



2014 TO DATE

# SEC Enforcement Round-Up

FALL 2014

*To date, 2014 has seen the Securities and Exchange Commission (SEC) continue its trend of the past several years of heightened enforcement in the municipal securities and public pension plan markets. This year has been remarkable, however, for the SEC's significant efforts to compel greater disclosure, and impose far more rigorous disclosure obligations, than is required either under current federal legislation or in practice. Unquestionably, the most meaningful enforcement event has been the SEC's Municipalities Continuing Disclosure Cooperation Initiative (MCDC Initiative), announced on March 10 and intended to address what the SEC perceives as widespread noncompliance with issuers' continuing disclosure agreements.*

The MCDC Initiative encourages self-reporting by municipal securities issuers and underwriters of possible securities law violations related to misrepresentations in offering documents concerning an issuer's prior compliance with its continuing disclosure obligations. It does not, however, provide incentives relating to other possible violations of the federal securities laws. Many issuers and underwriters have taken a measured approach to self-reporting through the Initiative, whether it is because they do not wish to attract the SEC's attention, believe the SEC cannot prove its case if required to state one, or have other reasons for doing so.

The SEC has nevertheless continued to promote the MCDC Initiative, despite significant skepticism whether, if litigated, the SEC could establish that a given violation of continuing disclosure obligations is material. On July 8, the SEC announced its first cease-and-desist order under the Initiative. The order does not include a detailed analysis regarding the types of continuing disclosure failures the SEC considers material and consequently offers little guidance to market participants deciding whether to self-report.

In a nod to widespread concern in the market, the SEC announced a handful of changes to the Initiative on July 30, including extending the deadline for issuers to self-report to December 1 and calibrating fines on underwriters to 2013 revenues. The deadline for underwriters to self-report was not extended, however, which led several members of Congress to write to SEC Chair Mary Jo White on August 28 to request that this deadline also be extended.

In other enforcement actions, the SEC's aggressive posture likewise persisted in the first half of 2014. In an unprecedented move, the SEC obtained an emergency court order on June 25 to prevent the city of Harvey,

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Illinois, from selling bonds in the municipal market amid allegations the city engaged in fraudulent market transactions. On August 11, the SEC announced a settled action against the State of Kansas. The SEC alleged the State failed to disclose a significant unfunded liability in its pension system in any of eight series of bonds offered over an 11-month period.

In 2014, the SEC also brought its first pay-to-play investment adviser action and wrapped up its high-profile case against Henry Morris, a “finder” for the New York State Common Retirement Fund (Fund), and related individuals in actions involving a multimillion-dollar kickback scheme to obtain investment business from the Fund.<sup>1</sup> As we previously have noted, pay-to-play violations are likely to remain a focus of SEC enforcement actions.

On the regulatory front, the SEC’s final registration rules for municipal advisors went into effect July 1. In addition to registration requirements issued by the SEC and the Municipal Securities Rulemaking Board (MSRB), municipal advisors are subject to a federal fiduciary duty and the MSRB’s “fair dealing” rule. The MSRB recently filed with the SEC seeking approval of a supervisory rule for municipal advisors and issued a second request for comment on its basic conduct rule for municipal advisors.

Looking ahead to the balance of 2014, the municipal market is likely to see additional MSRB municipal advisor rule changes. In addition, the SEC and MSRB will likely maintain their focus on price transparency for municipal market investors. The SEC has suggested that the MSRB pursue greater pretrade price transparency using its Electronic Municipal Market Access (EMMA) system, and the MSRB recently announced several initiatives—including EMMA’s price transparency tool—to enhance the availability of pricing information. In a recent speech, SEC Chair White stated: “I am . . . concerned that, in the fixed-income markets, technology is being leveraged simply to make the old, decentralized method of trading more efficient for market intermediaries, and its potential to achieve more widespread benefits for investors, including the broad availability of pretrade pricing information, lower search costs and greater price competition, especially for retail investors, is not being realized.”

## OFFERING AND DISCLOSURE

### *MCDC Initiative*

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

Under the MCDC Initiative, the SEC’s Enforcement Division will recommend standard settlement terms upon self-reporting possible securities law violations by municipal securities issuers and underwriters of possible securities law violations related to misrepresentations in offering documents concerning an issuer’s prior compliance with its continuing disclosure obligations. The clock for this voluntary self-reporting ended at 12:00 a.m. ET on September 10, 2014 for underwriters and will end at 5:00 p.m. ET on December 1, 2014 for issuers.

