Ballard Spahr LLP

Municipal Securities Regulation & Enforcement

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The second half of 2019 saw U.S. Securities and Exchange Commission (SEC) enforcement activity focused on municipal adviser registration and investor protections in addition to continued review of Municipal Securities Rulemaking Board (MSRB) rules and guidance.

Municipal Securities Activity

Of particular note across the municipal securities industry is the pending request by the market leader in municipal advisory services, PFM Financial Advisors LLC (PFM), from October 2018 to the SEC's Division of Trading and Markets and the SEC's Office of Municipal Securities seeking interpretive guidance that a non-dealer municipal adviser 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 shines a bright light on a gray area overlapping 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 the Securities Industry and Financial Markets Association (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. Despite such opposition, on October 2, 2019, the SEC issued a proposed exemptive order granting a conditional exemption from the broker registration requirements of Section 15(a) of the Securities and Exchange Act of 1934 (the Exchange Act) for certain activities of registered municipal advisers, including acting as a placement agent in connection with the direct placement of municipal securities. Comments were due December 9, 2019.

In the second half of 2019, the MSRB announced the effective date of rule changes for MSRB Rules G-11 and G-32, approved amendments to underwriters' fair dealing obligations under Rule G-17, and eliminated certain CUSIP requirements under Rule G-34.

For background on activities in the first half of 2019, see our MSRE 2019 Mid-Year Newsletter.

ENFORCEMENT ACTIONS

SEC Settles Charges of Unregistered Activities and Failure to Register as a Solicitor Municipal Adviser

On July 16, 2019, the SEC settled charges against a municipal advisory firm, a consulting firm, and an individual for failure to register as a solicitor municipal adviser under Section 15B(a)(1)(B) of the Exchange Act. The SEC charged the consulting firm and individual with soliciting municipal advisory business without properly registering as municipal advisers with the SEC. The municipal advisory firm engaged the consulting firm to solicit new municipal advisory clients on the advisory firm's behalf. The consulting firm communicated with school district clients to solicit them to hire the municipal advisory firm to provide services in connection with the sale of municipal bonds and to secure meetings between school districts and the municipal advisory firm. The municipal advisory firm paid the consulting firm a percentage of its earned fees from the new clients that had been solicited by the consulting firm. Between

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October 2011 and March 2016, the municipal advisory firm had also engaged two other unregistered parties to, among other things, solicit municipal advisory business on its behalf.

Without admitting or denying wrongdoing, the consulting firm and individual agreed to pay penalties of $10,000 each, and the municipal advisory firm agreed to pay a penalty of $25,000. All parties agreed to cease and desist from future violations. Read the cease and desist order for the municipal advisory firm here and the cease and desist order for the consulting firm here.

FINRA Settles Two Cases of Violation of Fair Dealing Rules

On August 1, 2019, the Financial Industry Regulatory Authority (FINRA) reached a settlement with a brokerage firm relating to violations of fair dealing rules and trade reporting rules. Between October 2015 and September 2017, FINRA alleged that the firm failed to report 892 TRACE-eligible (Trade Reporting and Compliance Engine) transactions and failed to timely report 364 municipal securities transactions to the MSRB's Real-Time Reporting System in violation of MSRB Rule G-14. FINRA also alleged the firm violated Rule G-27 on supervisory duties when it failed to supervise the conduct of the municipal securities activities of its broker/dealers to ensure compliance with MSRB rules, and violated Rule G-17 on fair dealing when it produced altered monthly MSRB reports to FINRA. Altered information included backdating dates when the reports were purportedly reviewed, or redacting dates when reports were generated. Without admitting or denying the findings, the firm agreed to pay $200,000 in sanctions; consented to the entry of findings that it failed to report, timely report, and/or correctly report securities transactions; and was required to review and revise its systems and procedures related to trade reporting.

Also on August 1, 2019, FINRA charged a principal at a municipal securities dealer with violation of MSRB Rule G17 when she failed to disclose that a "development fee" paid to a third party, at the request of a conduit borrower's board member, was included as a cost of issuance without proper disclosure that the fee would allegedly benefit the board member personally. Serving as municipal securities dealer in a conduit issuance to refinance a company's debt, the underwriter was approached by a member of the company's board who requested a $2 million development fee be paid from proceeds of a municipal securities offering to a second entity that was controlled by the board member. The borrower company had not specifically authorized the $2 million development fee payment, but the underwriter made provisions in the offering for the payment of the fee anyway. The underwriter ultimately disclosed the fee to the company shortly before the bonds were issued, and the payment was returned to the company as part of a settlement after litigation was filed. Without admitting or denying the findings, the underwriter agreed to pay a $7,500 fine and was suspended for three months from associating with any FINRA member firm.

