Ballard Spahr LLP

Municipal Securities Regulation & Enforcement

THE MUNICIPAL SECURTIES REGULATION AND ENFORCEMENT GROUP SUMMER 2019

If the first half of the year is any indication, 2019 will be a very active year for municipal securities regulation and enforcement.

Amendments to Rule 15c2-12

The most notable rulemaking event in the first quarter was the effective date of the new amendments to Rule 15c2-12. Designed to provide more transparency in the market and address the need for timely disclosure of important information related to an issuer's or obligated person's financial obligations, the new amendments took the issuer community by storm.

As discussed in our legal alert about the implementation of amendments to Rule 15c2-12, on February 27, 2019 the new amendments became effective and expanded the types of disclosures required under a continuing disclosure agreement from 14 to 16 material events. The impact of the amendments has had varying effects on issuers across the country. Generally, larger issuers and more frequent issuers have gotten ahead of the curve, posting financial obligations before the effective date of the amendments. Mid-size and smaller issuers—as well as those who file less frequently—have been hit hardest with challenging questions of materiality and types of financial obligations that have to be reported and the content of such disclosures.

Regulation Best Interest

The second quarter saw the U.S. Securities and Exchange Commission's (SEC) adoption on June 5, 2019 of "Regulation Best Interest," rulemaking designed to enhance the quality and transparency of retail investors' relationships with investment advisors and broker-dealers. Regulation Best Interest establishes a standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer when they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities. Regulation Best Interest enhances the broker-dealer standard of conduct beyond existing suitability obligations and aligns the standard of conduct with retail investor expectations, while preserving access (in terms of choice and cost) to a variety of investment services and products. Read the final rule here.

Municipal Securities Enforcement Activity

Municipal securities enforcement activity in the first half of 2019 ranged from Financial Industry Regulatory Authority (FINRA) fines for failure to disclose past business failures and failure to accurately report trades to the 38 Studios case settlement with the SEC to whistleblower variable rate demand obligation (VRDO) suits filed on the heels of last year's release of the Edelweiss VRDO suit in Illinois. Additionally, retail investor protections continue to be a focus for the SEC. 2018 saw enforcement actions brought against nearly two dozen parties for diverting bonds from retail investors to broker-dealers, and the focus on retail investor protections is expected to continue through 2019. The Office of Compliance Inspections and Examinations (OCIE) also included retail investor matters and select programs of FINRA and the Municipal Securities Rulemaking Board (MSRB) as two of its examination priorities for 2019. A summary of enforcement actions for the first half of 2019 is provided below.

Finally, the MSRB also was active in the first half of 2019, announcing the effective date of rule changes for amendments to MSRB Rules G-20 and G-41, announcing proposed rule changes to Rules G-11 and the SHORT reporting system, and requesting comment on interpretive guidance for prearranged trading and CUSIP requirements with respect to municipal advisors.

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ENFORCEMENT ACTIONS

FINRA Fines Firm for Failure to Reveal Past Business Failures

On January 16, 2019, FINRA fined a brokerage firm and its two top officers $223,000 for failure to disclose material information in connection with the sale of securities and for failure of the Chief Compliance Officer (CCO) in her duty of supervision.

The 2015 complaint alleged that, when marketing more than $8 million worth of certificates of participation tied to real estate ventures, the firm highlighted its president's decades of business successes but failed to reveal his past business failures. Those failures included two National Association of Securities Dealers bans, two bankruptcies, criminal fraud charges, and substantial liens against a company he controlled. FINRA's National Adjudicatory Council held that the full history should have been disclosed, explaining the firm was "selling [its president's] experience and integrity, and as such had an obligation to investors to include factual information that reflected business misconduct." The amount of time—five to 24 years—between the incidents of misconduct and current marketing did not render the history immaterial.

The firm's CCO also was disciplined for failing to supervise the president. The CCO was required by the firm's own written supervisory procedures to review the president's emails to ensure that he performed due diligence with respect to securities offerings. Although she knew of the substantial losses sustained by the offerings, among other things, the CCO failed to inform investors of any financial issues. The decision serves as a reminder that a compliance officer's supervisory obligations can extend to supervision of superiors. The full FINRA National Adjudicatory Council decision can be found here.

