

The SEC Cracks Down on School Districts

The SEC is turning up the heat in enforcing Rule 15c2-12 regarding posting financial reports.

By Renée Graves, Dan Warden, and Abigail Stokes Palsma



On July 29, 2013, the Securities and Exchange Commission (SEC) announced charges against West Clark Community Schools in Sellersburg, Indiana, and City Securities Corporation, an Indianapolis-based municipal bond underwriter, for falsely stating to bond investors that the school district had been properly providing annual financial information and notices that were required as part of its contract related to prior bond offerings.

This action is the first sting against a school district since the SEC turned up the heat in enforcing the nearly

20-year-old Rule 15c2-12, which requires underwriters to verify that government entities regularly post financial reports about existing bonds and that they will continue to do so for bonds they seek to issue.

Posting the reports is meant to keep investors informed about the district's financial health and operating condition over time, including disclosures of significant events that could affect key features of the bonds.

The *Washington Post* reported in June 2013 that the crackdown targeted municipalities that the SEC believed were intentionally hiding this information from

investors. Given that the rules haven't been enforced for decades, it is probable that many school districts are simply not fully aware of the requirements, even though each bond issuance includes the requirements in the contract.

The continuing disclosure agreement is only a small part of the avalanche of documents involved in a bond issue, and it is not typically on a "squeaky wheel" list for district administrators.

Even so, the SEC's focus on bond disclosures has been growing over the last several years as the securities market has been in upheaval. According to the same *Washington Post* article, the "turbulence in the bond market" is due to bankruptcies in several major cities (such as Detroit), as well as "a rash of bond selling" over uncertainty that the Federal Reserve's stimulus policy will continue.

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The Fed's September and October decision to delay reducing stimulus will continue quantitative easing and keep interest rates low for a while longer, maintaining, at least in the short run, an incentive for schools and local governments to sell bonds and invest in infrastructure. Regardless of the Fed's actions, the SEC's continuing disclosure rules remain in force.

Before underwriting new bonds, dealers are required to check the Electronic Municipal Market Access (EMMA) website hosted by the Municipal Securities Rulemaking Board to ensure that a district has a spotless history of posted reports with any previously issued bonds. This requirement is where West Clark Community Schools and City Securities got into trouble.

Documents related to bonds issued in 2007 include signatures of district staff as well as employees of City Securities Corporation indicating that the district had properly disclosed all required reports related to its 2005 bond issuance in a timely manner. The short story is, it hadn't, and City Securities had not conducted due diligence to detect the false statements.

"West Clark Community Schools defrauded bond investors by leading them to believe that it had provided the annual financial information contractually required in a prior bond offering, when in fact for five years they failed to submit the required information," said Andrew Ceresney, codirector of the SEC's Division of Enforcement. "This case demonstrates that we will be vigilant in making sure municipal issuers and underwriters comply with their obligations."

Vigilant they have been. Many believed that a San Francisco-based probe was an indication that the SEC

would focus initial investigations in California, since this state leads the country in the number of bonds issued and a 2011 California Debt and Investment Advisory Commission study revealed that 25% of California government entities were not fully compliant with disclosure rules.

Cases filed in 2010 against the state of New Jersey and former officials of the city of San Diego; an inquiry into dealings at the Office of the Chief Financial Officer in Washington, D.C., in 2012; settlements with three localities and the state of Illinois in 2013; and the July case in Indiana make it clear that the SEC's crackdown on continuing disclosures is nationwide.

