REGULATING MUNICIPALITIES BY PROSECUTION:
SEC ENFORCEMENT SINCE DODD-FRANK

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Co-Sponsored by the CBA-CLE, the Colorado Bar Association
and the Securities Subsection, Business Law Section

1900 Grant Street, Suite 300, Denver, Colorado

Thursday, June 7, 2018

REGULATING MUNICIPALITIES BY PROSECUTION:
SEC ENFORCEMENT SINCE THE ENACTMENT OF DODD-FRANK

# I. INTRODUCTION

This program is focused on the regulatory and enforcement activities of the Securities and Exchange Commission ("SEC") with regard to issuers (such as states, cities, towns, school districts and special districts) in the municipal securities marketplace since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), Public Law 111-203 (signed by the President and generally effective July 21, 2010). There is an emphasis on the antifraud provisions of federal securities law and disclosure obligations of issuers from which SEC enforcement actions can arise. By no means are these the only bases for regulatory and enforcement actions which can arise in the securities marketplace, and municipal issuers and their legal counsel are encouraged to explore in depth specific fact situations with competent securities counsel before selecting a course of action with regard to municipal securities.

The U.S. municipal bond market is nearly $4 trillion in size and 75% of all municipal bonds are held by retail investors. There are over 50,000 municipal issuers with approximately 1 million outstanding securities in the market. See Municipal Securities Rulemaking Board, Muni Facts (May 2018), http://msrb.org/msrb1/pdfs/MSRB-Muni-Facts.pdf.

# II. APPLICABILITY OF FEDERAL SECURITIES LAWS TO MUNICIPAL SECURITIES: A SUMMARY

## A. Definitions of Securities

The definitions of the term "security" contained in the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act") are, with regard to municipal issuers, practically the same. A "security" is

> "any note, stock, ..., bond, debenture, evidence of indebtedness, …, investment contract, … option or privilege on any security, … or, in general, any interest or instrument commonly known as a 'security,'… or any guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." [Sec. 2(a) (1), 1933 Act]

## B. Registration, Exemptions and Disclosure under the 1933 and 1934 Acts

The 1933 and 1934 Acts are designed to impose upon issuers of securities, including municipal securities, obligations to ensure that investors are provided with material information about new issues of securities offered for sale to the public (1933 Act) and about issues of securities which are trading in the securities markets (1934 Act). Thus, Section 5(a) of the 1933 Act provides: "Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly, … to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise…."

However, new issuances of municipal securities are generally exempt from registration under Section 3(a) of the 1933 Act.

> "[e]xcept as hereinafter expressly provided the provisions of this title shall not apply to any of the following classes of securities: … (2) any security issued or guaranteed by … any State of the United States, or by any political subdivision of a State, or by any public instrumentality of one or more states…." [Municipal securities are similarly exempt from registration pursuant to Sections 3(a)(12)(A) and 12 of the 1934 Act.]

There are a number of instruments which may be issued by political subdivisions which, by statute, rule, or judicial order, fall within this exemption, including conduit or on behalf of financings such as industrial development bonds and multi-family housing bonds. Other instruments of limited duration such as bank loan notes or certificates of participation in leases often require a deeper analysis on a case by case basis.

Congress in the legislative history of the 1933 Act indicated that it exempted municipal bonds from registration for several reasons: (1) the absence in the sale of municipal securities of significant abuses demonstrated in the sale of corporate securities, (2) the fact that purchasers or municipal securities were generally sophisticated or institutional investors who did not need as much protection as the general public, (3) the presence of "constitutional difficulties that might arise" by applying federal securities laws to municipal issuers, and (4) a perception that regulation would reduce the ability of municipalities to borrow needed monies.

While municipal securities are exempt from registration, there are SEC Rule 131 (pursuant to the 1933 Act) and Rule 3b-5 (pursuant to the 1934 Act) which help to clarify the situations in which "separate securities" may exist; separate securities are "any part of an obligation evidenced by any bond … which is payable from payments to be made in respect of property or money … under a lease, sale or loan arrangement by or for an industrial or commercial enterprise." A number of underlying obligations have been determined in no action letters of the SEC staff not to be separate securities. If there are separate securities involved, they may or may not need to be registered or other securities or transactional exemptions may be applicable.

It should be noted that, under the 1933 Act as originally drafted, the definition of 'person' included "a government or political subdivision thereof", whereas, under the 1934 Act the definition of 'person" did not until 1975 include similar language.

C. <u>State Securities Laws and Their Relevance to SEC Enforcement (e.g. Colorado)</u>

Municipal securities are subject to state securities laws. The laws of the several states tend to focus, often more than the federal statutes, upon protection of investors by prohibiting fraudulent practices in the sale of securities and by requiring registration of securities and the persons who are engaged in the issuance, sale and aftermarket trading of such securities.

In general, with regard to municipal securities, the definition of 'security' and the need for a registration (without an applicable transactional or securities exemption) under the statutes and regulations in the several states are comparable to what is required at the federal level. In Colorado, for example, securities exempt from state registration include "any security (including a revenue obligation) issued or guaranteed by the United States, any state, any political subdivision of a state, or any agency or corporate or other instrumentality of one or more of any of them…." [Colorado Securities Act, CRS Section 11-51-307]. While, since the enactment of the National Securities Markets Improvements Act ("NSMIA") in 1996, the states have been prohibited (i.e. preempted) from requiring the registration of a 'covered security" under Section 18(b) of the 1933 Act (NSMIA defines "covered security" to include municipal securities exempt from federal registration under the 1933 Act pursuant to Section 3(a)(2)), this preemption does not apply to the offer and sale of a municipal security in the state in which the issuer of the security is located.

D. <u>Municipal Rulemaking Securities Board and the Tower Amendments (1975)</u>

Federal securities regulation of the municipal securities markets developed very slowly (and independently of the increasingly detailed and complex regulation of the corporate securities markets) from 1933 until 1973-1974 and the municipal bond defaults of New York City. Dealers and brokers solely in municipal securities had up until those defaults been largely unregulated. The Securities Reform Act of 1975 ("Reform Act") amended the 1934 Act to require registration of the municipal securities dealers and brokers who had previously been exempt from registration. The Municipal Securities Rulemaking Board ("MSRB") was created in 1975 as a self regulatory organization with powers to regulate municipal securities dealers, brokers and dealers, but its rules are subject to approval and modification by the SEC. MSRB rules for those persons effecting transactions in municipal securities must, among other things, be designed to prevent fraudulent and manipulative acts and practices.

The Tower Amendments to the Reform Act state: "(1) Neither the SEC nor the [MSRB] is authorized . . . to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the SEC or the Board prior to the sale of such securities by the issuer any application, report or document in connection with the issuance, sale or distribution of such securities." Thus, rather than vetting through advance registration the SEC relies upon its express authority to regulate brokers, dealers, its oversight of the MSRB, and its enforcement authority under the antifraud provisions of the 1933 and 1934 Acts as regulatory tools.

The Tenth Amendment of the U.S. Constitution provides that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States, respectively, or to the people." It should also be noted that, in 1976, in <u>National League of Cities v. Usery</u>, 426 U.S. 1976, the Supreme Court stated that Congress does not have the power under the Commerce Clause to pass legislation displacing the freedom of states and cities to conduct integral operations in areas of traditional government functions. The scope of National League of Cities, when applied to SEC regulation of municipal issuers, has yet to be determined.

E. SEC Rule 15c2-12 and MSRB's EMMA (1989)

SEC Rule 15c2-12 was adopted in 1989, and amended in 1994, 2008 and 2010. The disclosure documents in initial offerings of municipal securities are referred to as official statements or private offering memoranda or the like (collectively, "official statements"). Rule 15c2-12 directly regulates the conduct of underwriters of municipal securities by requiring underwriters to, among other things, obtain "reasonable assurances" in the form of written contractual terms from issuers from whom financial or operating data is presented in the final official statement to provide specific ongoing disclosure information ("Continuing Disclosure Agreements" or "CDAs"). In addition to the underwriters' obligations with regard to filing the primary offering official statement in most public offerings of municipal securities, effective July 1, 2009, pursuant to such CDAs issuers must agree to provide follow on annual financial information, event notices relating to the occurrence of certain specified events and certain other data to the MSRB through its Electronic Municipal Market Access portal ("EMMA") (previously Rule 15c2-12 required such information to be provided to the appropriate nationally recognized municipal securities information repositories or "NRMSIRs"). It should be noted that private placement memoranda and bank loan disclosure documents are often exempt from such filing obligations, although sometimes they are voluntarily filed on EMMA. Rule 15c2-12(f)(10) also requires underwriters to obtain CDAs from "obligated persons", i.e. generally any person or entity that is committed by contract or other arrangement to support payment of all or part of the obligations of the municipal securities being offered. Thus, while the Rule applies only to underwriters, it indirectly imposes disclosure requirements on issuers and obligated persons.

