HAWKINS ADVISORY

SEC'S ENFORCEMENT ACTIONS RELATING TO INDIANA SCHOOL DISTRICT AND ITS UNDERWRITER

Introduction

On July 29, 2013, the Securities and Exchange Commission (the "SEC"), in an administrative proceeding,[1] accepted a settlement offer made by City Securities Corporation (the "Underwriter") and imposed a cease-and-desist order. The SEC found that the Underwriter committed numerous violations of the federal securities laws. Concurrently, the SEC in administrative proceedings imposed cease-and-desist orders on (i) the supervisor (the "Supervisor") of the Underwriter's public finance department and (ii) the issuer (and obligated person),[2] West Clark Community Schools, Indiana (the "School District"), whose misleading disclosures were the basis for the enforcement actions ("Order" or "Orders," as the context indicates[3]).

In March 2005, the School District, in connection with a bond financing, entered into a continuing disclosure agreement in accordance with Rule 15c2-12,[4] in which it contractually agreed to provide annual financial information and notices of material events. In December 2007, the School District, in its official statement for another bond financing, stated that it had not failed, in the previous five years, to comply in all material respects with any prior disclosure undertakings.[5] In fact, the School District had not provided any disclosure that was required by the March 2005 continuing disclosure agreement, which included the obligation to prepare and file annual reports.

Order against the School District

The SEC found that the statement in the School District's 2007 official statement regarding compliance with its continuing disclosure obligations, in addition to certificates and affidavits that were executed in connection with the financing which attested to the accuracy of the official statement, contained untrue statements of a material fact, and that the School District knew or was reckless in not knowing of its prior continuing disclosure failures. As a result, the SEC found that the School District violated Section 17(a)(2) of the Securities Act of 1933 (the "Securities Act") and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (the "Exchange Act"). The Order states that there is "a substantial likelihood that a reasonable investor determining whether to purchase the municipal securities would attach importance to the School District's failure to comply with its prior continuing disclosure undertakings."

As part of the Order, the School District agreed to (i) adopt written disclosure policies and procedures regarding its contractual continuing disclosure obligations, including designating an individual responsible for ensuring compliance, and (ii) implement annual training for personnel involved in the bond offering and disclosure process.

Order against the Underwriter and Supervisor

The Underwriter served as sole underwriter of the 2005 and 2007 bond offerings. The SEC determined that the Underwriter committed multiple violations of the federal securities laws in connection with these two bond offerings as well as when acting as underwriter for various other municipal bond offerings by Indiana municipalities. The SEC concluded:

- The Underwriter conducted inadequate due diligence and, as a result, failed to form a reasonable basis for believing the truthfulness of material statements in the School District's official statement and, in particular, the School District's assertion that it had complied with its prior continuing disclosure undertakings, and instead relied solely on representations of the School District, which resulted in the Underwriter offering and selling municipal securities on the basis of a materially misleading disclosure document.
- The Underwriter failed to enact adequate procedures, and did not take steps required by Rule 15c2-12 to reasonably ensure it would receive prompt notice of certain submissions by municipal issuers, or notice of an issuer's failure to make required submissions.
- The Underwriter mischaracterized expenses for entertainment, charitable donations and gratuities as expenses for "Printing, Preparation and Distribution of Official Statement," so as to obtain reimbursement

[1] The SEC may bring an enforcement action either by: (i) an administrative proceeding before an administrative law judge or (ii) a civil action in federal district court. Potential criminal proceedings may be referred by the SEC to the Department of Justice.

[2] An "obligated person" means a person (which can be the issuer) that is committed by contract or other arrangement to support payment of all or part of the obligations on the municipal securities being offered. West Clark Community Schools was the issuer for the 2005 financing and the obligated person for the 2007 financing.

[3] *In re* City Securities Corporation and Randy G. Ruhl, SEC Rel. Nos. 33-9434 and 34-70056 (July 29, 2013) and *In re* West Clark Community Schools, SEC Rel. Nos. 33-9435 and 34-70057 (July 29, 2013).

[4] Rule 15c2-12 under the Securities Exchange Act of 1934 (17 CFR §240.15c2-12).

[5] The definition of "final official statement" in Rule 15c2-12 requires disclosure of "any instances in the previous five years in which each person [with a continuing disclosure obligation] failed to comply, in all material respects, with any previous undertakings" in a Rule 15c2-12 continuing disclosure agreement.

from bond proceeds without the knowledge of various municipal securities issuers.

- The Underwriter approved and provided improper gifts and gratuities to representatives of issuers of municipal bonds.

As a result of such conduct, the SEC found that the Underwriter willfully violated the general antifraud provisions of the federal securities laws, Section 17(a)(2) of the Securities Act, and Section 10(b) and Rule 10b-5 of the Exchange Act; MSRB Rule G-17, which requires brokers, dealers, and municipal securities dealers to deal fairly with all persons and not engage in any deceptive, dishonest, or unfair practice; and Rule 15B(c)(1) of the Exchange Act, which prohibits a broker, dealer, or municipal securities dealer from effecting a transaction in violation of any MSRB rule; and that the Supervisor willfully aided and abetted and caused the Underwriter's violations of Section 10(b) and 15B(c)(1) of the Exchange Act and Rule 10b-5 thereunder and MSRB Rule G-17, and caused the Underwriter's violation of Section 17(a)(2) of the Securities Act. The Order also found that the Underwriter willfully violated MSRB Rule G-20 (prohibition on gifts and gratuities) and Section 15B(c)(1) of the Exchange Act, and that the Supervisor willfully aided and abetted and caused the Underwriter's violations.

