Two attorneys with Perkins Coie LLP examine the trend of continued intensified regulatory enforcement targeting the “gatekeepers” in the municipal bond industry, including auditors, bond underwriters, and others that serve investor clients entering the municipal bond market. The authors discuss the first-ever criminal municipal bond-related securities fraud conviction as well as a recent Securities and Exchange Commission action.

Spring Cleaning Enforcement Sweep of Muni Bond Gatekeepers

BY CARYN TROMBINO AND COURTNEY ROLDAN

The month of March brought with it the first-ever criminal municipal bond securities fraud conviction, the resolution of enforcement actions targeting banks and senior executives accused of shirking duties to oversee municipal bond issuances, and proposed rule amendments intended to improve municipal securities disclosures—continuing a trend of intensified regulatory enforcement that targets industry “gatekeepers” such as auditors, bond underwriters, and others that serve investor clients entering the municipal bond market. On April 5, 2017, the Securities and Exchange Commission (SEC) announced the settlement of additional enforcement actions against a municipal bond brokerage firm as well as the firm’s CEO and former underwriter’s counsel, underscoring yet again the regulator’s unrelenting view that gatekeepers are expected to perform a critical function and their failure to do so will not escape scrutiny in cases involving municipal bond fraud.

First Municipal Bond Fraud Conviction

On March 7, 2017, the Department of Justice secured its first municipal bond-related securities fraud conviction when the former executive director of the town of Ramapo’s Local Development Corporation (RLDC), N. Aaron Troodler, pled guilty to conspiring to defraud investors when he helped sell over $150 million in municipal bonds on the basis of fabricated financials. RLDC was incorporated as a not-for-profit in the state of New York to undertake development initiatives in Ramapo, and was authorized to issue bonds on the basis of fabricated financials. RLDC was incorporated as a not-for-profit in the state of New York to undertake development initiatives in Ramapo, and was authorized to issue bonds to the public.

Troodler was accused of making materially false and misleading statements (and omitting materials facts) regarding the finances of the town and the RLDC in order to inflate the balance of Ramapo’s primary operating fund, which concealed both the extent to which the town was funding a local stadium project as well as the RLDC’s illiquidity. For example, Troodler falsely stated that the RLDC had fully reimbursed Ramapo for certain payments of principal and interest on RLDC bonds. At one point, Troodler reimbursed the town out of funds drawn from RLDC’s line of credit (guaranteed by the town), as the RLDC did not have sufficient liquidity at the time to make the payment. According to prosecu-
tors, investors in the Ramapo and RLDC bonds suffered millions of dollars in losses.

The prosecution—which then-U.S. Attorney for the Southern District of New York, Preet Bharara, described as “a big step in policing and bringing accountability to the $3.7 trillion municipal bond market”—stemmed from the SEC’s 2016 fraud action against Ramapo, RLDC, and four town officials (including Troodler) for concealing Ramapo’s financial struggles from municipal bond investors. Troodler, along with the RLDC’s former president, were charged with liability as “control persons” under Section 20(a) of the Securities Exchange Act of 1934. Furthermore, demonstrating the SEC’s focus on “gatekeeper” liability, Ramapo’s audit firm, PKF O’Connor Davies LLP—and a senior partner at that firm, Domenick F. Consolo—settled SEC charges late last year based on allegations that they allowed Ramapo to record a profit of $3.08 million a receivable in its general fund for a property sale that the auditors were aware did not occur. The SEC found the auditor “ignored red flags,” failed to exercise professional skepticism, and failed to follow measures in place to prevent any material misstatements—even after senior management at the firm became aware that the town’s financial statements were the subject of various fraud complaints and multiple law enforcement investigations.

As part of Troodler’s guilty plea, he is expected to testify in the upcoming criminal trial of Ramapo’s current town supervisor, Christopher St. Lawrence. In April 2016, St. Lawrence was charged in the same indictment as Troodler and, among other acts, prosecutors allege that he made false statements to Ramapo’s outside auditors, including false and misleading promises that the RLDC would make whole or partial payments on a receivable, despite knowing that it was substantially unlikely that the RLDC would be able to do so. Prosecutors further allege that St. Lawrence lied to the city’s bond rating service when he claimed that the general fund balance would remain unchanged from the previous year, and then later told Ramapo employees that they were “going to have to all be magicians to get to some of those numbers.”

Jury selection for St. Lawrence’s trial is set to begin on April 19, 2017. Amid much controversy following his indictment as Troodler and, among other acts, prosecutors allege that he made false statements to Ramapo’s outside auditors, including false and misleading promises that the RLDC would make whole or partial payments on a receivable, despite knowing that it was substantially unlikely that the RLDC would be able to do so. Prosecutors further allege that St. Lawrence lied to the city’s bond rating service when he claimed that the general fund balance would remain unchanged from the previous year, and then later told Ramapo employees that they were “going to have to all be magicians to get to some of those numbers.”