FINRA Settlement Regarding Inaccurate Trade Reports

On January 31, 2019, a New York-based dealer firm—while neither admitting nor denying the findings—agreed to pay a $25,000 fine to settle FINRA charges that it failed to accurately report trades and maintain an adequate supervisory system. According to the complaint, firm employees did not enter the times of execution for its municipal securities transactions to the Real Time Transaction Reporting System required by MSRB Rule G-14, leading the system to record the time of entry into the system as the transaction time. FINRA alleged that this constituted a violation of MSRB Rule G-14, which requires dealers to report sales and purchase information "promptly, accurately, and completely."

FINRA also claimed the dealer firm violated MSRB Rule G-27, which requires firms to maintain written supervisory procedures "reasonably designed" to ensure compliance with securities laws and MSRB rules. The firm allegedly instructed its personnel to manually enter the transaction times, but failed to require or complete any supervisory reviews to certify accurate reporting.

Along with the fine, the firm has formulated new reporting instructions and has hired an employee to improve the firm's internal auditing. The Letter of Acceptance, Waiver and Consent can be viewed here.

Whistleblower VRDO Cases Filed in Four States

On March 8, 2019, an amended complaint alleging $100 million in fraudulent charges by multiple banks was filed in Massachusetts court, making it the latest in a series of unsealed whistleblower lawsuits. The suit initially was brought on behalf of Edelweiss Fund LLC, an entity formed specifically to pursue this litigation, but the Massachusetts court ruled that a company cannot act as a relator in a False Claims Act suit. It allowed the complaint to be amended to name an individual as the plaintiff.

The whistleblower suits have been filed in California, Illinois, Massachusetts, and New York, with plaintiffs collectively seeking to recover more than $1 billion. On May 31, 2019, Philadelphia and Baltimore, which each had filed separate similar suits, refiled amended complaints in a New York federal court, consolidating the similar claims with those already filed.

The lawsuits allege fraud by banks acting as remarketing agents in the VRDO market. The dealer firms allegedly promised to use their judgment to market and price the bonds at the lowest possible interest rates. Rather than resetting the rates individually as required, the banks are charged with engaging in a scheme to "mechanically set the rates *en masse* without due consideration of the individual characteristics of the bonds or the associated market conditions," thereby resulting in artificially high rates. Plaintiffs claim the higher interest rates then discouraged VRDO investors from redeeming the bonds.

SEC Action for Failure to Disclosure Conflict of Interest

On March 15, 2019, the SEC charged a former county manager for improperly providing—and failing to disclose to pension fund board members—an unfair competitive advantage to the investment advisor selected to manage more than $400 million of pension fund assets.[i]

i. *SEC v. Walker*, Case No. No. 5:19-cv-00097 (Mar. 15, 2019).

The SEC alleged that the former county manager had an undisclosed personal relationship with an individual associated with the advisor. In the request for proposal process, the former county manager allowed the advisor to review the proposals submitted by competitors and provide an analysis of the proposals and a numerical ranking of the potential investment advisors. The advisor ranked itself first, ahead of all other proposers. The former county manager then provided the analysis and rankings, without disclosing they had been drafted by the advisor, to three pension fund boards along with his own memos and recommendation that the advisor be selected as investment advisor.

Without admitting or denying the SEC's allegations, the former county manager consented to a final judgement enjoining him from violating the antifraud provision of Section 206(2) of the Investment Advisors Act of 1940 and ordering him to pay a $10,000 civil penalty. The former county manager also is prohibited from participating in the selection of market professionals on behalf of a government entity.

In recent years, the SEC has more frequently imposed personal liability on municipal officials. These actions were for intentionally and negligently violating the antifraud provisions of federal securities laws, aiding and abetting, and control person liability. For example, see our prior alert covering the SEC's action against Allen Park, Michigan.

SEC Action for Failure to Disclose Funding Issues and Conflict of Interest

On March 20, 2019, a municipal securities dealer agreed to pay an $812,500 civil penalty to settle an SEC lawsuit over a failed deal with now-defunct video game company, 38 Studios.

Former Boston Red Sox pitcher Curt Schilling founded 38 Studios in Massachusetts in 2006, but relocated the company to Rhode Island in 2010 after striking a deal with the state's economic development agency for a $75 million loan. After releasing a single game, 38 Studios filed for bankruptcy in 2012, leading Rhode Island to file a lawsuit against Mr. Schilling and the company's other backers.