## III. ANTI FRAUD PROVISIONS IN FEDERAL SECURITIES LAWS RELEVANT TO MUNICIPAL REGULATION

### A. Introduction

In light of the exemptions from registration of municipal securities contained in the 1933 and 1934 Acts, the principal means by which the SEC has, with regard to municipal issuers, accomplished its objective of prohibiting misrepresentations or other fraudulent conduct in connection with the purchase and sale of municipal securities has been through the antifraud provisions of these two securities acts.

### B. 1933 Act, Section 17(a)

Section 17(a) of the 1933 Act provides:

> "It shall be unlawful for any person in the offer or sale of any securities … by the use of any … instruments of transportation or communication in interstate commerce … (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

The definition of 'person' under the 1933 Act includes "a government or political subdivision thereof."

The SEC, in order to establish liability under Section 17(a), must prove by a preponderance of the evidence that (i) the defendant made an untrue statement of material fact or omitted to state a material fact needed to make any statements made not misleading, (ii) with the requisite mental intent, and (iii) the misstatement or omission was "in " the offer or sale of securities.

Negligence is sufficient to establish a violation of Sections 17(a)(2) and 17(a)(3), but scienter ("a mental state embracing an intent to deceive, manipulate or defraud") is required for purposes of Section 17(a)(1). "Scienter' includes intentional or knowing or reckless (in some circuits, grossly reckless) conduct. Although the question is not totally free from doubt, generally the SEC is the only person which can bring an action pursuant to Section 17(a).

C. 1934 Act, Section 10(b) and Rule 10b-5

Section 10(b) of the 1934 Act makes it unlawful to use manipulative or deceptive devices in connection with the purchase or sale of securities. In 1943, the SEC adopted Rule 10b-5. Rule 10b-5 makes it unlawful for any person:

> "(a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

As noted above, the Securities Act Amendments of 1975 revised the definition of 'person" in Section 3(a)(9) of the 1934 Act to include "a government, or political subdivision, agency or instrumentality of a government" and thereafter Section 10(b) and Rule 10b-5 have imposed antifraud obligations upon municipal issuers.

Rule 10b-5 has a scienter requirement and both the SEC and private litigants can bring claims under this Rule.

D. Control Person Liability

Section 20 of the 1934 Act provides that

> "[each] person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable."

Generally, Section 20(c) requires proof of (a) a primary violation by the controlled person and (b) proof of control, then, in most circuits, the control person tries to prove his good faith (that is, no bad faith or scienter) to avoid liability. There is a split among the circuits on whether the controlling person needs to have committed some act affecting the violation. In the Tenth Circuit, to be liable under Section 20 the controlling person need not be a 'culpable participant' in the violation by the controlled person. Maher v. Durango Metals, 144 F.3d 1302 (10th Cir. 1998).

E. Private Causes of Action for Municipal Securities Fraud and Their Relevance to SEC Enforcement

SEC Rule 10b-5 and Section 17(a) do not expressly permit private plaintiffs. Generally speaking, there is not a private right of action under Section 17(a) (the 10th Circuit has not specifically addressed the issue). As noted above, private litigants have acquired the ability to bring Rule 10b-5 claims against municipalities. See, e.g., Sonnenfeld v. City and County of Denver, 106 F.3d 744 (10th Cir. 1996). However, while the SEC need only prove under Section 17(a) by a preponderance of the evidence that (1) the defendant made an untrue statement of material fact or omitted to state a material fact needed to make any statements made not misleading, (ii) with the requisite mental state, and (iii) the misstatement or omission was ‘in connection with’ the purchase or sale of securities (Section 10(b)) or “in” the offer or sale of securities (Section 17(a)), private plaintiffs under Section 10(b) must also prove (iv) reliance, (v) loss causation, and (vi) damages.  Thus the SEC is often the only litigant practically capable of bringing Section 17(a) or Rule 10b-5 claims against a municipal issuer.

## IV. SEC ENFORCEMENT APPLICABLE TO MUNICIPAL SECURITIES

### A. The SEC and its Division of Enforcement

The 1934 Act created the SEC to be the principal entity which oversees and regulates the securities industry. The SEC has five commissioners, five divisions, and twenty three offices.

The SEC's Division of Enforcement is responsible for the investigations of potential federal securities laws violations, administrative proceedings involving these violations, and any civil suits filed in federal courts due to the violations. The Division was created in 1972 to consolidate all of the SEC's enforcement actions (which were previously handled among various other SEC divisions).

### B. Enforcement Investigations

The Division of Enforcement will initiate an investigation when it has reason to suspect, from complaints, referrals, whistleblowers or otherwise, that the federal securities laws have been violated. An SEC investigation usually involves scrutiny of all persons involved in the conduct in question. The SEC may gather facts and make a charging decision either through an informal ("Matters Under Inquiry") or MUI or formal investigation. At the informal stage, requests for documents or witness testimony are voluntary. In the event that the SEC needs to utilize its subpoena powers, it will open a formal investigation.

In substance, the only difference between an informal and a formal investigation is the staff's ability to issue subpoenas and take sworn testimony. The SEC Enforcement Manual recommends that informal investigations should be converted to formal investigations as a matter of course after sixty days. Formal investigations are commenced with the issuance of a Formal Order of investigation by the Commission, identifying SEC staff permitted to take testimony and issue subpoenas, and outlining in broad strokes the possible violations of federal securities laws under review. Whether an investigation has been designated as formal or informal does not necessarily provide insight into the staff's view of the matter. The SEC staff is not required to open a formal investigation before concluding its investigation or bringing charges. Likewise, the staff is not required to open an informal investigation before commencing a formal investigation.

SEC investigations generally develop on the following course: legal hold of documents; document requests; witness testimony; Pre-Wells Notice, Wells Notice and Wells Submission; and settlement negotiations.

<u>Legal Hold and Document Requests</u>. Most SEC investigations begin with a request to provide documents and to not destroy any documents related to the matter under investigation. In an investigation of any consequence, the SEC likely will make several sets of document requests. If it is a formal investigation, the request may be in the form

of a subpoena. A person compelled or requested to provide evidence may request a copy of the Formal Order.

Witness testimony. If the SEC, after reviewing the document productions, continues to have an investigatory interest, it will usually request sworn witness testimony. The SEC is likely to take sworn testimony from current and former officers and employees, and from outside professionals such as bond counsel, underwriters and municipal advisors. Sometimes the SEC will have non-sworn conversations with the parties. SEC staff identified on the Formal Order may take sworn on-the-record testimony ("OTRs"). Such OTRs are recorded and transcribed, or merely transcribed. Witnesses may have counsel present, but objections and certain other protections found in civil depositions do not apply. As in response to any request for documents, any person requested or compelled to testify may request a copy of the Formal Order.

Pre-Wells Notice. Before commencing a formal Wells procedure, the SEC staff is likely to provide an informal "pre-Wells" notice to inform the company or individual that the staff believes it has sufficient evidence to conclude that it is likely to provide a Wells Notice. The pre-Wells notice, while informal and not required by any rule or regulation, is nevertheless a common element of the enforcement process post- Dodd-Frank. The benefit to the staff of a pre-Wells notice is that the unofficial notice does not trigger the Dodd-Frank requirement that the Commission take action against the subject of an investigation within 180 days of a Wells Notice. For the recipient of the pre-Wells notice, this stage is an opportunity to dissuade the staff of the strength of its case before significant institutional inertia has set in.

At the pre-Wells stage, the staff is likely to permit counsel to present evidence to the staff as to why a Wells Notice and subsequent charges are not warranted. The staff may request a detailed white paper, or invite a meeting with counsel in which counsel will provide its view of the facts, along with prior SEC treatment of similar issues. Counsel at this stage is likely to point out any facts it believes the staff does not know or has not considered, along with any litigation outside counsel believes the SEC may have.

Wells Notice and Wells Submission. After witness testimony has been completed, the SEC's investigative staff will review the evidentiary record to determine whether to recommend the Commission institute charges. If the staff tentatively decides to make an enforcement recommendation to the Commission, in non-emergency cases it issues a so-called Wells Notice to the proposed defendant.