The findings entered by the SEC alleged that:\n\n- the inadequate due diligence performed on Brogdon’s bond offerings “failed to form a reasonable basis for believing the truthfulness of material statements in the official statements for the offerings,” and were then sold to retail customers and other broker-dealers. As specified in the settlement orders, the respondents conducted “only a cursory inquiry” into the information provided by Brogdon, and relied upon oral assurances, despite being aware of numerous red flags.
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In another municipal bond fraud gatekeeper liability case, on March 7, 2017, the SEC obtained a final judgment against Marrien Neilson, a former senior vice president at BOK Financial Corporation (BOKF), who was held responsible for the failures of the bank’s corporate trust department when overseeing fraudulent bond offerings managed by Christopher Brogdon—an Atlanta businessman accused of misusing investor funds raised to purchase and renovate senior living facilities. In 2015, the SEC filed an action against Brogdon, alleging that he raised over $190 million for senior living facility projects through 54 conduit municipal bond and private placement offerings.

Characterizing BOKF as a “crucial gatekeeper” regarding the Brogdon bond offerings, who was also the primary recipient of bonus compensation awarded on the basis of fees paid to BOKF for the offerings. According to the SEC, Neilson concealed Brogdon’s disclosure failures across more than two-dozen offerings for over a decade because she knew, or recklessly disregarded, that such disclosures could impair the viability of new Brogdon offerings.

The SEC’s final judgment against Neilson ordered her to pay $55,000 in monetary relief and prohibits her from engaging in corporate trust work related to municipal securities.

**Bond Underwriters Charged**

**By SEC with Gatekeeper Failures**

The SEC announced that the brokerage firm responsible for underwriting Brogdon’s offerings—Lawson Financial Corporation—agreed to settle charges that it failed to ensure Brogdon and his related borrowers were in compliance with their continuing disclosure undertakings. Lawson Financial’s founder and CEO Robert Lawson, as well as its former underwriter’s counsel John T. Lynch Jr., were also charged with failing to conduct reasonable due diligence.

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In settling with the SEC without admitting or denying the charges, Lawson and his firm agreed to pay combined disgorgement of nearly $200,000 as well as penalties of nearly $200,000 for the firm and $80,000 for
Lawson, who will be barred from the securities industry for three years. Lynch agreed to pay nearly $45,000 and to the entry of an order permanently suspending him from appearing and practicing before the SEC as an attorney.

Proposed Rule Amendments For Disclosure Obligations To Improve Investor Access

As further indication that the SEC’s focus on improving transparency in the municipal market will continue unabated, on March 1, 2017, the SEC released its proposed rule amendments to improve municipal securities disclosures, which create new disclosure obligations for issuers.

In particular, brokers, dealers, and municipal securities dealers acting as underwriters must provide to the Municipal Securities Rulemaking Board timely notice of, among other things, the incurrence of material financial obligations, events of default, modification of terms, or other similar events that reflect financial difficulties. These additional disclosures are designed to provide timely access to information regarding specific financial obligations incurred by bond issuers that could impact an entity’s liquidity and creditworthiness. SEC Acting Chairman Michael Piwowar stated the proposed amendments will “empower investors by improving their access to current information about the financial obligations incurred by municipal issuers and conduit borrowers.” Early critics of the proposed amendments argue that such burdensome proposals will limit capital growth through investment, and shift the banks’ role to that of compliance officers.

While addressing the topic at a recent industry conference in February 2017, Chief of the SEC’s Public Finance Abuse Unit, LeeAnn Gaunt, emphasized the need to protect the retail investors—who tend to be senior citizens—investing in the municipal bond market. Gaunt indicated that the Unit’s top priority remains combating offering and disclosure fraud, in addition to increasing its focus on public corruption. The latter initiative was underscored by the SEC’s first-ever breach of fiduciary duty enforcement action brought in 2016 against municipal advisors at Central States Capital Markets LLC who failed to disclose material conflicts of interest. According to Gaunt, the SEC will continue to bring actions in the financial fraud space, targeting issuers that fail to disclose known material risks and identifying fraudulent statements that mask issues or deficits in municipality general funds.

Conclusion

The recent flurry of regulatory and enforcement activity in the municipal bond market is, in reality, the continuation of a trend that has been growing in intensity over the last two years. The government’s focus on control person and gatekeeper liability in cases involving municipal bond fraud is expected to remain aggressive, suggesting that individuals in such roles should revisit and assess whether there exist red flags that should be promptly addressed, and whether disclosure obligations are being appropriately met.