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

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

The MCDC Initiative encourages issuers that may have made materially inaccurate statements in offering documents regarding their prior continuing disclosure compliance, and the underwriters of such offerings, to

self-report through the submission of a questionnaire. The questionnaire requires the submitter to identify transaction participants—including the issuer, the underwriter, the municipal advisor, bond counsel, underwriter’s counsel, and disclosure counsel, if any.

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

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

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

Underwriters will be required to take remedial actions including:

- Retaining an independent consultant to undertake a compliance review and provide recommendations regarding the underwriter’s due diligence process and procedures
- Taking steps to implement the consultant’s recommendations
- Cooperating with subsequent SEC investigations

- Providing a compliance certificate to the SEC regarding the above actions one year from the date on which the cease-and-desist proceeding is instituted

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

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

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

Issuers and/or underwriters who believe that their primary market disclosure regarding past continuing disclosure compliance may be inaccurate should consider seeking counsel to determine whether to self-report under the MCDC Initiative.

### *Failure To Disclose Conflicts of Interest*

On June 2, 2014, the SEC charged a Chicago charter school operator with defrauding investors in a \$37.5 million bond offering by failing to disclose transactions that presented conflicts of interest.<sup>2</sup> According to the

SEC's complaint, UNO Charter School Network, Inc. (UNO) failed to disclose a multimillion-dollar construction subcontract with a company owned by a brother of UNO's Chief Operations Officer, as well as the potential impact of this transaction on UNO's ability to repay its bond obligations. This announcement was notable both in itself and for what may be forthcoming: SEC officials have stated that the agency may bring charges against individuals in the ongoing investigation.

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

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

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

Nevertheless, the SEC alleged that the disclosures in the Official Statement were deficient due to UNO's

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

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

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

### *Misuse of Bond Proceeds*

On June 24, 2014, the SEC filed a complaint against the City of Harvey, Illinois, and its comptroller—who also served as the city's financial advisor—alleging material misrepresentations were made regarding the use of bond proceeds in official statements for offerings sold by the city in 2008, 2009, and 2010.<sup>3</sup>

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

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

The case is pending in U.S. District Court for the Northern District of Illinois.

### *MCDC Enforcement Action*

On July 8, 2014, the SEC announced its first cease-and-desist order under its MCDC Initiative. Without providing detailed analysis, the SEC found that the Kings Canyon Joint Unified School District of California (District) made a material misstatement in a 2010 official statement.<sup>4</sup>

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

District's noncompliance, and largely appears to have assumed that the fact of the District's noncompliance was material to investors.

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

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## **PAY-TO-PLAY AND PUBLIC CORRUPTION**

### *Receipt of Advisory Fees from Pension Funds Following Ban on Business*

On June 20, 2014, the SEC announced its first enforcement action under "pay-to-play" rules for investment advisers since those rules were adopted nearly four years ago.<sup>5</sup> TL Ventures Inc., a Philadelphia-area private equity firm, agreed to pay nearly \$300,000 in disgorgement and penalties to settle the charges that it continued to receive advisory fees from city and state pension funds after making mayoral and gubernatorial campaign contributions.

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

both SERS and the Retirement Board have remained investors in the funds.

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

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

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

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

In adopting the release of SEC Rule 206(4)-5, the SEC stated: “Public pension plans are particularly vulnerable to pay-to-play practices.” In its press release announcing the enforcement action, the chief of the SEC’s Municipal

Securities and Public Pensions Unit warned: “Public pension funds are increasingly investing in alternative investment vehicles such as hedge funds and private equity funds. When dealing with public pension fund clients, advisers to those kinds of investment vehicles should be mindful of the restrictions that can arise from political contributions.”

