Ballard Spahr LLP

2015 YEAR IN REVIEW

SEC Municipal Market Enforcement

SPRING 2016

The SEC's enforcement efforts in the municipal securities area in 2015 were dominated by the actions it brought pursuant to its Municipalities Continuing Disclosure Cooperation Initiative (the MCDC Initiative or MCDC). As we discussed in prior updates and alerts, through the MCDC Initiative, the SEC sought to obtain admissions of possible securities law violations by municipal securities issuers and underwriters related to representations in offering documents concerning an issuer's prior compliance with continuing disclosure obligations.

In 2015, the SEC brought a total of 58 enforcement actions against municipal securities underwriters. On February 2, 2016, the SEC wrapped up its MCDC enforcement actions against underwriters by issuing an additional 14 MCDC cease-and-desist orders. In total, the SEC collected approximately $18 million in fines as a result of its 72 MCDC actions against municipal securities underwriters. In each cease-and-desist order, the SEC provided at least one example of a failure by an issuer or obligated person to comply with its prior continuing disclosure agreements that was not reflected in subsequent offering documents. Approximately half of the examples provided were failures to file required financial information and operating data, while the other half noted late filings. The SEC has begun following up with issuers and obligated persons who filed self-reports, and we expect announcements concerning these actions within the coming weeks.

The MCDC Initiative is notable not only for the number of self-reports received by the SEC, but also for the legal theory it used to support its enforcement actions. For several years, widespread noncompliance with continuing disclosure obligations had been reported in the municipal market. The SEC unsuccessfully tried to convince Congress to erode or minimize the reach of the Tower Amendment and permit the SEC to require issuers to file annual financials and other continuing disclosure information with the Municipal Securities Rulemaking Board (MSRB).[i] By resorting to its antifraud authority, the SEC has shown both its willingness to broadly interpret its enforcement reach and its apparent resignation to the unlikelihood of expanded legislative authority. In essence, through the MCDC Initiative, the SEC is seeking to create a body of precedent that, in fact, is founded on voluntary settlements.

SEC 2015 ENFORCEMENT FOCUS:

- **Disclosure related to continuing disclosure compliance**
- **Failure to make bona fide public offering**
- **Dealer mark-ups**
- **Misuse of bond proceeds**
- **Disclosure of high-risk investments**

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Another example of the SEC using its enforcement authority to push regulatory changes occurred in August 2015. It brought an action against an underwriter for failing to adequately monitor whether the markups it charged customers in certain secondary municipal market transactions were reasonable, among other alleged securities law violations. In a press release announcing the enforcement action, the SEC stated that "[b]ecause current rules do not require dealers to disclose markups on municipal bonds, investors receive very little information about their dealer's compensation in municipal bond trades." The MSRB responded to SEC pressure to undertake rulemaking related to markup/markdown disclosure in September 2015 by issuing a request for comment on draft rule amendments to MSRB Rule G-15 that would require dealers to disclose the markup or markdown on retail customer confirmations for certain principal transactions. It is likely that these disclosures will continue to be an area of interest to regulators on both the rulemaking and enforcement fronts.

The SEC's Office of Compliance Inspections and Examinations is in the process of examining all registered municipal advisors for compliance with current federal securities law regulations. The SEC has emphasized the importance of a municipal advisor's role in municipal securities transactions and it is likely the SEC will bring enforcement actions against municipal advisors soon, including with respect to fulfilling their fiduciary duty to state and local government clients.

OFFERING AND DISCLOSURE

First Round of MCDC Enforcement

On June 18, 2015, the SEC announced enforcement actions against 36 underwriting firms for violations of disclosure requirements in connection with municipal bond offerings.[ii] Firms settled for a combined total of nearly $9.3 million, with the largest firms paying civil penalties of $500,000 each.

The settlements imposed remedial sanctions and issued a cease-and-desist order on all further activities amounting to inadequate disclosures. In the settlements, the SEC found that the underwriting firms violated Rule 15c2-12 of the Exchange Act, which governs financial disclosure requirements for the benefit of investors. Rule 15c2-12 requires underwriters to "obtain executed continuing disclosure agreements from the issuers and/or obligated persons with respect to such municipal securities."[iii]

In the settlement agreements, and consistent with the SEC's more general focus on the role of gatekeepers, the SEC highlighted the importance of an underwriter's position in a securities offering. The SEC quoted *Dolphin & Bradbury, Inc. v. SEC*, which held that "[b]y participating in an offering, an underwriter makes an implied recommendation about the securities [that it] . . . has a reasonable basis for belief in the truthfulness and completeness of the key representations made in any disclosure documents used in the offerings." Additionally, the SEC stated that "underwriters have a 'heightened obligation' to take steps to ensure adequate disclosure."