The Wells Notice outlines the legal charges the staff is prepared to recommend to the Commission and, sometimes, the factual basis for those charges. Wells Notices are usually given telephonically, followed by a written confirmation. (Jumping ahead, under Dodd-Frank, and as discussed above, not later than 180 days after SEC staff provide a written Wells Notice to any person, staff must either file an action against the person or provide notice to the Director of the Public Finance Abuse Unit of its intent not to file an action).

The subject of a Wells Notice may make a Wells Submission, which is an opportunity for the proposed defendant to explain its, his or her position via a memorandum or (less commonly) videotape. A Wells Submission may argue that no enforcement action is warranted or that lower- level charges and less severe relief are appropriate; it may also argue in favor of a proposed settlement. While Wells Submissions can be effective defense tools, they must be approached with care. Additionally, they may be discoverable in civil litigation with third parties. The SEC generally refuses to accept Wells Submissions that have been submitted under claims of privilege or as settlement materials.

The staff will submit the Wells Submission to the Commission along with its recommendation, providing the defendant with an opportunity to present an opposing view before the SEC's ultimate decision-makers. Subjects of an investigation and their counsel do not, however, have an opportunity to present their positions directly to the Commission.

Settlement negotiations. If defense counsel does not succeed in convincing SEC staff that no enforcement action is warranted, counsel will routinely engage the staff in settlement discussions to determine whether the matter can be resolved on mutually agreeable terms. At appropriate points in the enforcement process (during the fact-gathering stage, in connection with or following a Wells Submission, and even after an enforcement action has been commenced), a party can discuss settlement with SEC staff. SEC staff does not have independent authority to accept a settlement, but the SEC rarely accepts a settlement offer without staff support of the offer. A settlement reached prior to the commencement of an enforcement action often results in a reduction of the charges or relief the staff would otherwise seek. If a settlement is not negotiated, the SEC will commence an administrative or judicial proceeding.

The Enforcement Division's Enforcement Manual is available at www.sec.gov/divisions/enforce/enforcementmanual.pdf (May 14, 2018).

C. Statute of Limitations

Not taking into account tolling or scenarios that may extend the statute of limitations, the statute of limitations for a Rule 10b-5 claim is generally two years after the fraud is discovered and not more than five years after the fraud occurred, and for a Section 17(a) claim is generally five years after the date of the last transaction that is subject to the violation. Certain claims are not subject to the five-year statute of limitations, such as claims for injunctive relief. Since the Supreme Court ruling in Kokesh v. Securities and Exchange Commission, 581 U.S.__ (2017) (Slip. Op.) in June 2017 which held that a five-year statute of limitations applies to disgorgement sanctions, the SEC staff has been requesting tolling agreements at the outset of investigations more frequently.

D. Enforcement Procedures

The SEC is authorized to seek several forms of relief, including: an order against future violations in the form of an injunction, a cease-and-desist order; a censure; financial penalties; and/or a temporary or permanent bar from the securities industry. The availability of some of these remedies may depend on whether the matter is brought administratively or in federal court. Additionally, as a condition of settlement, the SEC often seeks other forms of relief such as an undertaking to improve relevant policies and procedures, and the appointment and adoption of an independent consultant's recommendations.

(a) Litigation

The SEC brings civil charges for violations of the federal securities laws in federal court. The SEC does not have criminal jurisdiction, though in certain circumstances it will refer matters to the Department of Justice for separate investigation or prosecution. Generally, the SEC will file an action in the district court in which the SEC office investigating the matter is located, assuming venue is proper in that district. As noted above, the Supreme Court in Kokesh recently limited the SEC's ability to obtain relief outside the five-year statute of limitations that included disgorgement; thus, federal court may not be available to the SEC under certain circumstances.

(b) Administrative Proceedings

As an alternative to federal court, the SEC has increasingly made use of its own internal adjudication system, bringing cases before an internal administrative law judge (ALJs) as opposed to federal court. The administrative proceeding is significantly more streamlined and quicker than its federal civil action counterpart. That streamlining, however, also involves removing certain protections that otherwise would be available to the defendant, provides less time for the defendant to review and assess evidence, and is adjudicated by an SEC-appointed ALJ. Unsurprisingly, the SEC has a stronger record of victory in the administrative proceeding courts than in the federal courts. ALJs prepare initial decisions which are subject to de novo review by the Commission, which can affirm modify, reverse, or remand for further proceedings.

In the wake of certain challenges to the constitutionality of ALJs, the SEC has reduced the number of cases brought as administrative proceedings as opposed to federal cases. On April 23, 2018, the U.S. Supreme Court heard arguments in Lucia v. Securities and Exchange Commission as to whether the appointment of ALJs violate the Constitution's appointments clause; however, a ruling against the agency would not be likely to have a lasting impact on the SEC's ability to avail itself of the administrative proceeding process.

(c) Settled Actions

Most SEC enforcement investigations that lead to charges are brought as settled actions. After negotiation with outside counsel, the staff must present any proposed settlement to the Commission for final approval. Once approved by the Commission, settled actions are filed in federal court for judicial approval. Baring certain extraordinary circumstances filed settled actions are generally approved, and an order of judgment is entered.

(d) Termination

Should the staff conclude that an investigation does not warrant an enforcement action, the staff will terminate the investigation. In order to close an investigation, the staff must prepare an internal memo outlining all the facts of the case, the investigative steps pursued, and a discussion as to why an enforcement proceeding is not warranted. The staff will provide the subject of the investigation with a "closing letter," which will state that the investigation has concluded and the staff does not intend to recommend an enforcement action. The conclusion of an investigation and the receipt of a closing letter is not an exoneration, and does not preclude the staff from reopening an investigation, nor does it limit the ability of other agencies to take separate actions or come to different conclusions.

(e) Cooperation Credit

The SEC has stressed repeatedly the need for cooperation with its investigations. Cooperation may lead to reduced sanctions or no enforcement action. In its October 23, 2001, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions (the "Seaboard Report"), www.sec.gov/litigation/investreport/34-44969.html, the SEC outlined the factors it may consider if, and to what extent, it grants leniency to investigated agencies for cooperating with its investigations. These factors include self-policing, self-reporting, remediation, and cooperation.

In January 2010, the SEC formalized its cooperation program and issued its Policy Statement Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions, www.sec.gov/rules/policy/2010/34-61340.pdf detailing the framework for evaluating cooperation by individuals—the importance of the underlying matter, the assistance provided by the cooperator, the societal interest in holding the individual accountable for his or her misconduct, and the appropriateness of cooperation credit based upon the profile of the cooperating individual. The impact of cooperation is determined on a case-by-case basis.

The SEC has a number of approaches to cooperation. At the outset, the SEC may determine to forgo any action against a cooperating party without formal designation. The SEC may also enter into a formal agreement with a party to recommend to the Commission that the cooperator receive credit for providing substantial assistance in an investigation, even where the staff is recommending that the Commission bring formal charges against the cooperator. Such credit may take the form of reduced or no penalties, or lessened injunctive relief. The SEC may also make use of deferred prosecution agreements (DPAs) or Non-Prosecution Agreements (NPAs), depending on the severity of the underlying conduct and the extent of cooperation provided.

While there are a number of factors involved in determining whether the SEC will provide cooperation credit, the most significant factors seem to be whether the defendant self-reported an issue to the Commission in a timely manner, to what extent the party made people and information available to the staff, and in the case of an entity, whether the institution had effective compliance controls in-place prior to the violation.

(f) Admission of Liability

Historically, the SEC's policy has been to allow a party to settle with the SEC without admitting or denying the SEC's allegations, although this policy has shifted in recent years for SEC administrative actions. Under the long-standing policy, when a party settles a federal injunctive action, neither the court nor the SEC makes any factual findings. The SEC files a complaint making its allegations, and the court enters a final judgment enjoining the defendant from similar actions in the future and may order other relief, but includes no findings of fact. However, when a party settles an SEC administrative action, the settling party (albeit without admitting or denying the SEC's charges) allows the SEC to make certain factual findings and conclusions of law. In such "no admit/no deny" settlements, the settling party is prohibited from publicly denying the SEC's charges, but could raise defenses to those charges in litigation with parties other than the SEC.

E. SEC Enforcement Applied to Municipalities Prior to 2010: A Summary

In the fifteen years leading up to the passage of Dodd Frank, there were a few enforcement actions against municipal issuers for failing to disclose in bond offering documents otherwise well-publicized shortfalls in, for example, government operating or project revenues or pension fund balances or operating or project cost overruns. SEC, Report on the Municipal Securities Market (July 31, 2012) (the "SEC Report"), www.sec.gov/news/studies/2012/munireport073112.pdf. See SEC Report text at notes 353-359. There were no SEC enforcement actions against municipal issuers based solely on alleged failures to comply with Rule 15c2-12 continuing disclosure obligations. Moreover, much more often than not, in the three decades leading up to 2010 the principal enforcement mechanism against municipal issuers who commit federal securities fraud was the U.S. Department of Justice in the aftermath of otherwise well-publicized bond defaults and restructurings and issuer bankruptcies. (New York City (1975), the Washington Public Power Supply System (1987).)

