Ballard Spahr LLP

2012 YEAR IN REVIEW

SEC Municipal Market Enforcement

WINTER 2013

INTRODUCTION

The Enforcement Division of the Securities and Exchange Commission announced the formation of a specialized municipal securities and public pensions enforcement unit a little more than two years ago. Since its formation, the Municipal Securities and Public Pensions Unit has filed increasing numbers of cases each year and filed a record number of municipal market enforcement actions in 2012.

The formation of the municipal securities enforcement unit, as well as the implementation of the municipal market provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), explains last year's increase in SEC enforcement actions related to the municipal market. In fact, the municipal securities unit announced five priority areas—offering and disclosure fraud, tax or arbitrage-driven fraud, pay-to-play and public corruption violations, public pension accounting and disclosure violations, and valuation and pricing fraud—and brought enforcement actions in all of these areas in 2012. The Dodd-Frank Act also provided a number of enforcement tools, including whistleblower provisions that strongly incentivize reporting of suspected fraud, and the ability to impose civil penalties of up to $150,000 in administrative proceedings. Previously, the SEC could obtain civil penalties only by bringing an action in federal court.

The municipal securities enforcement unit brought several groundbreaking cases in 2012. The SEC settled its first action for "pay-to-play" violations under Municipal Securities Rulemaking Board (MSRB) Rule G-37 involving "in-kind" non-cash political contributions.[i] This settlement represents the largest ever for an MSRB pay-to-play violation. The SEC also settled its first action against borrower's counsel in connection with the offer and sale of municipal bonds. Finally, led by its Los Angeles regional office, the SEC brought an enforcement action related to the largest public pension fund in the United States.

The SEC's municipal market activity, as well as its focus on municipal securities enforcement, shows no signs of slowing. The SEC Office of Compliance Inspections and Examinations issued risk alerts on municipal market underwriting practices and pay-to-play prohibitions in March and August 2012, respectively. Based on SEC field hearings covering municipal market issues, the SEC provided a 165-page report in July 2012 (the SEC Report) recommending, among other things, legislative and regulatory action to address issues related to municipal market price transparency and the timing and accounting methods used for market disclosures. Further, in December 2012, Commissioner Elisse B. Walter—who spearheaded the SEC Report—became SEC Chairman. Although Ms. Walter's tenure as Chairman will be brief, President Obama has nominated Mary Jo White, the former United States Attorney for the Southern District of New York, to serve as the SEC Chairman. Ms. White, the first former prosecutor nominated as SEC Chairman, is widely expected to lead the SEC to a more aggressive enforcement agenda. In addition, the SEC is expected soon to provide a final definition of "municipal advisor" for registration purposes under the Dodd-Frank Act, a precursor to additional municipal advisor regulation.

E-ALERTS:

- **Government Finance Officers Association Issues Guidelines for Pension Funding** (December 18, 2012)
- **New Best Practices Released for Pension Obligation Disclosure** (November 15, 2012)
- **Underwriters of Municipal Securities Subject to New Fair Dealing Liability under Federal Securities Laws** (August 2, 2012)

IN THIS ISSUE:

The following are summaries of key 2012 municipal market SEC enforcement actions. In sum, these cases demonstrate the SEC's increased focus on the sufficiency and accuracy of disclosures, as well as on the integrity of the underwriting and investment contract processes. For further information, please contact John C. Grugan at 215.864.8226 or gruganj@ballardspahr.com, or Tesia N. Stanley at 801.517.6825 or stanleyt@ballardspahr.com.

CASE SUMMARIES

OFFERING AND DISCLOSURE

Failure To Disclose Criminal Proceedings and Loan Related to Borrower

In the area of offering and disclosure, the SEC brought actions related to conduit financings. For example, in December 2011 the SEC filed a complaint alleging that a conduit borrower and its sole principal made material misstatements and omissions in connection with the issuance of $2.96 million in industrial development bonds in 2006.[ii]

The bonds were issued for the purpose of financing the borrower's acquisition of a casket manufacturing facility located within the issuer's jurisdiction. According to the SEC, the principal did not disclose to key transaction participants before the issuance of the bonds that he had been indicted for financial fraud in 2005 and was negotiating a plea agreement. The SEC also alleged that the principal failed to disclose to key transaction participants the terms of a $200,000 loan to the borrower, which required a $100,000 interest payment and provided the lender with 20 percent ownership in the company should the loan remain unpaid after six months. Due to the principal's non-disclosure of the criminal proceedings and the loan, the SEC claimed that the Official Statement for the Bonds contained materially misleading information about the principal as well as the borrower's financial projections and debt coverage.