The most common violation was when an issuer failed to disclose that it had either not filed annual reports or filed the reports late. Settling firms reported filing violations from as few as 14 days, and up to 1,517 days late.

Second Round of MCDC Enforcement

On September 30, 2015, the SEC announced the second wave of MCDC enforcement actions against 22 underwriting firms for violations of disclosure requirements in connection with municipal bond offerings.[iv] The firms settled a combined total of $4.12 million, with the largest firm paying the maximum civil penalty of $500,000. In this set of MCDC cease-and-desist orders, the SEC continued to focus on failures to file required financial information and operating data, or late filings of such information.

Identical to the first round of MCDC enforcement actions, the SEC imposed monetary fines and required the 22 underwriting firms to retain an independent consultant to conduct a review of the firms' policies and procedures relating to due diligence procedures in municipal securities deals. This second set of underwriter settlements contained a federal securities law analysis identical to the first wave, citing violations of Rule 15c2-12 of the Exchange Act. In each MCDC cease-and-desist order, the SEC provided at least one example of a failure by an issuer or obligated person to comply with its prior continuing disclosure agreements that was not disclosed in subsequent offering documents.

Also similar to the first round of MCDC enforcement actions, approximately half of the examples provided by the SEC were failures to file required financial information and operating data, with the other half constituting late filings. One notable example provided by the SEC was of an issuer's annual report filed eight months late. Although the late report was properly disclosed and included in an official statement, the SEC found

that the lack of a cross-reference to that official statement on the issuer's EMMA continuing disclosure pages was a sufficient factual basis for a fraud action.[v]

Combined, both sets of MCDC enforcement actions in 2015 resulted in nearly $13.5 million in civil penalties against 48 self-reporting municipal bond underwriting firms for alleged due diligence failures in connection with municipal bond offerings.

Regarding future MCDC enforcement actions, SEC enforcement staff has indicated that it plans to follow up with all MCDC self-reporters, including entities that will not face a cease-and-desist order. Now that it has concluded its underwriter MCDC actions, the SEC has launched enforcement actions against issuers and other obligated persons who self-reported and/or who were reported by an underwriter.

Misappropriation of Senior Living Facility Funds

On November 20, 2015, the SEC obtained an emergency freeze on the assets of Christopher Brogdon and filed a lawsuit which charged him with fraud due to misappropriating funds intended to renovate senior living facilities.[vi] In addition to naming Brogdon, the SEC also named his wife, son, and several of his entities as defendants.

The SEC's complaint alleged that since 1992, Brogdon has raised more than $190 million for senior living facility projects through more than 50 conduit municipal bond and private placement offerings. Brogdon raised the money through offering documents which stated that the money raised would be used in connection with certain real estate projects. The SEC alleged Brogdon comingled investor funds beginning as early as 2000 and used the funds for personal expenses instead of the real estate projects. Additionally, the SEC alleged Brogdon failed to file required financial statements and failed to adequately disclose the fact that he was making interest payments to investors from a reserve fund.

The SEC offered several examples of Brogdon's alleged fraudulent offerings. In one 2011 example, Brogdon raised $2.15 million through the issuance of Clayton County, Georgia First Mortgage Revenue Bonds. The disclosures in the Official Statement stated that $425,000 of the proceeds would be used as working capital. Instead, Brogdon used the working capital to pay loans on another nursing home project, his personal airplane, an American Express bill, and to fund a transfer to his wife in the amount of $74,000.

In its complaint, the SEC brought four claims for relief including violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, Sections 20(e) of the Exchange Act and Section 15(b) of the Securities Act, and Section 20(a) of the Exchange Act. The SEC requested a return of his ill-gotten gains with interest and penalties as well as a permanent bar on his eligibility to act as an officer or director of any public company. The litigation is currently pending.

VALUATION AND PRICING

Failure to Make Bona Fide Offering and Ensure Reasonable Markup

On August 13, 2015, the SEC issued a cease-and-desist order against an underwriter based on an alleged failure to make bona fide public offerings to its customers and to ensure reasonable markups were charged to customers in the secondary municipal securities market.[vii] The enforcement action was the first against an underwriter for pricing-related fraud in the primary municipal securities market.