SEC Charges Broker-Dealer Firm for Recommending Unsuitable Municipal Bond Transactions

On September 17, 2019, the SEC announced administrative and cease-and-desist proceedings against a broker-dealer firm for allegedly recommending unsuitable municipal bond transactions to its customers. From June 2013 through December 2017, the firm recommended 135 transactions to its retail customers in which the customer sold one municipal bond while purchasing another nearly identical municipal bond or bond that did not provide an economic benefit to the customer, and for which the firm received over $340,000 in commissions and fees. Such fees were returned to customers during the course of the SEC investigation. The firm also did not document information about the suitability of the recommendation of the transaction for its customers. The order found that the firm violated Section 15B(c)(1) of the Exchange Act and MSRB Rules G-8, G-17, G-19, and G-27. Without admitting or denying the findings, the firm consented to a censure and paid a $225,000 civil penalty.

FINRA Fines Firm for Mislabeling Municipal Securities

On September 18, 2019, FINRA settled charges against a New York-based firm for allegations of 13,442 instances of inaccurately logging municipal securities trades as unsolicited, even though they were solicited. A solicited trade occurs when a broker recommends the transaction as opposed to an unsolicited trade when the investor itself initiates the transaction. Between September 2012 and April 2015, the firm mismarked 12,387 trades—90 percent of the firm's municipal securities during that time. Even after these errors were discovered in April 2016, the percent of mislabeled municipal securities remained at approximately 14 percent of all such trades over the course of the next 20 months. The FINRA investigation stemmed from errors discovered in a trade blotter during a routine regulatory exam in 2016. The issue was corrected in 2017. Customers did not experience financial harm, and the inaccurate information was not disseminated to

the market. Without admitting or denying the findings, the firm consented to a $100,000 fine ($70,000 of which relates to MSRB violations) and to the entry of findings that it failed to make and keep accurate records of customer confirmation and trade blotters.

SEC Charges Los Angeles County School District and Two Officials with Defrauding Investors in $100 Million Bond Offering

On September 19, 2019, the SEC filed a complaint charging a school district, its former Chief Business Officer, and its Superintendent with violating the antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5, as well as Section 17(a) of the Securities Act of 1933, as amended (the Securities Act). The charges specifically included defrauding investors by failing to disclose fraud and internal controls concerns raised by the school district's auditor in connection with the school district's sale of $100 million of general obligation bonds in December 2016. The independent auditor had repeatedly raised concerns about allegations of fraud and control issues to the board of education and school district management. The school district fired the audit firm and proceeded with the bond offering, failing to disclose the allegations of fraud and mismanagement to investors. The school district included the prior year's "clean" audit in the offering document. The SEC complaint alleges that the former Chief Business Officer helped prepare misleading offering documents and that the Superintendent of Schools signed the final bond offering document and made false certifications in connection with the issuance of the bonds. Without admitting or denying the findings, the school district and Superintendent of Schools agreed to settle with the SEC. The school district was ordered to cease and desist from future violations of the antifraud provisions of the Exchange Act and Securities Act and to engage an independent consultant to evaluate policies and procedures related to its municipal securities disclosure. The Superintendent of Schools was ordered to cease and desist from future violations of the antifraud provisions of the Exchange Act and Securities Act and also ordered to pay a $10,000 penalty.

FINRA Fines Firm for Failure to Timely Submit Interest Rate Reset Information

On October 14, 2019, FINRA reached settlement with a municipal securities dealer for failing to make timely submissions or to submit accurate information regarding the result of an interest rate reset for variable rate demand obligations to the MSRB's Short-Term Obligation Rate Transparency (SHORT) system. The findings stated that the firm failed to establish and maintain a supervisory system, including written supervisory procedures, reasonably designed to achieve compliance with its obligation to make accurate and timely submissions to the SHORT system. Without admitting or denying the findings, the firm agreed to pay a fine of $25,000 and was required to revise its written supervisory procedures.

Whistleblower VRDO Cases – Decisions Loom

As described in our 2019 Mid-Year Newsletter, lawsuits were filed in California, Illinois, Massachusetts, and New York (joined with suits filed by the Cities of Philadelphia and Baltimore) alleging fraud against several investment banks acting as remarketing agents in the Variable Rate Demand Obligation (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.

On July 16, 2019, an Illinois intermediate appellate court denied a motion for interlocutory appeal filed by some of the investment banks named in the lawsuits on the basis that "there is substantial ground for difference of opinion as to whether the trial court should consider the nature of the information relied upon in deciding the original-source question."

On July 23, 2019, the Massachusetts Superior Court dismissed the Massachusetts lawsuit on the basis that the "public disclosure bar," a legal standard existing to prevent whistleblowers from filing lawsuits supported by information that was already known to the public, applies to the allegations.

In late July, attorneys for several of the banks filed a motion to dismiss the New York, Philadelphia, and Baltimore lawsuits in the U.S. District Court for the Southern District of New York. Responses to the motion to dismiss were filed in October and November by attorneys for the Cities of Philadelphia and Baltimore, and the Edelweiss Fund with respect to the New York lawsuit.

The California Superior Court ruled that the complaint needed more specificity before allowing the court to consider it further and asked the plaintiffs to file an amended complaint by October 8, 2019. The amended complaint contains additional detail regarding remarketing reset rates and the alleged "bucketing" of VRDOs.