The SEC later charged the dealer with securities fraud, claiming it failed to notify investors that 38 Studios needed at least $75 million to produce its first video game but would receive only $50 million of proceeds from the bond offering, leaving a $25 million shortfall. It also asserted that the dealer should have disclosed that it was representing both the video game company and the state economic development agency as the agency's bond placement agent. The dealer agreed to pay the $812,500 civil penalty without admitting any wrongdoing to settle the suit.

Following the dealer's settlement, the lawsuit remained continued against the dealer's employee, who was the lead banker in the deal. The employee was accused of misleading investors during the bond offering. In an ultimately successful motion for summary judgment, the banker argued that the SEC failed to provide any evidence to support its allegations that he had acted recklessly. His attorneys stated in a press release that their client "did not encounter any red flags when preparing documents related to [the municipal bond offering]." On June 12, 2019, the district court granted the banker's motion for summary judgment.

SEC Action for Concealing Deteriorating Financial Condition

On March 28, 2019, the SEC charged a former college controller for hiding the college's deteriorating financial condition from municipal securities investors.[ii] According to the SEC's complaint, the former controller took a number of steps to conceal the effects of the college's declining student enrollment and decreasing tuition revenue.

The SEC alleges that the former controller was the primary author and preparer of the college's fiscal year 2015 financial statements, and certified their accuracy. The former controller took steps to hide the college's financial stress, including falsifying financial records, not filing payroll tax submissions, and not determining the collectability of pledged donations. In its fiscal year 2015 financial statements, the college's net assets were overstated by $33.8 million as a result of the former controller's actions. The fiscal year 2015 financial statements were posted on the MSRB's EMMA website pursuant to the college's continuing disclosure obligations.

The SEC alleges that the former college controller engaged in intentional securities fraud in violation of 10(b) of the Exchange Act or, alternatively, aided and abetted in the violation of securities laws.

In its press release announcing the action, LeeAnn Ghazil Gaunt, Chief of the SEC Enforcement Division's Public Finance Abuse Unit, stated that "[f]inancial difficulties are no excuse for engaging in accounting misconduct and concealing critical information from investors."

ii. *SEC v. Borge*, Case No. 1:19-cv-02787 (Mar. 28, 2019).

When a municipality or other obligated person faces financial stress, the SEC will review the primary and secondary market disclosure, or lack thereof, regarding the financial decline. Material misstatements or material omissions related to financial decline has formed the basis of other recent SEC actions, including against the Town of Ramapo, New York, and City of Harrisburg, Pennsylvania.

Oyster Bay, NY settles SEC Fraud Charges

On June 7, 2019, the SEC announced a settlement with the Town of Oyster Bay, New York. The SEC had brought charges in November 2017 against Oyster Bay and a former town supervisor for defrauding investors in the town's municipal securities offerings.

In its complaint, the SEC alleged that Oyster Bay agreed to indirectly guarantee four private loans totaling more than $20 million to a local businessman who owned and operated restaurants at several town facilities. The agreement allegedly stemmed from the vendor's longstanding relationship with certain town officials that involved gifts, bribes, kickbacks, and political support.

The town did not disclose the loan guarantees during its 26 subsequent securities offerings between August 2010 and December 2015. The complaint asserted that the guarantees were material to investors due to the potential impact on the town's finances. The complaint alleged that in one scenario, the town could have been required to make a termination payment of approximately $16 million (approximately 16 percent of the town's operating budget) within 60 days if the vendor defaulted on its loans.

In its settlement of the suit, Oyster Bay agreed to permanent injunctions against violating the antifraud provisions of Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 and to retain an independent consultant to advise the town on its policies, procedures, and internal controls regarding its disclosures for securities offerings.

SEC Action for Violation of MSRB's "Fair Dealing" Rule

On June 27, 2019, the SEC settled an administrative proceeding against a broker-dealer, finding that the dealer violated MSRB Rule G-17 and Section 15B(c)(1) of the Securities and Exchange Act of 1934 in connection with its underwriting of the Harvey, Illinois Public Library District $6,000,000 municipal bond offering in 2015. The order states that the dealer did not act with reasonable care in underwriting the bonds and, when it had difficulty finding investors for the bonds, sold all of bonds to another broker-dealer at a price that was not fair and reasonable to the district.