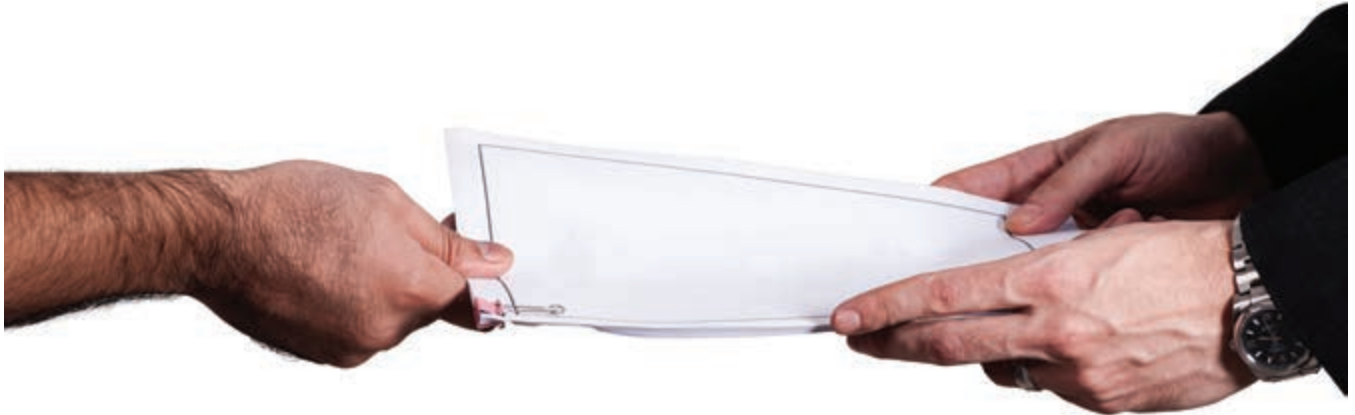
Who Pays for Noncompliance?

The SEC's authority in the municipal bond market is limited to oversight of the banks and investment firms that make initial bond offerings. The SEC can sanction government agencies that have defrauded the public, but it typically does not issue monetary fines to municipalities since such penalties will be passed on to taxpayers. However, in 2012, the SEC stated that Congress should empower it to set baseline disclosure standards and give it a viable way to enforce compliance. If bond issuers as a whole don't correct instances of noncompliance, the SEC may have a stronger case before Congress to again request expanded power to regulate and penalize.

Districts have been asked to hand over all documents showing disclosure-related communications.

Without a clear indication from Congress of forthcoming laws that would provide such powers, the agency's only option has been to enforce Rule 15c2-12 by charging municipalities, underwriters, and even individuals with noncompliance. In some cases, districts have been asked to hand over all documents showing disclosure-related communications between the issuer and the underwriter, the names of all issuer representatives involved in the drafting of official statements, and all underwriter personnel involved in the solicitation and underwriting of bonds. District officials may also be liable under the securities fraud laws.

In the West Clark case, the SEC settled with City Securities, which agreed to pay nearly \$580,000. The investigation also revealed that Randy G. Ruhl, the head of the public financing and municipal bond department at City Securities, had provided improper gifts and gratuities to the district representatives and charged them back to the bond issuers under the accounting code for "printing, preparation, and distribution of official



statements.” Ruhl’s settlement included a one-year bar from activity with the bond industry and fines of more than \$42,000.

West Clark Community Schools was not fined, but the SEC issued a cease-and-desist order, which included orders to become compliant with continuing disclosure requirements according to Rule 15c2-12. The district was also directed to write policies and procedures for ongoing compliance and to provide training for the district employees responsible for posting the disclosures.

The real consequence for West Clark remains to be seen with respect to how the community will view management’s integrity going forward.

What You Can Do

Posting financial reports and material events on time is the best way to protect your district’s ability to sell bonds when you need to and to protect your reputation regarding bonds previously issued.

For more information regarding financial reports and significant event notices required by the SEC’s Rule 15c2-12, see the October 2012 *School Business Affairs* article, “Protecting Your District’s Ability to Sell Bond or Other Debt.” In addition, the Municipal Securities Rulemaking Board has added a toolkit to their website for state and local governments (www.msrb.org/MSRB-For/Issuers/Issuer-Toolkit.aspx). The toolkit houses several informational articles as well as video tutorials that address bond issuance, required disclosures, and posting reports on EMMA.

MSRB has also posted a Market Transparency Advisory—Suggested Practices in Submitting of Financial Disclosures to EMMA. Extensive explanations of required financial disclosures and suggested practices are preceded by background information and a discussion of recent SEC enforcement actions, which mentions the West Clark case: “Significantly, the SEC’s recent enforcement activities illustrate with clarity the importance of issuers and obligated persons providing all expected disclosures to EMMA on an accurate, timely and complete basis.” Read the entire Advisory here: www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2013/2013-18.aspx.

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