MSRB ACTIONS

MSRB Eliminates Year-Old Rule Requiring All Municipal Advisers to Apply for a CUSIP in Competitive Sales

In July 2019, the MSRB decided to eliminate Rule G-34's requirement that all municipal advisers, whether dealer or non-dealer, must apply for a CUSIP number when advising in competitive municipal securities sales. This requirement originally became effective June 14, 2018. However, through the comment process, the MSRB learned that the requirement imposed on municipal advisers outweighed the limited benefit to market functionality, and that no real market harm was being remedied with the provision. Before the repeal can become effective, the MSRB must still file the change with the SEC and get SEC approval. Even with the repeal of the requirement, issuers can still request that their municipal advisers obtain CUSIP numbers on the issuer's behalf.

SEC Approves Amendments to Interpretive Guidance Related to Underwriters' Fair Dealing Obligations under Rule G-17

An ongoing topic of discussion in the second half of 2019 has been proposed amendments to the regulatory framework around an underwriter's obligation to deal fairly with issuers. In June of 2018, the MSRB publicly announced a retrospective review of its August 2, 2012, Interpretive Notice on the conduct of municipal securities and municipal advisory activities (the Interpretive Notice) and then followed up with a request for comment on November 16, 2018. The goal of the retrospective review was to update and streamline certain underwriter disclosure obligations and bring them current with current market practices.

On August 1, 2019, the MSRB filed with the SEC proposed amendments to the Interpretive Notice. After receiving additional comment letters on the proposed amendments, the MSRB filed Amendment No. 1 on October 7, 2019, and Amendment No. 2 on October 25, 2019, to identify who needs to provide specific disclosures to an issuer, to clarify obligations when an underwriter is acting as a placement agent on behalf of an issuer, and to make certain technical revisions. The MSRB received approval from the SEC on November 6, 2019, to amend and restate the Interpretive Notice.

The amendments:

- Require an underwriter to provide "clear and concise" disclosures to issuers.
- Require an underwriter to separately identify and present its disclosures concerning the role of the underwriter and the underwriter's compensation separate from dealer-specific conflict of interest disclosures and transaction-specific disclosures.
- Assign the syndicate manager the fair dealing obligation of delivering standard disclosures and eliminate the obligation of the other syndicate members to make the same disclosures.
- Require underwriters to implement a new standard disclosure highlighting the distinct roles of underwriters and municipal advisers.
- Clarify that an underwriter making a recommendation to an issuer regarding a financing structure or product has a fair dealing obligation to deliver the applicable transaction-specific disclosures.
- Clarify that an underwriter may develop policies and procedures for standardized complex municipal securities transaction disclosures.
- Establish that an underwriter only has a fair dealing obligation to disclose a potential conflict of interest if it is "reasonably likely" to mature into an actual conflict of interest during the course of the transaction.
- Expressly state that an underwriter's fair dealing obligation does not require it to make any written disclosures on the part of issuer personnel or any other parties to the transaction.
- Permit an e-mail read receipt to serve as the issuer's acknowledgement.

A further summary of the amendments and implementation of the new interpretive guidance is available here.

The compliance date for the amendments will be set by the MSRB within 90 days of November 13, 2019 (the date the SEC approval order was published in the Federal Register).

2020 FORECAST

We expect the SEC will continue to be active in the municipal securities space in 2020, with a focus on municipal adviser rules, the substance and timeliness of issuer financial disclosures, and broker dealer supervision, record-keeping, and other perceived abuses. Additionally, the SEC Office of Compliance Inspections and Examinations announced that the 2020 examination priorities will include retail investor protection, market infrastructure, information security, and examinations related to investment advisers, broker-dealer, and municipal advisers. SEC Chairman Jay Clayton has spoken publicly several times on the topic of timely and meaningful issuer disclosure, including more timely annual financial reporting from issuers and more consistent release of unaudited interim information in an effort to improve municipal disclosure. It is unclear how far the SEC can go in this effort before it runs into limitations imposed on the SEC's ability to regulate issuers under the Tower Amendment and likely resistance from the issuer community.

Interpretation and implementation by market participants of the 2019 amendments to Rule 15c-2-12, as more municipal securities obligated parties enter into continuing disclosure undertakings under the new Rule, will continue to be a topic of review and discussion, as will implementation of Regulation Best Interest.

Additionally, we expect to see some changes in approach to G-17 letters and fair dealing rules related to the recent amendments to Rule G-17 interpretive guidance. We also anticipate the MSRB will consider new guidance on Rule G-11 and G-32 implementation, continue its retroactive review of certain MSRB Rules, including Rule G-27, and possibly re-examine Rules G-19, G-20, G-23, and G-42 in light of Regulation Best Interest and the potential shift in the municipal adviser regulatory space.

Lastly, we expect all market participants to focus heavily on the resolution of the SEC's proposed exemptive order granting a conditional exemption from the broker registration requirements to municipal advisers.

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