The SEC noted that the district's bonds were insured and "bank qualified," both features of which would in theory make these bonds appealing to certain classes of investors. Despite the fact that the bonds were insured (and therefore rated investment grade), the dealer had difficulty finding buyers and encountered investor confusion about the relationship between the district and the City of Harvey, which had been the subject of its own prior SEC enforcement action. The SEC noted that the dealer did not contact potential investors until a few business days before the planned order period, and at that time the bond insurance was not yet confirmed. Once the bond insurance was confirmed—on the evening of the planned start of the order period—the planned order period was postponed one business day. The SEC found that the dealer made insufficient attempts to market the bonds to regional or community banks and did not reasonably manage the marketing of the bonds. The SEC considered the marketing effort unreasonable under the circumstances, particularly given that the district was a first-time issuer.

Additionally, the SEC alleged that the bonds were sold at a price that was not fair and reasonable. The bonds initially were sold only to a single investor, at a premium price of 115.73 and a 5.05% yield and were sold on the same day by the initial purchaser to a client at a price of 116.15 and a 5.0% yield. They were sold again approximately one month later to an investment bank at a price of 122.35 and a 4.3% yield, then immediately sold to six customers of the investment bank (all small regional banks) at a price of $124.86 and a 4.0% yield.

The SEC order states that the dealer violated MSRB Rule G-17 as to a duty of an underwriter to deal fairly with issuers of municipal securities. Without admitting or denying the findings, the dealer agreed to a censure, an order to engage an independent compliance consultant, and the payment of a $50,000 civil penalty.

MSRB ACTIONS

MSRB Request for Comments: Prearranged Trading Guidance

On January 3, 2019, the MSRB published a request for comments regarding a draft interpretive guidance concerning municipal securities dealers in connection with primary offerings. The draft guidance aims to remind dealers engaged in certain prearranged trading of existing MSRB requirements under Rules G-11 and G-17. The guidance focuses primarily on a scenario in which a dealer that is not a member of an underwriting syndicate or selling group (a non-member dealer) enters into a prearranged trade to purchase bonds from an underwriting syndicate or selling group member or investor (a member dealer). Priority provisions governing the allocation of bonds generally give priority to customer orders over orders by dealers for their own accounts. In the described scenario, the non-member dealer secretly purchases bonds using a member dealer as a proxy, with an explicit or implicit shared assumption that, when the order is placed, the non-member dealer's interest in the order will not be properly disclosed. The order subsequently will appear to be a customer order and receive a higher priority allocation than the non-member dealer would receive by purchasing the bonds directly.

The draft guidance cautions that purchasing bonds in such a manner violates the disclosure requirements of Rule G-11. Additionally, this type of prearranged trading is likely to negatively impact the fairness and efficiency of the overall municipal securities market and is, therefore, a violation of Rule G-17. The comment period for the draft guidance closed March 5, 2019.

MSRB Proposed Rule Change: SHORT System Information Facility

On February 25, 2019, the MSRB filed a proposed rule change related to its Short-Term Obligation Rate Transparency (SHORT) system information facility. The SHORT system was implemented in 2009 to collect and disseminate interest rate and descriptive information regarding auction rate securities and variable rate demand obligations. The proposed changes will not substantively affect users, but rather revise or remove certain language within the system information facility to reflect recent updates to the EMMA and Real-Time Transaction Reporting System (RTRS) and to streamline the operation of the SHORT system.

The comment period for the proposed change ended March 26, 2019. As a noncontroversial rule change, the proposal was made operative on April 8, 2019.

MSRB Approved Rule Change: Advertising Rules

On February 26, 2019, the MSRB announced an effective date of August 23, 2019 for amendments to MSRB Rule G-21 and Rule G-40, along with new guidance concerning those rules. Rule G-21 addresses advertising by brokers, dealers, and municipal securities dealers, while Rule G-40 concerns advertising by municipal advisors. The amended rules exempt certain interactive content from the requirement that advertisements receive principal approval prior to distribution. "Interactive content" refers to material that is posted or disseminated for real-time interaction with an audience in an interactive electronic forum, such as a direct chat or messaging program. Dealers still will be required to manage such correspondence under current supervisory requirements.