The SEC alleged that the conduct of the company and its principal violated Section 17(a) of the Securities Act of 1933 (the Securities Act) and Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act) and Rule 10(b)-5 thereunder. In July 2012, the district court entered a default judgment against the company and its principal, holding that both defendants are jointly and severally liable for disgorgement, interest, and penalties of more than $4.5 million.

In a related action, the SEC filed a complaint alleging that borrower's counsel also failed to disclose to key transaction participants material information regarding the criminal proceedings against the principal of the borrower as well as the borrower's loan.[iii] Borrower's counsel served as personal counsel to the borrower's principal in the criminal proceedings. The SEC's complaint alleged that—by failing to correct misstatements and omissions in the Official Statement known by borrower's counsel—borrower's counsel aided and abetted the borrower and its principal in violating securities laws.

The SEC's complaint focused on the signed opinion letter of borrower's counsel. The SEC alleged that the opinion letter stated that there was no "action, suit or proceeding at law or in equity" pending or affecting the borrower that would have an adverse financial impact on the borrower. The SEC further alleged that the opinion letter stated that the Official Statement did not "contain any untrue statement of a material fact, and did not omit to state any material fact necessary to make the statement therein . . . not misleading."

In January 2012, without admitting or denying the allegations in the complaint, borrower's counsel consented to a permanent injunction from violating Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10(b)-5 thereunder, as well as aiding and abetting such violations. Borrower's counsel further agreed to pay $10,000 in disgorgement, $3,052 in prejudgment interest, and a $25,000 civil penalty. Borrower's counsel is suspended from appearing or practicing before the SEC as an attorney, with the right to request reinstatement in five years.

Personal Use of Funds by a Former Registered Broker-Dealer Representative

In April 2012, the SEC announced the filing of a complaint against a former registered representative of a broker-dealer.[iv] According to the SEC, this former representative solicited and received approximately $1 million from investors by committing to invest their money in municipal bonds insured by the Securities Investor Protection Corporation (SIPC).

The SEC alleges that beginning in 2010, the former representative solicited and received investments through friends and through magazine ads placed with *The Pasadena Foothills Magazine* on the premise that the funds would be invested in municipal bonds. According to the SEC's complaint, the former representative instead collected and maintained the funds for his personal use, providing investors with false documentation regarding the details of the bond transactions and SIPC coverage. The complaint alleges these false documents included a "Preview Bond Order" stating the investor's name, account number, amount invested, broker fee, and the trade settlement date. The SEC further claims the former representative incorrectly informed investors he was currently associated with a broker-dealer, among other misstatements. As of the time of publication, this matter remained in litigation.

Failure To Understand or Disclose Investment Risk

In August 2012, the SEC issued an administrative order in a settled action in which the SEC charged a bank and one of its former vice presidents with the sale of asset-backed commercial paper (ABCP) to state and local governments, nonprofit

institutions, and others without fully understanding or disclosing the risk associated with those investments.[v]

The SEC found that the bank and former vice president improperly recommended and sold ABCP issued by structured investment vehicles largely tied to mortgage-backed securities and collateralized debt obligations without understanding or disclosing the nature and volatility of ABCP. In support of its finding, the SEC noted that the bank and its registered representatives relied heavily on the credit rating of the ABCP in recommending these products to investment-conservative customers, without reviewing the commercial paper private placement memoranda listing the associated risks.

Ten of the bank's customers were holding $104.4 million in three ABCP programs that defaulted in 2007. Two of these customers realized losses of approximately $4.2 million, and another two settled claims with the bank related to their ABCP purchases.

The bank since has taken remedial steps to ensure that its registered representatives possess adequate knowledge to recommend ABCP and that adequate disclosure is provided to potential investors. These steps include restricting the types of commercial paper products that may be offered to institutional investors, enhancing supervision of registered bank representatives, conducting quarterly meetings among high-level bank employees to review the types of products sold to state and local governments, and providing ABCP investors with copies of associated offering documents.

The SEC found, but neither the bank nor the former vice president admitted, that the bank and its former vice president willfully violated Section 17(a) of the Securities Act. In its legal discussion, the SEC cited case law providing that the recommendation of a broker "carries the implicit representation that it was responsibly made on the basis of actual knowledge and careful consideration."