## V. DODD FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2010)

### A. Creation of the Office of Municipal Securities and its Statutory Mandate

Section 979 of Dodd Frank required the formation in the Commission of an Office of Municipal Securities. Congress was concerned that the SEC had reduced the number of staff in its municipal securities office in the decades leading up the financial crisis while the office was part of the Division of Markets and Trading, and anticipated “increased supervisory attention to the municipal market” with such an Office. See Senate Report 111-176 (April 30, 2010) (Section by Section Analysis of the Bill: Section 979). Pursuant to that Section, the Office is to “(1) administer the rules of the [SEC] with respect to the practices of municipal securities brokers and dealers, municipal securities advisors, municipal securities investors, and municipal securities issuers; and (2) coordinate with the Municipal Securities Rulemaking Board for rulemaking and enforcement actions as required by law.” Thus the SEC is to both “regulate” the practices of municipal issuers and “protect” municipal issuers from the bad acts of others. The staff of the Office is required by Dodd Frank to include individuals with knowledge of and expertise in municipal finance. The Office was created in 2012 and reports directly to the Chair of the SEC. The current director of the office is Jessica Kane.

### B. Expansion of MSRB Rulemaking and Rules to Municipal Advisors and Dealers

Under Sections 975 of Dodd Frank, Congress established municipal advisors as a new category of SEC registrant and extended to municipal advisors and broker dealers expanded sanctions provisions in the event that those persons engage in proscribed behavior towards “municipal entities”.

For example, the 1934 Act was amended by Section 975 of Dodd Frank to provide in Section 15B(a)(5):

> “No municipal advisor shall make use of the mails or any means or instrumentality of interstate commerce to provide advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products [or] the issuance of municipal securities … in connection with which such municipal advisor engages in any fraudulent deceptive, or manipulative act or practice.”

Section 15B(c)(1) as amended by Section 975 imposes upon municipal advisors and their associated persons a fiduciary duty to their municipal entity clients, and prohibits them from engaging in any act, practice, or course of business that is not consistent with their fiduciary duty.

The MSRB was provided with additional rulemaking authority with regard to the municipal securities activities of brokers, dealers, municipal securities dealers and municipal advisors. For example, effective December 22, 2010, MSRB Rule G-17 was made applicable to municipal advisors and their associated persons. MSRB Rule G-17 states that, in the conduct of its municipal securities business, every broker, dealer, municipal securities dealer, and municipal advisor shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice. Negligence is sufficient to establish a violation of MSRB Rule G-17. The SEC is responsible for disciplinary actions involving violations of MSRB rules.

C. Creation of Enforcement's Public Finance Abuse Unit

The Municipal Securities and Public Pensions Unit, now known as the "Public Finance Abuse Unit" (the "Municipal Unit"), was established in 2010. The Municipal Unit is responsible for five categories of misconduct related to municipal bonds: (1) offering and disclosure fraud; (2) tax or arbitrage-driven fraud; (3) pay-to-play and public corruption violations; (4) public pension accounting and disclosure violations; and (5) valuation and pricing fraud. Since 2013 Lee Ann Gaunt has been Chief of the Municipal Unit.

D. Whistleblower Awards

Section 922 of the Dodd-Frank provides that the Commission shall pay awards to eligible whistleblowers who voluntarily provide the SEC with original information that leads to a successful enforcement action yielding monetary sanctions of over $1 million. The award amount is required to be between 10 percent and 30 percent of the total monetary sanctions collected in the Commission's action or any related action such as in a criminal case. Dodd-Frank also expressly prohibits retaliation by employers against whistleblowers and provides them with a private cause of action in the event that they are discharged or discriminated against by their employers in violation of the Act.

The SEC has implemented the Dodd-Frank requiring through the creation of the Office of the Whistleblower (OWB) within the Division of Enforcement. The OWB fields thousands of calls per year, and has awarded more than $270 million to over 50 individuals since 2012. It is notable that whistleblower awards are available to individuals who reported misconduct internally through their institution's compliance system. Thus, individuals should not be disincentivized from availing themselves of their institution's own internal compliance or whistleblowing procedures.

In fiscal 2017, the SEC received only 67 'tips' which it identified as relating to municipal securities (out of a total of over 4,000, of which 54 were from individuals in Colorado). See SEC, Whistleblower Program: 2017 Annual Report to Congress, Appendix, http://www.sec.gov/whistleblower.

## VI. SURVEY OF SEC ENFORCEMENT ACTIONS REGARDING MUNICIPAL ISSUERS AFTER DODD FRANK

### A. SEC Report

The purpose of the SEC is to "protect investors—including investors in municipal securities—maintain fair, orderly and efficient markets, and facilitate capital formation." SEC Report at 2.

The main function of the SEC Report was to identify areas of concern relating to investor protections and to put forth recommendations for solutions within the municipal securities market. Although the SEC Report does not on its own have any regulatory effect, it is viewed as a framework that the SEC will use to propose rules governing the municipal securities market in the years to come.

Two broad areas of concern emerged in the SEC Report: disclosure and market structure. The specific disclosure-related concerns highlighted were: (1) the timeliness and comparability of financial information; (2) the absence or insufficiency of continuing disclosure in instances of conduit borrowers, pension funding obligations, and derivative instruments; (3) disclaimers of responsibility for disclosure information; and (4) undisclosed or inadequately disclosed conflicts of interest.

The SEC Report's principal recommendation as to disclosure was to enact legislative changes that, without repealing or amending the Tower Amendment, would still provide the SEC with the authority to adopt policies and requirements addressing the above-listed disclosure concerns and which would give the SEC a mechanism to enforce such policies and requirements. For example, the SEC Report recommended an extension of SEC authority to permit the SEC to require municipal issuers to prepare and make available official statements and to authorize the SEC to establish frequency, timing and minimum disclosure requirements for such official statements (SEC Report, pg. 134). Further, the SEC Report recommended that SEC authority be extended to allow the SEC to establish form and content requirements for the financial statements of municipal issuers (SEC Report, pg. 136). The SEC Report proposed elimination of registration exemptions for conduit borrowers, a modification that would provide investors with substantial added municipal securities information (SEC Report, pg. 135). And the SEC Report also suggested that the SEC Commission should receive statutory authority to require municipal issuers to have their financial statements audited (SEC Report, pg. 137). No action has been taken publicly on any of the foregoing items.

However, since the SEC Report, prior to the inauguration of President Trump there were a number of "first-of-their-kind" enforcement actions in the municipal arena:

(a) First imposition of civil penalties against municipal officials (San Diego, 2010)(see below);

(b) In re West Clark Community Schools, SEC Release No. 33-9435 (July 29, 2013): First civil action against a municipal issuer for failure to comply with 15c2-12 obligations ("West Clark");

(c) In re City of Harrisburg, Pennsylvania, SEC Release No. 34-69515 (May 6, 2013): First charge of municipality for misleading statements outside of its securities disclosure documents ("Harrisburg");

(d) City of Allen Park, Michigan, SEC Release No. 34-73539 (November 6, 2014): First bars on municipal officials from participating in further offerings ("Allen Park");

(e) First invocation of control person liability against a municipal official (Allen Park 2014) (see below);

(f) First injunction filing to halt a bond offering in progress (Harvey, IL 2014) (see below);

(g) First ever municipal bond criminal securities fraud charges against public official (Ramapo, NY 2016) (guilty plea, 2017) (see below);

(h) First ever federal jury trial against a municipality (Miami, FL 2016)(see below); and

(i) First municipal issuer to admit wrongdoing in an SEC enforcement action (Port Authority of NY and NJ 2017). SEC Press Release, SEC: Port Authority, Omitted Risks to Investors in Roadway Projects, http://www.sec.gov/news/pressrelease/2017-4.html (Jan. 10, 2017)

B. Rule 15c2-12 and the Municipalities Continuing Disclosure Cooperation Initiative

The SEC had noted in the SEC Report that the Commission lacked the authority to enforce issuer compliance with CDAs provided per SEC Rule 15c2-12 (SEC Report pg. 138. Nonetheless, in a compliance "sweep" intended to build awareness of the MSRB investor protection rules previously underenforced, that is, the "Municipalities Continuing Disclosure Cooperation Initiative" ("MCDC") (announced in July 2014 and modified in November 13, 2014), SEC, Municipalities Continuing Disclosure Cooperation Initiative, http://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml (November 13, 2014), the Enforcement Division provided to municipal issuers, obligated parties, and underwriters the opportunity to self-report inaccurate statements in final official statements about their prior compliance with the continuing disclosure obligations specified in Rule 15c2-12. For persons who self-reported and were found to have inaccurate statements in their disclosure documents, the Municipal Unit agreed to recommend standardized, favorable settlement terms.