The related guidance takes the form of frequently asked questions and attempts to clarify the application of the advertising rules to social media usage. Most notably, the FAQs reveal the MSRB's expansive understanding of what may constitute an advertisement. Any material relating to a dealer's or advisor's products or services and made available to the public through electronic media may be covered by the advertising rules, even if published on an associated individual's personal social media account.

MSRB Request for Comments: The CUSIP Requirement

On February 27, 2019, the MSRB published a request for comments regarding MSRB Rule G-34(a)(i)(A)(3) (the CUSIP Requirement), which requires a municipal advisor advising an issuer with respect to a competitive sale of a new issue of municipal securities to apply for the assignment of a CUSIP number or numbers with respect to such issue within a specified time frame. A 2017 amendment to the rule extended the CUSIP Requirement to all municipal advisors, whether dealer or non-dealer. The MSRB states it is taking a retrospective review of this requirement due to "the market's experience with the rule in operation" and the "burden on municipal advisors in practice" as well as stakeholder input received by the MSRB since the implementation of the amendment. The comment deadline was May 28, 2019.

MSRB Proposed Rule Change: Primary Offering Practices and Disclosures

On March 21, 2019, the MSRB announced a proposed rule change to amend MSRB Rule G-11 on primary offering practices and MSRB Rule G-32 on disclosures in connection with primary offerings. The MSRB published MSRB Notice 2019-15 on June 28, 2019 that the SEC approved the proposed rule changes. The compliance date for amendments to Rule G-11 and G-32 will be January 13, 2020.

The proposed amendments to Rule G-11 would, among other things, codify the existing requirement that selling group members comply with issuer terms and conditions, priority provisions, and other requirements as communicated. In addition, the proposed amendments would require the senior syndicate manager to communicate concurrently to all syndicate and selling group members when an issue is free to trade. Proposed amendments to Rule G-32 include requiring each underwriter in an advance refunding (if and when advance refundings become permissible again in the future) to submit relevant documentation to EMMA within a certain timeframe so that all market participants have equal access to the information.

The proposed rule changes mark the conclusion of the MSRB's two-year effort to review its rules on primary offering practices in the municipal securities market.

MSRB Request for Comments: Rule G-23 on Activities of Dealers Acting as Financial Advisors

On May 20, 2019, the MSRB published a request for comments regarding MSRB Rule G-23 on activities of dealers acting as financial advisors. Rule G-23 establishes ethical standards and disclosure requirements for dealers who act as financial advisors to issuers with respect to the issuance of municipal securities. The MSRB lists the principal goal of its review of Rule G-23 as determining "whether the rule is appropriately aligned" with recent significant changes in the regulatory landscape. Ten questions are posited for examination, including: (1) Has the rule been effective in addressing the conflict of interest that exists when a dealer acts both as a financial advisor and an underwriter? (2) Have small and/or infrequent issuers experienced any particularized benefits or costs due to the rule? (3) Are there ways the MSRB could achieve Rule G-23's purpose without retaining it as a standalone rule? (4) Should any amendments be made to the Role Switching Exceptions included in the rule?

The comment deadline is August 19, 2019.

CONCLUSION

We expect to see the MSRB address responses to the various proposed rule changes and requests for comments put out in the first half of 2019. We also expect a large volume of regulation and enforcement activity by the SEC, particularly concerning retail investor protections, where the SEC and OCIE have emphasized a focus on matters of importance to retail investors. We also expect to see new regulatory guidance related to the definition of, and distinction between, broker-dealer activity and municipal advisor activity. In October of 2018, PFM Financial Advisors LLC (PFM), the market leader in municipal advisory services, submitted a letter to the SEC's Division of Trading and Markets and the SEC's Office of Municipal Securities requesting interpretive guidance that a non-dealer municipal advisor would not be required to register as a broker-dealer if it engages in certain specified activities related to direct placements of municipal debt. Since regulators generally consider placement agent activity to be broker-dealer activity, this request has trained a light on a gray area between two separate regulatory regimes, and the respective duties they impose upon separately regulated entities, in connection with the issuance of municipal securities. The request for interpretive guidance has raised concern and opposition within the broker-dealer community as both SIFMA and the Bond Dealers of America submitted letters to the SEC in June 2019 in response to PFM's letter asking that PFM's request be denied.