The SEC ordered the bank to cease and desist violations of 17(a) of the Securities Acts, pay disgorgement of $65,000, pay prejudgment interest of $16,571.96, and pay a civil penalty of $6.5 million. The former vice president was ordered to cease and desist violations of 17(a) of the Securities Acts and pay a civil penalty of $25,000, and was suspended from the securities industry for six months. In announcing this action, Elaine Greenberg, Chief of the Municipal Securities and Public Pensions Unit, stated that "[b]roker-dealers must do their homework before recommending complex investments to their customers."

Failure To Disclose Use of Bond Proceeds

In September 2012, the SEC alleged that a company's former chief executive officer misled city officials and investors about the use of bond proceeds from the offer and sale of $39 million in appropriations credit bonds backed by the City of Moberly, Missouri, in 2010.[vi] The purpose of issuing the bonds was to finance a sucralose processing plant in the City. The project was to be operated by the former CEO and engineered and constructed by a Hong Kong company that the former CEO was to form. Under a financing agreement with the Industrial Development Authority for the City, the City provided general revenues for principal and interest payments due on the bonds, subject to an annual appropriation. Although the former CEO's company was required to make periodic payments to the City to pay bondholders, the City ultimately was obligated to repay bondholders.

The SEC alleges in its complaint that the former CEO failed to disclose to City officials that he never took any steps to form the Hong Kong company that was to engineer and construct the processing plant. The SEC further alleges that the former CEO instructed unknowing company employees and consultants to create false documentation related to project expenses that would allow him to submit draw requests consisting of invoices and receipts to the City finance manager, such as construction bills for the Hong Kong company. According to the SEC, the former CEO instructed employees to wire approximately $900,000 in bond proceeds to the former CEO's wife on the premise that his wife was an agent of the Hong Kong company. These funds were subsequently used to pay the former CEO's mortgage, credit card debt, and other expenses unrelated to the project, according to the SEC's complaint.

At closing, the former CEO certified that the information contained in the bonds' Official Statement regarding the project did not contain any misstatements or omissions of material facts. The SEC alleges in its complaint that, as signatory of the certificate, the former CEO was ultimately responsible for the information contained therein.

The SEC alleges in its complaint that the conduct of the former CEO violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10(b)-5 thereunder. The former CEO's wife was named as a relief defendant, from whom the SEC seeks disgorgement. Both defendants have denied liability, and the matter is in litigation.

PAY-TO-PLAY AND PUBLIC CORRUPTION

The SEC charged an underwriter and one of its former vice presidents with violating pay-to-play prohibitions by providing undisclosed in-kind and cash contributions to a former state treasurer during his campaign for governor of Massachusetts.[vii]

According to the SEC's orders, between 2008 and 2010 the underwriter's former vice president substantially assisted the former state treasurer in his gubernatorial campaign by, among other activities, fundraising, drafting speeches, approving campaign expenditures, arranging advertisements, reviewing office space leases, and providing legal advice. The SEC found that the former vice president conducted some of these activities during business hours and while using the resources of the underwriter. During an approximately one-year period, the SEC alleged that the former vice president sent at least 364 e-mails related to the candidate's campaign using his company e-mail account. In

addition to these in-kind campaign contributions, the former vice president made a $400 campaign contribution indirectly, through a friend.

In support of its allegations, the SEC cited several e-mails from the former vice president's corporate e-mail account regarding underwriting opportunities linked to the candidate's campaign for governor. One such e-mail stated: "[t]he boss [Former State Treasurer] mentioned to me this morning that he spoke to [the Assistant Treasurer] and that it is looking good for us on the build America bond deal." According to the SEC, the underwriter terminated the former vice president in December 2010.

The SEC's order charged the underwriter with violating Section 15B(c) of the Exchange Act and MSRB Rules G-37, G-8, and G-9, which contain a two-year ban on business with an issuer following a political contribution to an official of such issuer, as well as political contribution disclosure and records requirements. The SEC also charged the underwriter with violating the "fair dealing" and supervisory requirements of MSRB Rules G-17 and G-27, respectively. The SEC's order charged the former vice president with violating MSRB Rules G-37, G-8, G-9, and G-17.

The underwriter consented to the SEC's order without admitting or denying its findings and agreed to pay approximately $7.5 million in disgorgement, $670,000 in prejudgment interest, and $3.75 million in penalty fees, minus $2.1 million in credit for payments pursuant to an action by the Commonwealth of Massachusetts. The SEC paid nearly $1.9 million to the MSRB pursuant to the fine-sharing provisions of the Dodd-Frank Act.

"Fighting efforts to improperly influence the underwriting selection process is one of the unit's top priorities," Ms. Greenberg stated in the SEC's press release. The action against the underwriter was the first in the SEC's history involving non-cash political contributions.