The Underwriter was censured and was required to pay disgorgement ($238,000) and a civil money penalty ($300,000). The Supervisor was barred for one year from numerous positions, including associating with any broker, dealer, or municipal securities dealer, with a right to apply for reentry after one year. The Supervisor was also required to pay disgorgement ($18,155) and a civil money penalty ($18,155). In addition, the Underwriter undertook numerous remedial measures, including (i) amending the firm's written supervisory policies and procedures as they relate to Rule 15c2-12, (ii) updating procedures and records relating to the firm's expense reports, (iii) conducting training sessions and scheduling monthly compliance meetings, and (iv) engaging an independent consultant to conduct a comprehensive review of the firm's newly created fixed income capital markets department.

Analysis

In many respects, these are straightforward SEC enforcement actions. The School District never complied with its continuing disclosure obligations, yet its official statement stated that it had. The Underwriter took such representations at face value and never undertook any diligence to determine whether any of the required annual filings had been made.

However, there are two interesting items to note. First, the SEC concluded that the School District's failure to comply with its prior continuing disclosure obligations was material, and therefore the misstatements regarding compliance was a violation of Rule 10b-5. Had the School District instead stated that it had never filed any annual financial information or material event notices as required by its existing continuing disclosure agreements, there would have been no basis for this claim by the SEC against the School District.

The second noteworthy matter is that the SEC chose to bring the enforcement action against the Underwriter under Rule 15c2-12(c) rather than under Rule 15c2-12(b)(5)(i). Rule 15c2-12(c) provides that it is unlawful for a broker, dealer, or municipal securities dealer to *recommend* the purchase or sale of a municipal security unless it has procedures in place that provide reasonable assurance that it will receive prompt notice of material events and failures to file annual financial information. Rule 15c2-12(b)(5)(i) provides that an underwriter cannot underwrite in a primary offering of municipal securities unless it has reasonably determined that the issuer (or obligated person) will provide annual financial information (as defined in Rule 15c2-12) and notices of material events.

The SEC has in the past made strong statements regarding an underwriter's obligation under Rule 15c2-12(b)(5)(i),[6] although to date it has not taken an enforcement action under that subsection. The SEC instead chose to bring the enforcement action against the Underwriter under Rule 15c2-12(c). The SEC views an underwriting as an implied recommendation[7] and therefore thought it was appropriate to apply Rule 15c2-12(c) in an underwriting context. *But Rule 15c2-12(c) was written to address secondary market trades*, to ensure that brokers and dealers on the trading desk, when they recommend the purchase of a municipal security to an investor, check to determine whether there are any material event notices on file that should be taken into account.[8] Please also note that in Rule 15c2-12, subsection (c) applies to "any broker, dealer, or municipal securities dealer," while subsection (b) applies to "Participating Underwriters" (i.e., any of these

[6] The SEC has issued stern warnings about the need to comply with Rule 15c2-12(b)(5)(i). Most recently, in connection with the adoption of the amendments to Rule 15c2-12 in June 2010 (SEC Rel. No. 34-62184A), the SEC stated:

> the Commission believes that it is doubtful that an underwriter could form a reasonable basis for relying on the accuracy or completeness of an issuer's or obligated person's ongoing disclosure representations, if such issuer or obligated person has a history of persistent and material breaches or has not remedied such past failures by the time the offering commences.

[7] In setting forth its interpretation of a municipal underwriter's responsibilities in the 1988 release that proposed Rule 15c2-12, the SEC stated, "By participating in an offering, an underwriter makes an implied recommendation about the securities [being underwritten]." SEC Rel. No. 34-26100 (Sept. 22, 1988). The SEC staff reiterated this position recently by quoting this same sentence from the 1988 release in a Risk Alert. "Strengthening Practices for the Underwriting of Municipal Securities," National Examination Risk Alert, Office of Compliance Inspections and Examinations (Mar. 19, 2012).

[8] When initially proposed, the provision that is now Rule 15c2-12(c) would have required brokers and dealers to review continuing disclosure filings prior to recommending the purchase or sale of a municipal security. Commenters were concerned about the impact on liquidity:

> In view of the importance of *secondary market liquidity* in municipal issues, the Commission requested comment on whether the Proposed Amendments would have a substantial or long-lasting effect on market liquidity. This request for comment was based on concerns raised about whether municipal securities dealers would be willing to effect *secondary market transactions* in a broad range of municipal securities if review was required on a recommendation by recommendation basis.
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> SEC Rel. No. 34-34961 (Nov. 10, 1994) (emphasis added).

In response to such comments, the SEC revised the proposed rule to "replace the proposed review standard with a requirement that dealers have procedures in place that provide reasonable assurance that they will receive promptly any notices of material events regarding the securities that they recommend."

same entities but only in the context of a primary offering). The SEC may have determined that it was preferable to enforce the objective fact that there was a lack of proper procedures, rather than the requirement of Rule 15c2-12(b)(5)(i), which would have hinged on the reasonableness of the Underwriter's determination.

In both of the Orders, the SEC again emphasized the importance of written controls and procedures and comprehensive, periodic training of key personnel. This emphasis has been a key component of the SEC's recent settlements with issuers regarding primary disclosure. Hawkins has developed written disclosure controls and procedures and conducted disclosure and due diligence training for municipal issuers and underwriters across the country.

The SEC has been very active in the municipal enforcement arena recently. Three other significant enforcement actions in 2013 have been the subject of analyses in recent Hawkins Advisories (State of Illinois; Harrisburg; and South Miami). Hawkins Advisories are available on the Hawkins website at www.hawkins.com.

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