Between February 2009 and December 2012, the underwriter participated in several negotiated offerings as a co-manager. The SEC alleged that the underwriter obtained municipal securities for its own portfolio and, in turn, improperly offered the same securities to its customers for prices higher than the negotiated initial offering price. According to the SEC, such customers paid at least $4.6 million more than would have been paid during the underwriting period using the initial offering price. As a result of these actions, the SEC also found the underwriter failed to prioritize customer orders over its own accounts. The SEC alleged the underwriter offered "90 bonds in 32 negotiated transactions to its customers at prices above the initial offering prices while syndicate restrictions were still in effect, either through the initial offer or through a later price increase after an offer at the initial offering price."[viii]

With regard to the secondary municipal securities market, the SEC scrutinized the markup charged by the underwriter to its customers. According to the SEC, between January 2011 and October 2013, the underwriter "failed to establish an adequate supervisory system to identify and review certain of [the underwriter's] customer orders to buy and sell municipal securities. As a result, [the underwriter] was unable to adequately monitor whether the markups it charged for certain transactions were reasonable."[ix]

The SEC charged the underwriter with violating Section 17(a)(2) and (3) of the Securities Act, Section 15(b)(c)(1) of the

Exchange Act, and MSRB Rules G-17, G-11, G-30, and G-27. In determining the sanctions, the SEC took into consideration Edward Jones' remedial efforts since 2013 including the disclosure of markups to customers, personnel changes, a compliance consultant, partial restitution to customers, and instituting new procedures for new issues and markups on the secondary market. The underwriter agreed to pay more than $20 million to settle the SEC's charges.

ADVISORY SERVICES

Misappropriation and Unauthorized High-Risk Investments

On April 16, 2015, the SEC brought a complaint against a financial adviser, alleging that he abused his position as adviser at a global bank by inducing customers to withdraw millions of dollars on the promise that he would purchase safe and low risk municipal bonds on their behalf.[x] Instead of investing in the promised municipal bonds, the SEC alleges the financial adviser invested in high risk securities which proved unfruitful. According to the SEC, the financial adviser misappropriated at least $20 million from customers and then lost a majority of the money in unprofitable trading.

To cover up the fraud, the SEC alleged the financial adviser created fake accounts and false account statements which reflected municipal bond holdings. Additionally, the financial adviser would take an account statement reflecting a legitimate account of another customer and simply paste a different customer's name over the statement when asked to provide investment information. The SEC brought two claims for relief including violations of Section 10(b) of the Exchange Act and sections 206(1) and (2) of the Advisers Act. Additionally, the SEC named the financial adviser's wife as a defendant based on her receipt of ill-gotten funds transferred to her by her husband. The litigation is currently pending.

Misrepresentation of Investment Risk

On August 17, 2015, the SEC issued a cease-and-desist order against an investment firm by which the firm agreed to pay nearly $180 million to settle charges that it defrauded investors by misrepresenting the risk associated with certain investments.[xi] The investment firm raised nearly $3 billion from 4,000 investors in the two hedge funds, ASTA and MAT funds (ASTA/MAT) and the Falcon Strategies funds (Falcon), which collapsed in the wake of the economic crash of 2008. According to the SEC's order, the "[f]inancial advisers and the fund manager orally represented to investors that [a hedge fund] was a 'safe,' 'low-risk' investment, akin to a 'bond substitute' or 'bond alternative' that had the same risk profile as a municipal bond investment but with a slightly higher return." In reality, ASTA/MAT and Falcon were not bond substitutes and an investment carried significantly greater risk than a bond investment. The investment firm performed back-testing on a hypothetical portfolio and drastically misrepresented the findings of the tests to financial advisers and investors. In August 2007, Falcon experienced margin calls. After becoming aware of these high-liquidity risks, the investment firm continued to recommend, offer, and sell additional shares of Falcon totaling approximately $110 million.

In its order, the SEC found that the investment firm "failed to implement a system in which the fund manager's authority was checked adequately or to ensure that the fund manager's communications with investors and financial advisers concerning the ASTA/MAT and Falcon funds were accurate and not misleading." The fund manager had complete control of the information disseminated to investors without sufficient review to ensure the accuracy of the information. The investment firm employed sales personnel who followed sales pitches drafted by the fund manager without any policies or procedures to confirm the legitimacy of the information used to sell the fund investments. In short, the SEC alleges that investment firm advisers failed to implement sufficient oversight into the information which investors relied upon to make investments in what they believed to be similar to low-risk bond substitutes.