PUBLIC PENSION ACCOUNTING AND DISCLOSURE

In April 2012, the SEC filed a complaint alleging that a former chief executive officer of the California Public Employees' Retirement System (CalPERS) and a placement agent provided falsified documents to an investment firm to induce the firm to pay approximately $20 million in placement agent fees.[viii] CalPERS is the largest public pension fund in the United States, with approximately $250 billion in assets.

According to the SEC's complaint, CalPERS acquired approximately 10 percent of the investment firm's non-voting shares in June 2007. The investment firm required a signed disclosure letter from one of its investors before it would pay a placement agent's fee, according to the complaint. The SEC alleges that the investment firm's former CEO and the placement agent, who were personal friends, created a false disclosure letter on purported CalPERS letterhead signed by the former CEO and provided it to the investment firm's counsel. Upon receipt of the disclosure letter, the investment bank paid the placement agent's firm approximately $3.5 million in fees, according to the SEC. The SEC alleges that the former CEO, placement agent, and the placement agent's firm subsequently produced additional false disclosure letters to the investment bank, ultimately receiving approximately $20 million in placement agent fees. The SEC alleges that the conduct of the former CEO, the placement agent, and the placement agent's firm violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10(b)-5 thereunder. The matter remains in litigation.

In one of its most high-profile actions in 2012, the SEC filed an action in May against a former mayor and a former treasurer of the City of Detroit.[ix] The SEC alleges that, while acting as trustees for two of the City's pension funds, each solicited and received non-business travel and other gifts from an advisory firm and its chief executive officer.

According to the SEC's complaint, in 2007 the former mayor and treasurer were voting members of the boards of trustees of the General Retirement System of the City of Detroit and the Police and Fire System of the City of Detroit (Pension Funds). The SEC alleges that throughout 2007, both former Detroit officials received gifts worth approximately $125,000 from the advisory firm, including a three-day Las Vegas vacation and flights on a private jet to Bermuda and Tallahassee, Florida. At around the same time, the SEC alleges that the advisory firm and its CEO sought a $115 million investment from the Pension Funds. According to the SEC, this conflict of interest was not disclosed to the other trustees of the Pension Funds, who voted to continue and expand their investments with the advisory firm.

The SEC alleges in its complaint that the conduct of the advisory firm and its CEO violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10(b)-5 thereunder, and Sections 206(1) and 206(2) of the Investment Advisers Act of 1940. The conduct of the former Detroit city officials, according to the SEC, violated Section 10(b) of the Exchange Act and constituted aiding and abetting under Section 206(1) and 206(2) of the Investment Advisers Act of 1940. The SEC has sought disgorgement and civil penalties, as well as permanent injunctions prohibiting further securities law violations and participation by the advisory firm in decisions related to public pension investments in securities. The matter remains in litigation.

TAX/VALUATION AND PRICING

The SEC continued its enforcement in the area of municipal market bid-rigging. For example, in January 2012, the district court entered judgment in the SEC's favor in a case where the SEC alleged that a provider of reinvestment products engaged in municipal market bid-rigging.[x] The SEC charged that the provider participated in bidding setups by obtaining information from a bidding agent of a state or local government in advance of a bid. According to the SEC, the provider subsequently won bids

per the bidding agent's collection of "throwaway" or "courtesy bids" from other providers, and made larger profits off of these bids by receiving "last looks" from the bidding agent whereby the provider could lower the amount of its bid and still win.[xi] The SEC further charged that the provider facilitated setups by submitting courtesy bids.

During the relevant time period, the provider won bids for at least 203 municipal reinvestment instruments and submitted at least 125 courtesy bids, according to the SEC's complaint. The SEC charges that the provider threatened the tax-exempt status of billions of dollars in municipal securities by falsely certifying that such bids were the result of bona fide solicitations, a bidding process requirement of applicable tax regulations.

Without admitting or denying the allegation in the SEC's complaint, the provider consented to a permanent injunction from violating Section 17(a) of the Securities Act. The provider further agreed to pay approximately $10.6 million in disgorgement, $3.8 million in prejudgment interest, and a $10.5 million civil penalty. At the request of the provider, the SEC waived the small-offering exemption from registration disqualification under the Securities Act.[xii]

In September 2012, the SEC barred from the securities industry a number of officers and employees of a registered investment adviser in connection with criminal proceedings related to municipal market bid-rigging.[xiii] The SEC's orders followed guilty pleas entered by the officers and employees on charges of conspiracy and wire fraud. The investment adviser had been hired by state and local governments to act as an agent for competitive bidding for municipal bond investment contracts. According to the indictments, the defendants defrauded state and local governments and the Internal Revenue Service by determining the winning bidders and price to be paid for the investment contracts before bidding began. The indictments additionally charged the defendants with receiving kickbacks and concealing material information in order to manipulate the bidding process.