To avoid political contributions that may result in inadvertent bans on business with government entities, investment advisers should ensure their policies and procedures cover:

- Direct and indirect political contributions by the adviser and its general partners, managing members, executive officers, and similar individuals
- Direct and indirect political contributions by the adviser’s employees who solicit government entities for the adviser and the employees’ supervisors
- Direct and indirect political contributions by political action committees (PACs) controlled by the adviser or its general partners, managing members, and executive officers, solicitation employees, and their supervisors
- Direct or indirect payments made by the above entities and individuals to any person to solicit a government entity for investment advisory services
- Coordination or solicitation by the above entities and individuals of direct or indirect contributions by any person or PAC to officials of a government entity to which the adviser is providing or seeking to provide investment advisory services
- Direct or indirect payments made by the above entities and individuals to a state or local political party where the adviser provides or seeks to provide investment advisory services to a government entity

Such policies and procedures are not only designed to prevent prohibited political contributions, but are also a consideration of the SEC under Rule 206(4)-5(e) in determining whether to exempt the adviser from a two-year ban on business if a prohibited political contribution has occurred.

## PUBLIC PENSION ACCOUNTING AND DISCLOSURE

### *Failure To Disclose Pension Plan Underfunding*

On August 11, 2014, the SEC issued a cease-and-desist order to settle charges that the State of Kansas defrauded investors in eight bond offerings totaling \$273 million in 2009 and 2010 by failing to disclose to investors in the offering documents that the State's pension system was significantly underfunded.<sup>6</sup> This is the third SEC action directly against a state for allegations of fraud related to public pension plan disclosure.<sup>7</sup>

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

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

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## 2014 UPDATE ON PRIOR ENFORCEMENT ACTIONS

### *Multimillion-Dollar Kickback Scheme*

In March 2014, the SEC obtained favorable judgments against various individuals, including Henry Morris,<sup>8</sup> who the SEC alleges engaged in a fraudulent scheme

involving undisclosed kickback payments made by investment management firms in order to obtain New York Common Retirement Fund business. The SEC filed its complaint against Mr. Morris in 2009.

### *Material Misstatements in Official Statements Related to Construction and Management Fees*

In April 2013, the SEC filed a complaint against an underwriter, two investment bankers, a developer, the City of Victorville, the director of economic development for the City, and an airport authority, alleging fraud related to tax increment bonds issued by the authority in 2006, 2007, and 2008.<sup>9</sup> Proceeds from the bonds were used to fund redevelopment projects on a former Air Force base in San Bernardino County, California. The case is pending in the U.S. District Court for the Central District of California. As of September 11, 2014, the case is still in its initial stages, with defendants seeking to strike the prayer for disgorgement from the SEC's First Amended Complaint.

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

In July 2013, the SEC filed an enforcement action in federal court against the City of Miami and its former budget director alleging securities fraud related to the city's 2007 and 2008 annual financials and subsequent 2009 bond offerings.<sup>10</sup> The SEC's complaint against the City focused on alleged improper conduct—and the consequent annual financials and bond offering disclosures—involving interfund transfers by the City.

The SEC alleged that, from 2007 to 2009, the City made transfers from capital project funds (which comprised monies restricted to specific purposes) to a general use fund to mask deficits in the general fund. The case is pending in the U.S. District Court for the Southern District of Florida. As of September 11, 2014, the action is stayed pending the appeal of the district court's denial of the former budget officer's motion to dismiss raising the defense of qualified immunity.

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

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

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## Endnotes

1. Henry Morris is one of the reasons “finders” and “solicitors” are regulated as municipal advisors under federal securities law.
2. *SEC v. United Neighborhood Organization of Chicago and UNO Charter School Network, Inc.*, Case No. 1:14-cv-04044 (June 2, 2014).
3. *SEC v. City of Harvey, Illinois and Joseph T. Letke*, Case No. Case: 1:14-cv-04744 (June 24, 2014).
4. *In the Matter of Kings Canyon Joint Unified School District*, Admin. File No. 3-15966 (July 8, 2014).
5. *SEC v. TL Ventures, Inc.*, Admin. File No. 3-15940 (June 20, 2014).
6. *SEC v. State of Kansas*, Admin. File No. 3-16009 (Aug. 11, 2014).
7. The SEC's first action directly against a state was in *SEC v. State of New Jersey*, Admin. File No. 3-14009 (Aug. 18, 2010). The SEC's second action directly against a state was in *SEC v. State of Illinois*, Admin. File No. 3-15237 (Mar. 11, 2013).
8. *SEC v. Henry Morris et al.*, Case No. 09-CV-2518, (Mar. 19, 2014).
9. *SEC v. City of Victorville, Cal. et al.*, Case No. EDCV13-0776 (Apr. 29, 2013).
10. *SEC v. City of Miami, Florida et al.*, Case No. 1:13-cv-22600-CMA (July 19, 2013).