2015 UPDATE ON PRIOR ENFORCEMENT ACTIONS

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, California, 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.[xii] Proceeds from the bonds were used to fund redevelopment projects on a former Air Force base in San Bernardino County, California. The case is pending in the U.S. District Court for the Central District of California. In

the initial stages of the litigation, the City of Victorville moved to dismiss certain of the SEC's fraud claims and its claim for relief based on allegations of aiding and abetting violations of Rule Section 10(b) of the Exchange Act and Rule 10(b)-5 promulgated thereunder. The City's motion was denied. Motions for summary judgment were filed by the parties and pre-trial and trial dates have been vacated by the Court pending final orders on the pending motions.

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, Florida, and its former budget director alleging securities fraud related to the City's 2007 and 2008 annual financials and subsequent 2009 bond offerings.[xiii] The SEC's complaint focused on alleged improper conduct—and the consequent misleading 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. On December 11, 2015, the parties reported that the case did not settle as a result of mediation. The report of the mediator stated that "[t]he result of the Mediation Conference is that the City of Miami and the Securities and Exchange Commission continue to have dialogue on settling the case and the Securities and Exchange Commission and Michael Bourdeaux [the former budget director] are at an impasse." Trial is expected to take place in late 2016.

CONCLUSION

We expect continued large numbers of self-reporting obligated settlements in 2016. We also expect a large amount of regulation and enforcement activity with regards to the SEC. The efforts to crack down on regulation and enforcement on the municipal front continue a multi-year campaign by the MSRB and the SEC to address key market weaknesses and practices identified in the 2012 report. Such enforcement activity is expected to continue at least until a new administration takes over the White House in January 2017.

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

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

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ENDNOTES

i. The SEC currently only has antifraud authority over issuers of municipal securities. ^

ii. Each of the following SEC enforcement actions were issued on June 18, 2015: ^
In the Matter of The Baker Group, LP, SEC Admin. Proc. No. 3-16605;
In the Matter of B.C. Ziegler and Company, SEC Admin. Proc. No. 3-16606;
In the Matter of Benchmark Securities, LLC, SEC Admin. Proc. No. 3-16607;
In the Matter of Bernardi Securities, Inc., SEC Admin. Proc. No. 3-16608;
In the Matter of BMO Capital Markets GKST Inc., SEC Admin. Proc. No. 3-16609;
In the Matter of BOSC, Inc., SEC Admin. Proc. No. 3-16611;
In the Matter of Central States Capital Markets, LLC, SEC Admin. Proc. No. 3-16612;
In the Matter of Citigroup Global Markets, Inc., SEC Admin. Proc. No. 3-16613;

In the Matter of City Securities Corporation, SEC Admin. Proc. No. 3-16614;
In the Matter of Davenport & Company, LLC, SEC Admin. Proc. No. 3-16615;
In the Matter of Dougherty & Co., LLC, SEC Admin. Proc. No. 3-16616;
In the Matter of First National Capital Markets, Inc., SEC Admin. Proc. No. 3-16617;
In the Matter of George K. Baum & Company, SEC Admin. Proc. No. 3-16618;
In the Matter of Goldman, Sachs & Co, SEC Admin. Proc. No. 3-16619;
In the Matter of Hutchinson, Shockey, Erley & Co., SEC Admin. Proc. No. 3-16620;
In the Matter of J.P. Morgan Securities LLC, SEC Admin. Proc. No. 3-16621;
In the Matter of L.J. Hart and Company, SEC Admin. Proc. No. 3-16622;
In the Matter of Loop Capital Markets, LLC, SEC Admin. Proc. No. 3-16623;
In the Matter of Martin Nelson & Co., Inc., SEC Admin. Proc. No. 3-16624;
In the Matter of Merchant Capital, LLC, SEC Admin. Proc. No. 3-16625;
In the Matter of Merrill Lynch, Pierce, Fenner & Smith Inc., SEC Admin. Proc. No. 3-16626;
In the Matter of Morgan Stanley & Co. LLC, SEC Admin. Proc. No. 3-16627;
In the Matter of The Northern Trust Company, SEC Admin. Proc. No. 3-16628;
In the Matter of Oppenheimer & Co. Inc., SEC Admin. Proc. No. 3-16629;
In the Matter of Piper Jaffray & Co., SEC Admin. Proc. No. 3-16630;
In the Matter of Raymond James & Associates, Inc., SEC Admin. Proc. No. 3-16631;
In the Matter of RBC Capital Markets, LLC, SEC Admin. Proc. No. 3-16632;
In the Matter of Robert W. Baird & Co. Incorporated, SEC Admin. Proc. No. 3-16633;
In the Matter of Siebert Brandford Shank & Co., LLC, SEC Admin. Proc. No. 3-16634;
In the Matter of Smith Hayes Financial Services Corporation, SEC Admin. Proc. No. 3-16635;
In the Matter of Stephens Inc., SEC Admin. Proc. No. 3-16636;
In the Matter of Sterne, Agee & Leach, Inc., SEC Admin. Proc. No. 3-16637;
In the Matter of Stifel, Nicolaus & Company, Inc., SEC Admin. Proc. No. 3-16638;
In the Matter of Wells Nelson & Associates, LLC, SEC Admin. Proc. No. 3-16639;
In the Matter of William Blair & Co., LLC, SEC Admin. Proc. No. 3-16640.