OUR MUNICIPAL SECURITIES PRACTICE

Ballard Spahr houses one of the premier public finance practices in the country. Our public finance attorneys represent state and local governments and authorities, nonprofit organizations, investment banks, and banking institutions in virtually every type of bond transaction. Our public finance practice is enhanced by the firm's more than 60 securities attorneys who assist with bond issuers' original and secondary disclosure obligations and other securities issues, including state blue sky laws and federal securities regulations. Several lawyers in the firm's Securities Group previously served as staff members at the SEC, providing a unique perspective and invaluable experience in guiding our clients through the regulatory requirements and exemptions of federal and state securities laws. Members of our Securities Group work with municipal market clients to assist them in developing policies and procedures and drafting disclosure and underwriting agreements to assure compliance with all SEC and MSRB Rules applicable to municipal securities.

Ballard Spahr's transactional capabilities are complimented by the experience of our Securities Litigation Group, which advises municipal market participants on every type of securities claim, including regulatory investigations by the SEC, IRS, FINRA and bank regulators. We are experienced litigators before federal and state courts at the trial and appellate levels. We also have in-depth knowledge of FINRA and other financial arbitration forums. Our team includes former federal prosecutors and the former assistant director for the Division of Corporation Finance with the SEC, bringing added depth to devising defense strategies and reaching resolution. Our clients include state and local governments and authorities, nonprofit organizations, underwriters, broker-dealers, investment advisers, accountants, and attorneys. For more information, please visit www.ballardspahr.com.

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i. The Dodd-Frank Act increased enforcement coordination among the SEC and fellow municipal market regulators the MSRB and the Financial Industry Regulatory Authority (FINRA).

ii. *SEC v. Charles A. Aiken, et al.*, Civil Action No. CA 5:11-1018 (S.D. West Va., Dec. 29, 2011).

iii. *SEC v. Chalmer E. Detling, II, Esq.*, Civil Action No. 1:11 cv 4565 (N.D. Ga. Dec. 29, 2011).

iv. *SEC v. Michael Anthony Gonzalez*, Case No. 12-03319 SJO (C.D. Cal., Apr. 17, 2012).

v. *In the Matter of Wells Fargo Brokerage Services, et al.*, Administrative Proceeding File No. 3-14982 (Aug. 14, 2012).

vi. *SEC v. Bruce Cole, et al.*, Case No. CV 12-8024 (C.D. Cal., Sept. 18, 2012).

vii. *In the Matter of Goldman Sachs & Co.*, Administrative Proceeding File No. 3-15048 (September 27, 2012); In the Matter of Neil M.M. Morrison, Administrative Proceeding File No. 3-15049 (Sept. 27, 2012).

viii. *SEC v. ARVCO Capital Research, et al.*, Case No. 3:12-cv-00221-ECR-WGC (D. Nev. Apr. 23, 2012).

ix. *SEC v. Kwame M. Kilpatrick, et al.*, Case No. 12-cv-12109 (E.D. Mich., May 9, 2012).

x. *SEC v. GE Funding Capital Market Services, Inc.*, Civil Action No. 2:11-cv-07465-WJM-MF (D. N.J. Jan. 23, 2012).

xi. In June 2012, the SEC approved a new MSRB rule that regulates, for the first time, the conduct of broker's brokers that act as intermediaries between selling and bidding dealers. This new rule prohibits conduct such as providing last looks.

xii. *In the Matter of GE Capital Market Services, Inc.*, Release No. 9298 (Feb. 1, 2012).

xiii. *In the Matter of Matthew Adam Rothman*, File No. 3-15050 (Sept. 27, 2012); *In the Matter of Douglas Alan Goldberg*, File No. 3-15051 (Sept. 27, 2012); *In the Matter of Daniel Moshe Naeh*, File No. 3-15052 (Sept. 27, 2012); *In the Matter of Zevi Wolmark*, File No. 3-15053 (Sept. 27, 2012); *In the Matter of Evan Andrew Zarefsky*, File No. File No. 3-15054 (Sept. 27, 2012); *In the Matter of David Rubin*, File No. 3-15055 (Sept. 27, 2012).