Prior to the MCDC, as noted above, the SEC had done little with regard to issuer compliance with Rule 15c2-12. However, in its formation of the MCDC Initiative the Enforcement Division was informed by its knowledge of facts surrounding the City of South Miami and its attempts to correct its EMMA filings. See City of South Miami, SEC Release No. 1933-9404 (May 22, 2013. The City had participated in a pooled conduit municipal bond offering in 2002 and 2006 to obtain funds to complete a parking facility, but failed to disclose that it had improperly used the proceeds of both offerings and had altered the terms of a lease (without informing the pool issuer, bond counsel, or any third persons) with regard to the parking facility in a manner which threatened the tax exempt status of the bonds. The City sought permission from the IRS to apply for a settlement under the IRS's Voluntary Compliance Agreement Program on July 13, 2010 in an attempt to preserve the tax exempt status of the bonds and the City settled with the IRS on August 17, 2011. The City filed a 'material event notice' on EMMA on July 19, 2010 (the first time that the City publicly acknowledged any potential adverse impact on the 2002 and 2006 bonds). The City agreed in its settlement to retain an independent third party consultant who, for three years was to conduct annual reviews of the City's policies, procedures, and practices related to disclosures for municipal securities offerings and to abide by the independent consultant's determinations and implement all recommendations with regard to appropriate procedures and policies. This type of settlement presaged the settlements reached with municipal issuers in the MCDC.

In West Clark, per the SEC, a municipal issuer had entered into a CDA in connection with a 2005 official statement and bond offering, failed to submit any 'contractually required' disclosures to EMMA, and then represented in a 2007 official statement for a new bond offering that it had complied in all material respects with prior disclosure undertakings. The issuer, in response to the SEC's accusations of violations of Section 17(a)(2) and Section 10(b) and Rule 10b-5 undertook to bring its disclosure submissions current, to adopt written disclosure policies and procedures, to designate a responsible person for compliance activities, to require that person to certify compliance in future bond issuances, to require the issuer to submit any changes to its disclosure policies in the future to EMMA, to implement annual training for personnel involved in bond offerings and to require persons who attended the training to certify that they had done so, to establish policies re reporting to the MSRB.

The first settlement pursuant to the MCDC Initiative occurred in Kings Canyon Joint Unified School District, SEC Release. No. 33-9614 (July 8, 2014). In that action, the SEC implemented cease-and-desist proceedings against Kings Canyon Joint Unified School District ("Kings Canyon") for including misrepresentations in the final official statement published in connection with Kings Canyon's offering of $6.8 million of municipal bonds in 2010. The official statement stated that Kings Canyon "has had no instance in the previous five years in which it failed to comply in all material respects with any previous continuing disclosure obligation under [Rule 15c2-12]." Kings Canyon reviewed, authorized and approved this official statement.

However, previously Kings Canyon had publicly offered $19 million of municipal bonds in 2006 and publicly offered $4.5 million of municipal bonds and $6.7 million of certificates of participation in 2007. Pursuant to these offerings, Kings Canyon executed CDAs to make disclosures in compliance with Rule 15c2-12. Specifically, it agreed to submit to EMMA annual reports containing certain financial information and operating data to appropriate national and state repositories and to make timely notices of certain specified events pertaining to the municipal securities at issue. Between at least 2008 and 2010, however, Kings Canyon did not submit some of the contractually required disclosures. Thus, the SEC found the statement in the 2010 offering statement regarding compliance with prior continuing disclosure obligations in the official statement was an untrue statement of a material fact.

The SEC found that Kings Canyon violated Section 17(a)(2) of the 1933 Act. The SEC ordered Kings Canyon to cease-and-desist violating the securities laws and required it to implement the following undertakings: (1) establish appropriate written policies and procedures regarding continuing disclosure obligations; (2) comply with existing continuing disclosure undertakings, including updating past delinquent filings; and (3) disclose the terms of the order in any final official statement for an offering by Kings Canyon within the next five years.

The Kings Canyon settlement and order set the tone for the MCDC settlements to follow. Between 2014 and 2016 there were three rounds of settlements involving self-reporting broker dealers and underwriters, in which 72 firms paid just over $18 million (and agreed to have independent consultants review their policies and procedures on due diligence for municipal securities underwriting) for failing to identify misstatements and omissions under Rule 15c2-12 before offering and selling municipal securities, SEC Press Release, SEC Completes Muni-Underwriter Enforcement Sweep (February 2, 2016), http://www.sec.gov/news/pressrelease/2016-18.html.

Then in 2016 the SEC announced that under the MCDC it had entered into settlements with 71 self-reporting issuers and "obligated persons". SEC Press Release, SEC charges 71 Municipal Issuers in Muni Bond Disclosure Initiative (August 24, 2016), https://www.sec.gov/news/pressrelease/2016-166.html. Included among these were the State of Colorado, the County of Boulder, and Thompson School District R2-5.

In Colorado Department of the Treasury and State Treasurer on behalf of the Colorado Department of Transportation, SEC Release No. 33-10154 (August 24, 2016), CDOT was determined to have failed to file its fiscal 2006-2010 audited financial information with EMMA, yet stated in its 2011 final official statement for new securities that it had complied with prior CDAs. This amounted to, per the SEC, a violation of 1933 Act Section 17(a)(2). The State Treasurer agreed to a cease and desist order, to establish appropriate written policies and procedures and periodic training, to designate an individual responsible for ensuring compliance and responsible for implementing and maintain a record of training, to comply with existing disclosure obligations, to disclose the terms of the settlement in future final official statements for the following five years, and "to cooperate with any subsequent investigation by the Division [of Enforcement] regarding the false statements(s) and/or material omissions(s), including the roles of individuals and/or other parties involved. The County and the School District entered into comparable agreements. Boulder County, Colorado, SEC Release No. 33-10135 (August 24, 2016); Thompson School District No. R2-J, SEC Release No. 33-10189 (August 24, 2016).

All the MCDC issuers were required to establish written procedures and policies, have periodic training, update delinquent filings, and certify compliance.

The SEC ended the MCDC with the August 24th announcement.

C. Financial Penalties: A Sampling

Historically, the SEC had not sought financial penalties against municipal issuers or individual officers and former officers of municipal issuers.

However, in The Greater Wenatchee Regional Events Center Public Facilities District, Allison Williams, Global Entertainment Corporation, and Richard Kozuback, SEC Release No. 33-9471 (November 5, 2013), the SEC imposed financial penalties against the issuer district following a 2011 bond default on $41.77 million in three year bond anticipation notes issued in 2008 to finance a multi-use arena and ice hockey rink. The SEC alleged that the district's contracts manager (who signed the closing certificate of the district re the official statement for the BANs) and the operator of the facility and its president knowingly produced a series of improper and inflated revenue projections for the 2008-11 period and deleted a paragraph in the POS which highlighted the limited ability of the district to issue the long bonds, resulting in violations by the district, the facility operator and its president of 1933 Act Sections 17(a)(2) and (3) and by the contracts manager of Section 17(a)(3).

In SEC v. Uberuaga, Ryan, Frazier, Webster, and Vattimo (8-CV-0621 S.D. CA) (filed April 7, 2008), on October 27, 2010, the SEC announced that four former San Diego officials had agreed to pay financial penalties for their roles in misleading investors in 2002 and 2003 official statements regarding the underfunding of the city's future pension and retiree health care obligations (violations of Section 17(a)(2); per the SEC this was the first time that it had secured financial penalties against city officials in a municipal bond fraud matter. SEC Press Release, Former San Diego Officials Agree to Pay Financial Penalties in Municipal Bond Fraud Case, http://www.sec.gov/news/press/2020/2010-204.html (Oct. 27, 2010).

In Westlands Water District, Thomas W. Birmingham, and Louie David Ciapponi, SEC Release No. 33-10053 (March 9, 2016) the SEC imposed penalties on the water district (the largest agricultural district in California), its general manager, and its assistant general manager for misrepresenting in its 2012 official statements reserve account monies as additional revenues to cover up a revenue shortfall and enhance debt coverage ratios, i.e. Section 17(a)(2) violations)(NB the outside accountants okayed the reclassification).