iii. See e.g., *In the Matter of The Baker Group, LP*, SEC Admin. Proc. No. 3-16605, 2 (June 18, 2015) available at http://www.sec.gov/litigation/admin/2015/33-9811.pdf. (The example cited is one of the thirty-six SEC settlements made on June 18, 2015. Each settlement is textually identical except for parties and specific factual instances of violations.) ^

iv. Each of the following SEC enforcement actions were issued on September 30, 2015: ^
In the Matter of Ameritas Investment Corp., SEC Admin. Proc. No. 3-16860.
In the Matter of BB&T Securities, LLC, SEC Admin. Proc. No. 3-16861.
In the Matter of Comerica Securities, Inc., SEC Admin. Proc. No. 3-16862.
In the Matter of Commerce Bank Capital Markets Group, SEC Admin. Proc. No. 3-16863.
In the Matter of Country Club Bank, SEC Admin. Proc. No. 3-16864.
In the Matter of Crews & Associates, Inc., SEC Admin. Proc. No. 3-16865.
In the Matter of Duncan-Williams, Inc., SEC Admin. Proc. No. 3-16866.
In the Matter of Edward D. Jones & Co., L.P., SEC Admin. Proc. No. 3-16867.
In the Matter of Estrada Hinojosa & Company, Inc., SEC Admin. Proc. No. 3-16874.
In the Matter of Fifth Third Securities, Inc., SEC Admin. Proc. No. 3-16853.
In the Matter of The Frazer Lanier Company, Incorporated, SEC Admin. Proc. No. 3-16854.
In the Matter of J.J.B. Hilliard, W.L. Lyons, LLC, SEC Admin. Proc. No. 3-16855.
In the Matter of Joe Jolly & Co., Inc., SEC Admin. Proc. No. 3-16856.
In the Matter of Mesirow Financial, Inc., SEC Admin. Proc. No. 3-16857.
In the Matter of Northland Securities, Inc., SEC Admin. Proc. No. 3-16858.
In the Matter of NW Capital Markets Inc., SEC Admin. Proc. No. 3-16859.
In the Matter of PNC Capital Markets LLC, SEC Admin. Proc. No. 3-16868.
In the Matter of Prager & Co., LLC, SEC Admin. Proc. No. 3-16869.
In the Matter of Ross, Sinclaire & Associates, LLC, SEC Admin. Proc. No. 3-16870.
In the Matter of UBS Financial Services, Inc., SEC Admin. Proc. No. 3-16871.
In the Matter of UMB Bank, N.A. Investment Banking Division, SEC Admin. Proc. No. 3-16872.
In the Matter of U.S. Bank Municipal Securities Group, SEC Admin. Proc. No. 3-16873.

v. *Commerce Bank Capital Markets Group*, SEC Admin. Proc. No. 3-16863, 3 (Sept. 30, 2015) *available at* http://www.sec.gov/litigation/admin/2015/33-9951.pdf. ^

vi. Complaint, *SEC v. Brogdon*, (Nov. 20, 2015) *available at* http://www.sec.gov/litigation/complaints/2015/comp-pr2015-264.pdf. ^

vii. *Edward D. Jones & Co., L.P.*, SEC Admin. Proc. No. 3-16751, 2 (Aug. 13, 2015) available at http://www.sec.gov/litigation/admin/2015/33-9889.pdf. ^

viii. *Id.* at 8-9. ^

ix. *Id.* ^

x. Complaint, *SEC v. Oppenheim*, (Apr. 16, 2015) *available at* http://www.sec.gov/litigation/complaints/2015/comp-pr2015-68.pdf. ^

xi. *Citigroup Alternative Investments LLC and Citigroup Global Markets Inc.*, SEC Admin. Proc. No. 3-16757, 4 (Aug. 17, 2015) *available at* https://www.sec.gov/litigation/admin/2015/33-9893.pdf. ^

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

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