video games, (ii) moral obligation of Governor to request appropriated State funds if needed to pay debt service, and (iii) bond insurance. Bonds were offered and sold to sophisticated institutional investors.

c. SEC alleged that OS failed to disclose that the proceeds of the private placement borrowing would not provide sufficient funding to complete the development of the contemplated video games. Bond issue of $75M yielded $50M of net proceeds, although feasibility studies showed $75M would be needed to make 38 Studios viable. The OS contained no financial information about 38 Studios, but did include information about the State (audited financial statements, economic information, and credit ratings) and the bond insurer.

d. 38 Studios did go bankrupt, but bondholders are being paid in accordance with the State's moral obligation pledge.

e. Status:

(i) The two issuer officials settled, and each paid $25K penalty and had a permanent injunction imposed that enjoins them from participating in an offering of municipal securities.

(ii) The investment banker had his case dismissed for failure to state a claim. The dismissal was without prejudice; the SEC filed an Amended Complaint; and the case has been reinstated.

(iii) The case against the issuer entity and the investment banking firm are ongoing.

f. Importance - May get a judicial determination concerning whether information about an underlying obligor is material to investors in the context of (i) sophisticated institutional investors buying the bonds in a private placement notwithstanding that there was no disclosure of such information, and (ii) disclosure was provided regarding both the State's financial condition and that of the bond insurer.

5. *SEC v. Rangel* (June 21, 2016)

   a. Former President of an Illinois charter school "approved and signed the Official Statement on behalf of [charter school] without reading it to confirm it was complete and accurate."

   b. Official Statement did not disclose that the charter school had multi-million dollar contracts with two brothers of the school's COO, and that such conflicts breached grant agreements, which could have resulted in grant moneys being suspended and already-paid grant moneys being recouped

   c. Defendant found to have violated Securities Act §17(a)(2) [negligence] and was barred from engaging in the municipal securities business

6. *In re School Business Consulting; In re Keygent LLC* (June 13, 2016)

   a. School Business Consulting ("SBC") provided general consulting services to school districts in CA, including recommendations to school district clients on the selection of municipal advisors. SBC entered into a contract with the municipal advisor firm, Keygent, and the principal of SBC went on the Keygent Board. The principal of SBC provided to Keygent confidential information regarding its school district clients that were seeking to hire a municipal advisor, including advance notice of the questions to be asked and the specifics of competitors' proposals; reviewed Keygent's pitch books before they were sent to SBC's clients; and recommended Keygent to SBC's clients.

   b. SBC securities law violations:

      (i) SBC was engaged in the "solicitation of a municipal entity" for compensation, and thus was a municipal advisor. Violated 34 Act §15B(a)(1)(B) for failure to register as a municipal advisor.

      (ii) Statutory fiduciary duty established by 34 Act §15B(c)(1)

      (iii) MSRB Rule G-17 re fair dealing

      (iv) 34 Act §15B(a)(5), the general antifraud provision applicable to municipal advisors, adopted as part of the Dodd-Frank Act

   c. Keygent securities law violations:

      (i) MSRB Rule G-17 re fair dealing

      (ii) Statutory fiduciary duty established by 34 Act §15B(c)(1)

      (iii) 34 Act §15B(a)(5)

7. *Town of Ramapo, New York* (Apr. 14, 2016)

   a. Joint criminal indictment (by US Attorney against two Town officials) and SEC Complaint (against the Town, the Local Development Corporation, and four individuals)

   b. First time there has been a criminal indictment in connection with municipal bond offerings

   c. Bonds had been issued by the Town, and the Town had guaranteed bonds issued by the Ramapo Local Development Corporation

   d. "They cooked the books of the town's primary operating fund [General Fund] to falsely depict positive balances between $1.4 million and $4.2 million during a six-year period when the town had actually accumulated balance deficits as high as nearly $14 million" (SEC Press Release)

e. "a scheme to artificially inflate the balance of the General Fund for at least FY 2009 through FY 2014, by recognizing fraudulent receivables, omitting unpaid liabilities, and improperly recording transfers from other funds with different tax bases." (SEC Complaint)

f. Relief sought by the SEC:

(i) Require Town and RLDC to retain an independent consultant to review and recommend financial reporting and municipal securities disclosure policies

(ii) Require Town and RLDC for a period of five years to retain an auditor not unacceptable to the SEC staff

(iii) Prohibit the Town and RLDC for a period of five years from offering municipal securities unless they retain and cooperate with independent Disclosure Counsel

(iv) Lifetime ban on four named individuals from ever participating in a municipal bond offering

8. *In re Central States Capital Markets* (Mar. 15, 2016)

a. Three individuals were concurrently registered reps of a broker-dealer that underwrote bond issues for a municipality and working for a separate firm as a municipal advisor to such municipality

b. The municipal advisor firm was found to have violated MSRB Rule G-17 (fair dealing) and paid disgorgement of $251,650; prejudgment interest of $38,177.80; and civil money penalty of $85,000

c. The three individuals were found to have violated MSRB Rules G-17 and G-23 (by concurrently being financial advisor and underwriter on bond issues). The individuals paid civil money penalties, and were barred from association with a broker-dealer or rating agency with a right to apply for reentry after periods of time ranging from six months to two years

9. *In re Westland Water District, Birmingham, and Ciapponi* (Mar. 9, 2016)

a. Cease-and-desist order against California agricultural water district, its general manager, and former assistant general manager, based on 17(a)(2) [negligence]

b. Civil penalties of $125,000, $50,000, and $20,000 against district, GM, and asst. GM, respectively

c. District had covenant to fix and maintain water rates at least sufficient to generate net revenues equal to at least 1.25 debt service coverage. Failure to meet ratio would be technical default on the outstanding bonds.

d. Due to drought conditions, water district had to purchase water from private rather than less expensive federal sources. 2012 Official Statement included table showing 1.25 coverage was reached for fiscal years 2008-2012, without adequate disclosure regarding how such coverage was achieved.

e. Debt service coverage met not by raising rates but by reclassifying cash reserves and retained earnings to record additional revenue in lieu of collecting current revenue. Outside auditor had advised that such reclassifications were permissible under accounting guidelines and issued an unqualified opinion. The reclassification and its import on the debt service coverage ratio were not disclosed.

f. Compliance with accounting standards is not a defense to disclosures considered to be materially misleading under the federal securities law.

10. *In re State Street Bank and Trust Company* (Jan. 14, 2016)

    a. An employee of State Street entered into an agreement with the Deputy Treasurer of the State of Ohio to make illicit cash payments and political campaign contributions in exchange for the awarding of custodian contracts

    b. Some of the payments were made through an individual whose law firm was the lobbyist for State Street

    c. Cease-and-desist order against State Street based on a finding of a violation of Rule 10b-5

        (i) State Street paid a disgorgement penalty of $4 Million and a civil money penalty of $8 Million

    d. The lobbyist is challenging the SEC's enforcement action against him on the argument that the abuses were not sufficiently in connection with the purchase or sale of a security

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