In the first ever admission of wrong doing by a municipal issuer in an SEC enforcement action, in Port Authority of New York and New Jersey, SEC Release No. 33-10278 (January 10, 2017), the Authority agreed to pay fines after ignoring its internal lawyers' repeated written warnings that the Authority lacked the legislative power to undertake financing certain road projects and failing to disclose as risks the concerns in this regard in official statements for five separate bond financings in 2012, 2013, and 2014. The SEC alleged violations of 1933 Act Sections 17(a)(2) and (3). The Authority had not used outside bond or disclosure counsel for the five bond financings, but, during the SEC's investigation, hired a new permanent general counsel and retained and used outside bond counsel for its bond offerings. The Authority undertook in its settlement with the SEC to retain an independent consulting firm to review its internal disclosure policies with regard to municipal securities offerings and to adopt that consultant's recommendations and the Authority agreed to adopt a policy requiring that the Authority's law department certify in writing to the Board that Board expenditures were legally authorized and to provide a legal opinion to this effect with regard to expenditures in excess of $50 million. [Was this a whistleblower case?]

D. Control Person Liability: A Sampling

In 2014 in SEC v. Burtka (14-CV-14278, E.D MI) (November 11, 2014) the SEC brought fraud charges against the City of Allen Park, Michigan and two former city officials, former mayor Gary Burtka and former city administrator Eric Waidelich, in connection with two offerings of municipal securities issued to finance a movie studio project in the city and misleading disclosure documents. The mayor did not participate in the drafting of the disclosure documents, In a settlement entered on January 28, 2015, under Section 20(a) of the 1934 Act, the former mayor was held liable as a "control person" for the city and the city administrator's violations of Section 10(b) of the 1934 Act and Section 17(c)(2) of the 1933 Act. The original complaint stated that the former mayor was "an active champion of the project and in a position to control the actions of the city and [the former city administrator] with respect to the fraudulent bond issuances. Based on this control, the SEC charged Burtka with liability for violations committed by the city and [the former city administrator]." SEC Press Release 2014-249, November 6, 2014. As a result, the former mayor was held jointly and severally liable with, and to the same extent as, the city and the city administrator. In a companion matter, Allen Park, the city agreed that Section 17(a)(2) of the 1933 Act and Section 10(b) had been violated.

In SEC v. Kellogg (16-CV-5384, N.D. Ill.) (May 16, 2016) Harvey, Illinois in three separate bond financings in 2008, 2009, and 2010 regarding TIF bonds to construct a hotel redevelopment failed to disclose the improper diversion of proceeds into the general operating accounts of the city, alleged violations of Section 10(b) and Rule 10b-5. The SEC alleged that the mayor should be personally liable under Section 20(a) of the 1934 Act as a control person inasmuch as the mayor appointed and supervised the city controller AND signed off on the official statement and closing certificates in each of the financings.

## E. Court Order to Halt Bond Offering

In June 2014 the SEC obtained an emergency court order against the City of Harvey, Illinois and its comptroller to stop a city bond offering. SEC v. City of Harvey et alia (14-cv-4744, N.D. Ill (June 24, 2014). The SEC asserted that the city and its comptroller had been involved in a scheme for a number of years to divert bond proceeds for improper uses. The judge in the matter on July 2, 2014 issued a restraining order preventing the city from offering or selling bonds for a specified period of time. SEC, SEC Obtains Court Order to Halt Fraudulent Bond Offering by City of Harvey, Ill., SEC Press Release 2014-122 (June 25, 2014). In December 2014 the city entered into a consent permanently enjoining it from future violations of 1934 Act Section 10(b); in January 2015 the former controller entered into a similar consent.

## F. Bars from Participating in Future Municipal Bond Offerings: A Sampling

In 2016 in SEC v. Rangel (16-CV-06391, N.D. Ill) (June 21, 2016) the SEC settled with Juan Rangel, the former President of UNO Charter School Network Inc. and former CEO of United Neighborhood Organization of Chicago ("UNO"), for materially misleading investors by failing to disclose terms of certain outstanding obligations in its offering documents, including certain conflicts of interest and violations of Illinois state statutes in that regard. Rangel had personally approved and signed (although he had not read) a 2011 official statement which touted the strength of the conflicts of interest policies of UNO. SEC, Former CEO of Chicago Charter School Operator Settles Muni-Bond Fraud Charges, SEC Press Release 2016-125 (June 21, 2016) www.sec.gov/news/pressrelease/2016-125.html. The SEC had settled with UNO in 2014. As part of the 2016 settlement, Rangel agreed to pay civil penalties, to be permanently enjoined from future violations of Section 17(a)(2) and to be barred from participating in any future municipal bond offerings.

## G. Criminal Charges Against Municipal Officers

In 2016 the SEC brought fraud charges under 1933 Act Sections 17(a)(1), (2), and (3) and 1934 Act Rule 10b-5 and Section 20(a) against the Town of Ramapo, New York, the town's local development corporation, and four town officials (including the town attorney) for failing to adequately disclose the town's failing financial condition by inflating on paper its operating funds, for example, by reporting false receivables and non-existent federal government disaster relief funds and by recording transfers from funds with different tax bases. SEC v. Town of Ramapo, New York (16-cv-02779, SDNY) (April 15, 2016). The U.S. Department of Justice ("DOJ") also brought criminal charges against Christopher St. Lawrence, the town supervisor, and N. Aaron Troodler, the assistant town attorney and executive director of the local development corporation (who certified the official statements), consisting of 22 counts of securities fraud (Rule 10b-5), wire fraud (for false EMMA filings and five separate transfers of bond proceeds), and conspiracy—the first criminal securities fraud case brought against public officials for accounting fraud in connection with the sale of municipal bonds. United States v. St. Lawrence and Troodler (16-cv-259, SDNY) (April 14, 2016). Troodler pled guilty on March 7, 2017 and was ordered to pay a $20,000 fine and a special assessment of $200, and was sentenced to three years of probation (this was the first municipal bond related securities fraud conviction in DOJ history) (Troodler was later also disbarred as a result of this felony conviction). St. Lawrence was found guilty by jurors in May 2017 of securities fraud, wire fraud, and conspiracy. In November 2017 the SDNY permanently enjoined the Town and the local development corporation from violating the antifraud provisions and ordered them to retain independent consultants to review and recommend improvements to financial reporting procedures and controls and disclosure practices and to adopt such recommendations, to retain independent auditing firms, and for a period of three years, to retain separate disclosure counsel (unaffiliated with bond counsel) prior to proceeding with the offering or sale of municipal securities. In January 2018 St. Lawrence was sentenced to 30 months in prison. The SEC action is ongoing as of this writing.

The SEC and DOJ have lodged a similar set of actions against the Town of Oyster Bay and its former Supervisor John Venditto. In 2016, Mr. Venditto, then-current Nassau County Executive Edward Mangano, and Mangano's wife, were all charged in a federal indictment with crimes related to privately held loans which Oyster Bay illegally guaranteed and concealed from the public. Indictment, Oct. 18, 2017, United States v. Mangano (2:16-cr-00540-JMA-SIL, Doc. No. 1). The loans were for a political supporter, who was the operator of many Oyster Bay restaurants. In exchange for the guaranteed loans, the former elected officials were allegedly bribed with meals, chauffeurs, vacations, jewelry, and a $450,000 "no-show" job for Mr. Mangano's wife. Gov't's Omnibus Mem. of Law in Opp'n to Defs.' Pretrial Motions, November 14, 2017, United States v. Mangano (2:16-cr-00540-JMA-SIL, Doc. No. 90).

[In November 2017, in a superseding indictment, federal prosecutors charged Mr. Venditto with securities fraud and wire fraud related to Oyster Bay municipal securities offerings, alleging that he concealed four illegal loan guarantees from investors and others. Superseding Indictment, Nov. 21, 2017, United States v. Mangano (2:16-cr-00540-JMA-SIL, Doc. No. 92). Concurrently with the superseding indictment, the SEC in parallel civil litigation charged Oyster Bay and Mr. Venditto, with the knowledge of the Town's attorney, violations of 1933 Act Sections 17(a)(1) and (3) and 1934 Act Section 10(b) and Rule 10b-5 by defrauding investors in the town's bonds by hiding the existence and potential financial impact of the illegal loan guarantees. SEC v. Town of Oyster Bay, New York and John Venditto, (1:17-cv-6809, E.D.N.Y.) (November 21, 2017). Venditto also was charged with aiding and abetting the Town attorney's violations and with 1934 Act "control person" liability vis-à-vis the Town's violations. The federal criminal trial commenced in mid-March 2018 and is ongoing at this time.]

H. Greater Emphasis on Actions in Federal District Courts?

As shown above, in the municipal securities context, the SEC has shown since 2010 a slight willingness to bring more cases in federal district court. The SEC has more remedies available in that forum, including control person liability and injunctions, than in its administrative civil proceedings. In 2013, in SEC v. City of Miami, Florida and Michael Boudreaux (1:13-cv-22600-CMA, S.D. FL) (July 19, 2013) the SEC sought declaratory and injunctive relief, orders to comply with prior orders, and civil money penalties for violations of 1933 Act Section 17(a) and 1934 Act Section 10(b) and SEC Rule 10b-5 against the City of Miami, Florida, and its former budget director, Michael Boudreaux. The SEC alleged that the City and Mr. Boudreaux had made numerous misstatements and omissions in three sets of bond offering documents in 2009 and in the City's annual financial reports concerning inappropriate inter-fund transfers from its capital projects funds to its general fund, including the transfer of restricted fees. On September 14, 2016, Miami and Boudreaux were each found liable by a jury for multiple counts of violating these securities laws and were assessed $1,000,000 and $15,000 (reduced from $450,000), respectively, in civil fines. The fact that Miami had previously been found in an SEC administrative proceeding to have violated these same provisions in 2003 with regard to bonds issued in 1995 clearly played into the Enforcement Division's decision in 2013 to go to federal court. Statement of Andrew Ceresney, Director, Division of Enforcement, September 14, 2016, https://www.sec.gov/news/pressrelease/detail/pressrelease/1370539727618.

I. Disclosures Outside of Offering and CDA Documents: One Instance (so far)

In City of Harrisburg, SEC Release No. 34-69515 (May 6, 2013) the SEC alleged that Harrisburg had violated 1934 Act Section 10(b) and SEC Rule 10b=5 not only by failing to comply with its prior CDAs by failing to file information with its NRMSIRs (the precursors to EMMA), but also by making material misrepresentations and omissions in its "2009 Budget and Transmittal Letter, 2009 State of the City Address [by the mayor], and its Mid-Year Fiscal Report for 2009", all of which were reproduced on the city's website. As the chief of the Municipal Unit said at the time, "A municipal issuer's obligation to provide accurate and timely material information to investors is an ongoing one. Because of Harrisburg's misrepresentations, secondary market investors made trading decisions based on inaccurate and stale information." SEC, SEC Charges City of Harrisburg for Fraudulent Public Statements, SEC Press Release 2013-82 (May 6, 2013), http://www.sec.gov/news/pressrelease/2013-82.html.

J. Protecting the Municipal Issuers: Aside re Financial Advisors

In 2016, the SEC brought first-of-their-kind enforcement actions regarding regulation of municipal advisors under Dodd-Frank.

In March 2016, in Central States Capital Markets, LLC; Mark R. Better; David K. Malone; and John D. Stepp, SEC Release No. 34-77369 (March 15, 2016) the SEC brought an enforcement action related to the fiduciary duty for municipal advisors created by Dodd Frank for the first time. Central States involved three individuals, Stepp, Defter and Malone, who worked for both Central States (a Kansas based registered municipal advisor, broker-dealer, and investment advisor}and an unnamed broker-dealer (the "Broker-Dealer"). In March 2011, a city hired Central States as a municipal advisor to assist with certain bond transactions. Central States procured underwriting services for the offerings by selecting the Broker-Dealer. Central States received fees both as an advisor and as a broker dealer (from those earned by the Broker-Dealer) on the same bond offerings. Although both Defter and Malone were aware of the conflict, neither disclosed the conflict or their direct financial interest in underwriting the transactions.

The SEC found that that all defendants breached their fiduciary duty to the city under Section 15B(c)(1) of the 1934 Act (as amended by Dodd Frank) by failing to disclose: (a) that certain employees of Central States were also employees of the Broker-Dealer, (b) that the persons providing underwriting services at the Broker-Dealer were the same individuals providing municipal advisor services at Central States and (c) that certain Central States employees had a conflict of interest because they received a direct financial benefit from the underwriting services. The SEC entered an order requiring the defendants, among other penalties, to cease and desist from committing any future violations and to pay disgorgement and civil monetary penalties to the SEC and two individuals were barred from the industry.

In June 2016, in <u>School Business Consulting Inc. and Terrance Bradley</u>, SEC Release No 34-78054 (June 13, 2016), the SEC found that School Business Consulting Inc. ("SBCI") had violated Section 15B(a)(1)(B) of the 1934 Act (as amended by Dodd Frank) by failing to register as a municipal advisor. It also found that SBCI and Bradley had breached their fiduciary duties under Section 15B(a)(5) and MSRB Rule G-17.

In February 2014, SBCI registered with the SEC as a municipal advisor under the temporary registration rules, but did <u>not</u> register under the final rule and never registered with the MSRB. Bradley was the President and sole employee of SBCI. Bradley served on the Board of SBCI's client, a registered municipal advisor, Keygent LLC. As a member of the Board, Bradley received compensation and introduced Keygent to school districts that sought to hire a municipal advisor, including the school district clients of SBCI. In this role, Bradley improperly provided Keygent with certain confidential information.

The SEC determined that because SBCI was engaged in the solicitation of a municipal entity, received direct compensation from Keygent and was soliciting school districts on Keygent's behalf for the purpose of obtaining an engagement in connection with the issuance of municipal securities, SBCI should have registered as a municipal advisor. Moreover, SBCI and Bradley breached their fiduciary duties by failing to disclose and providing certain confidential information to Keygent. The SEC ordered SBCI and Bradley to cease and desist from committing any future violations of the securities laws and to pay certain monetary penalties. It also barred Bradley from associating with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent or nationally recognized statistical rating organization and from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor or principal underwriter.

In a companion matter, <u>Keygent LLC, Anthony Hswieh, and Chet Wang</u> , SEC Release No. 34-78053 (June 13, 2016), Keygent and its principals were censured and fined and ordered to deliver copies of the cease and desist order to all Keygent clients and prospective clients for the next 12 months.

## VII. THE TRUMP ADMINISTRATION APPOINTMENTS AND RECENT SEC MUNICIPAL ISSUER ENFORCEMENT

It is becoming clear as to how the Trump Administration will affect SEC enforcement priorities vis-à-vis municipal issuers. The SEC operated for the first 4 months of 2017 with only 2 commissioners, which stymied Commission level action. A majority of the SEC Commissioners are now Trump appointees. Chair Jay Clayton recently celebrated his first year as a Commissioner but as yet has not appeared to be pro active in the municipal area. Kara Stein will leave the Commission on July 7 and Commissioner Michael Piwowar soon thereafter and as of this writing there are no replacement nominees for either.

For much of 2017, the SEC operated under the threat of pending legislation focused specifically upon the Enforcement Division in the form of the provisions of the Financial CHOICE Act and the public statements of its chief sponsor, Representative Jeb Hensarling (R-TX), The proposed Financial CHOICE Act, while relatively silent with regard to municipal issuers, would have resulted in fewer administrative proceedings and more removals to federal courts with concomitant heightened standards of proof, advance notice regarding proceedings alleging “unlawful conduct”, a loss of judicial deference to SEC interpretation of the 1933 and 1934 Acts, a requirement of investigations being coordinated with other agencies, and limits on whistleblower award. The Act would also have moved the Office of Municipal Securities into the SEC’s Division of Trading and Markets (which would have deemphasized its role vis-à-vis municipal issuers). This Act was approved by the House of Representatives on June 8, 2017, but as of this writing there has been no substantive action in the Senate.

Since January 2017 in line with SEC enforcement activity generally, there has been a dramatic reduction compared to 2016 in the number of SEC investigations announced and enforcement actions reported involving municipal issuers. To some degree, this reduction simply reflects the statistics of the MCDC 2014-1016 sweep. However, there can be little doubt that reduced SEC regulation and enforcement generally is also sua sponte in light of the pending Financial CHOICE Act and the attitudes of new Commissioners. While it is generally clear that Commissioners such as Hester Peirce wish to incline the SEC away from what she calls its prior flawed ‘broken windows’ enforcement policies toward the private sector (see her speech to the Rocky Mountain Securities Conference, Denver, Colorado, May 11, 2018), attitudes towards municipal issuers and municipal advisors have not publicly been so marked. There are no dramatic Commissioner speeches on the record regarding municipal enforcement and there has been one new issuer/officer enforcement action announced since January 2017.

On August 23, 2017 in Beaumont Financing Authority, SEC Release No. 1933-10406 (August 23, 2017) the SEC alleged that the municipal issuer had issued approximately $260 million in municipal bonds between 2003 and 2013, failed to comply with CDAs from 2004 to April 2013, and failed to disclose in five officials statements in 2012 and 2013 its compliance failures in prior bond offerings. Per the SEC these amounted to violations of 1933 Act Sections 17(a)(2) and 17(a)(3). The issuer agreed to establish policies and procedures regarding its municipal disclosures and accounting for bond proceeds and recordkeeping, to designate an officer responsible for the same, to comply with all its prior CDAs, to retain an independent consultant "not unacceptable to the Commission staff", to review its policies and procedures, to require that this consultant enter into an agreement not to enter into another other relationship with the issuer or its related persons, to require this consultant to submit a written report of its findings to the issuer, to require the issuer to adopt all recommendations of the consultant, to disclose in all final official statements for the next five years the terms of this SEC action, <u>and</u> <u>to</u> <u>certify</u> <u>compliance</u> to the SEC within sixty days of the completion of the foregoing. In a separate federal court proceeding, <u>SEC v. Kapanicas</u> (5:17-cv-1704), (C.D. Cal. August 23, 2017), the SEC entered into a settlement with the issuer's executive director, who had signed all the official statements in question, whereby he agreed to pay a civil penalty and to be barred from participating in any future municipal bond offerings. In a separate administrative proceeding, the registered broker dealer and municipal advisor and one of its primary investment bankers, for failing to perform sufficient due diligence to discover and disclose the failures of the issuer to comply with its CDAs, agreed, among other things, to pay civil penalties and not to violate in the future 1933 Act Sections 17(a)(1) and (2), 1934 Act Section 15(b) and 15B(c), and MSRB Rule G-17. "The SEC's Enforcement Division uncovered the violations as part of a review of municipal issuers . . . that did not voluntarily self-report under the [MCDC]." The parties "would have been eligible for more lenient remedies had they self-reported during the MCDC Initiative." SEC Press Release, <u>Muni Bond Issuer and Underwriter Charged with Disclosure Failures,</u> https://www.sec.gov/news/press-release/2017-148 (August 23, 2017). Per LeeAnn Gaunt, the Chief of the Municipal Unit, "Investors in municipal bonds depend on timely and complete continuing disclosure from municipal issuers…. Issuers . . . will continue to be held accountable when they fail to provide investors with an accurate picture of past compliance with continuing disclosure obligations."

There have been a very few additional enforcement actions against municipal officers and advisors. One case to note is an enforcement action against the former mayor of Markham, Illinois, for engaging in a pay-to-play scheme involving bond proceeds, <u>SEC v. David Webb, Jr.</u> (17-cv-8685, N.D. Ill) (December 1, 2017).

Last month in <u>Barcelona Strategies, LLC and Mario Hinojosa</u>, SEC Release No. 34-83191 (May 9, 2018), the SEC initiated and settled administrative proceedings against an SEC registered municipal advisor and its owner and sole employee in connection with three municipal bond offerings between January 2013 and December 2014 which allegedly misrepresented its prior experience in municipal financings and failed to disclose that its owner was an employee of the bond counsel to the issuer in the financings. The SEC found that the advisor and associated person had violated Section 15B(a)(5) of the 1934 Act and MSRB Rule G-17, the advisor and associated person agreed to pay civil penalties and Hinojosa agreed to be barred from associating with regulated persons.

With regard to Rule 15c2-12, new additional "event notices" for obligated persons were proposed by the SEC on March 1, 2017. SEC, SEC Proposes Rule Amendments to Improve Municipal Securities Disclosures, SEC Press Release 2017-57, https://www.sec.gov/news/pressrelease/2017-57.html (March 1, 2017). These included:

(a) Incurrence of a material financial obligation or agreement to material covenants, events of defaults, remedies, priority rights, or similar terms;

(b) Occurrence of a default, event of acceleration, termination event, modification of terms or similar items which reflect financial difficulties; and

(c) Compliance date would be three months after date of adoption.

See Proposed Amendments to Municipal Securities Disclosure, SEC Release No. 34-80130 (Mar. 1, 2017), 82 Fed. Reg. 13928 (Mar. 15, 2017) available at https://www.sec.gov/rules/proposed/2017/34-80130.pdf. As of this date, the Office of Municipal Securities is still meeting with interested parties to discuss the proposed amendments.

## VIII. LESSONS LEARNED AND THE PATH FORWARD

### A. SEC Enforcement Generally

The SEC staff has placed significant emphasis post- financial crisis on cooperation and self-reporting, going so far as to formalize the relief available under its cooperation program. The incentives for institutions to self-report and demonstrate that they had been operating with sufficient controls are at the forefront of every enforcement investigation. Further, institutions are encouraged to provide the staff with information quickly, including documents, data, access to individuals, and, where applicable, computer code. These incentives may make it difficult for entities to fully understand the extent of a potential problem before management believes it must report the issue to the SEC. Likewise, individuals have a strong incentive to provide complete information to the SEC as soon as possible, making it difficult for their institutions to fully appreciate the facts of a matter before the SEC staff begins formulating its legal theories. These pressures have increased the need for entities to address potential problems as soon as possible, and for management to be fully informed of all the relevant facts of a situation at the earliest stage possible.

### B. SEC and Municipal Issuers

Since 2010, the apparent focus of SEC enforcement with regard to municipal issuers has been more on the inadequate content of issuer disclosure from the point of view of an investor and much less in instances where the issuer has been the 'victim' of intermediaries such as brokers, dealers, municipal dealers and municipal advisors (i.e. those regulated obligated persons who owe duties to the issuers). There need not be fault or financial harm for the SEC to act against issuers, and pre-Trump most SEC actions arise from omitted information, e.g. omitted disclosures of failed financial controls or diversion of prior bond proceeds. Ramapo and Oyster Bay, since Dodd Frank was enacted, remain the only two actions where the SEC has been active in criminal proceedings, although there are similar fact patterns in other SEC actions before and after 2010; it is not at all clear that, if criminal activity by municipal officers is discovered, it will consistently bring both civil actions and referrals to the Department of Justice. Since Dodd Frank, SEC settlements with municipal issuers have required the removal of actors who have been personally enriched, and through the MCDC initiative the adoption of disclosure policies and procedures. However, since the appointment by President Trump, enforcement prosecution activity against municipal issuers has publicly evaporated. While it appears as of this writing that the proposed Financial CHOICE Act is not likely to be adopted in its entirety, certain provisions could still become law and significantly impact the Enforcement Division's rules and procedures.

### C. Convergence: The Long View of Municipal Disclosure and SEC Regulation

Dodd Frank empowered the SEC with regard to regulating the municipal issuer and the municipal securities markets in a manner more aligned with the regulation afforded issuers and market intermediaries in the corporate issuer world. While the Office of Municipal Securities is small, the SEC now has enough statutory enforcement authority and unchallenged recent regulatory experience to act with confidence when municipal fraud is discovered in false or omitted filings with EMMA. However, the Tower Amendment remains in place and, without third party referrals or media publicity, SEC involvement prior to the offering of municipal securities remains reliant upon regulation of market intermediaries alone and not of municipal issuers.

It is easy to foresee the MSRB and the SEC routinely reviewing EMMA filings to determine whether documents have been timely filed in accordance with CDAs; thus every government official who signs or is responsible for financial statements and financial disclosures has an obligation to make sure that those statements are accurate and that past statements filed on EMMA are not now misleading. Clearly, having effective policies and procedures in place to maintain up to date filings with EMMA and compliance with CDAs, and a designated individual responsible for implementing the procedures and doing the maintenance, is imperative.

One factor preventing more and harsher enforcement actions against municipal issuers is likely a belief held by some inside the Office of Municipal Securities that municipal issuers' failures to disclose are because they are so "lightly regulated" that failures to disclose are because "all [such issuers] are unsophisticated" [personal remarks of LeeAnn Gaunt to Rocky Mountain Securities Conference, May 2016]; thus issuers most often "fall victim" to the sophistication of regulated market intermediaries. Since the enactment of Dodd Frank this "issuer as victim" motivation is still stronger than that of the "issuer as perpetrator." This could change quickly, however, and is nothing upon which issuers' counsel can rely.

Otherwise, short of a massive wave of bond defaults in some far distant future, it is difficult to foresee a scenario in which Congress will set fit to empower the SEC to review in advance official statements or to regulate systematically the activities of public officials in the performance of their financial duties.

May 23, 2018

# Appendix A

# Appendix B

# Appendix C