

Commentary: The SEC Sets its Sights on Muni Bonds

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Until recently, the municipal bond market received relatively little attention from the prying eyes of regulators. Municipal bonds were thought of as the “Toyotas” of investment products: mundane but reliable. Today, like Toyotas, the safety and reliability of muni bonds are being called into question. The SEC’s discovery of fraud and corruption in muni bond offerings, including its recent landmark fraud case against the State of New Jersey, appears to have been a wake-up call leading to a range of long-overdue regulatory responses.

Last month, New Jersey earned the distinction of being the first state in the union ever to be charged by the SEC for violations of the federal securities laws. According to the SEC, New Jersey offered and sold more than \$26 billion of municipal bonds between August 2001 and April 2007. The SEC claims that New Jersey’s offering documents were misleading and failed to disclose that the Teachers’ Pension and Annuity Fund and the Public Employees’ Retirement System were not being adequately funded, which failure presented a false picture of the state’s financial health. Robert Khuzami, Director of the SEC’s Division of Enforcement noted that New Jersey “*didn’t give its municipal investors a fair shake, withholding and misrepresenting pertinent information about its financial situation.*”

The SEC’s fraud charges against New Jersey appear to be the opening salvo in an outright war against corruption in the muni bond market. The muni bond market is immense in size and importance. States, cities, counties and other governmental entities issue muni bonds to finance basic necessities such as public transportation, education and healthcare. Investor appetite for muni bonds seems limitless. In 1945 there was less than \$20 billion of municipal debt outstanding. Today, there are about \$2.8 trillion of municipal bonds outstanding, and more than \$400 billion of new bonds were issued last year. Moreover, muni bonds are a favorite of individual, retail investors, who hold about two-thirds of the currently outstanding bonds.

The SEC’s concerns are not limited to New Jersey’s offerings, but extend to the integrity of the muni bond market in general. In a May 2010 speech by SEC Commissioner Elisse Walter, she noted that the municipal securities market “*keeps me up at night.*” She went on to decry “*the relative lack of attention being given to this market, even though it is enormous and operates with increasing participation*

by retail investors."

Commissioner Walter seems to have prodded the SEC into action. In addition to the New Jersey case, the SEC announced several new regulatory initiatives focusing on fraud, including establishing a specialized task force and proposing rule changes intended to improve the quality and timeliness of municipal securities disclosure.

The new specialized task force, the Municipal Securities and Public Pension Unit, will focus on misconduct in the municipal securities market, including offering and disclosure fraud, tax or arbitrage-driven fraud, pay-to-play and public corruption violations, and valuation and pricing fraud. The SEC believes that this specialized unit will allow it to file cases with *"strike-force speed"* and, according to Elaine Greenberg, Chief of the new unit, the stepped up enforcement efforts will *"send a resounding message about particular conduct--cases that will have an impact on the behavior of market participants."*

The SEC also is focusing on improving regulations governing this market. Despite its significance, the municipal securities market currently is subject to limited regulatory oversight. Although muni bond issuers are subject to the anti-fraud provisions of federal securities laws, municipal securities are exempt from registration requirements, and the related reporting requirements, of the federal securities laws. Rule 15c2-12 under the Exchange Act, which provides the exemption, allows brokers and dealers to purchase and sell municipal securities if they reasonably believe that the state or local governments issuing the securities have agreed to make certain disclosures, including annual financial statements and notices of events such as payment defaults, rating changes and prepayments. These limited disclosures do not provide anything approaching the detailed reporting required of registered public companies.

In May 2010, the SEC approved rule changes improving the quality and timeliness of municipal securities disclosure. The SEC's rule amendments apply to brokers and dealers, and are enhancements to the Rule 15c2-12 requirements. The new rules do not directly impose requirements on muni issuers, but provide more particularity for the disclosure necessary to satisfy the exemption from registration. Brokers and dealers, who have the responsibility for determining whether disclosure satisfies the exemption, now have much more detailed guidance concerning the scope of securities covered, the nature of the events that issuers must disclose, and time periods in which disclosure must be made. The rules will take effect on December 1, 2010.

The upcoming disclosure enhancements may be only the start of things. Beginning this month, the SEC is conducting a series of field hearings across the country, led by Commissioner Walter, to examine the municipal securities market. Topics will include the availability of continuing information on municipal bonds, accounting

practices, sales practices and potential conflicts of interest- all of which seem intended to help the SEC determine whether additional regulatory initiatives would be appropriate. The SEC plans to release a report on these hearings with recommendations for regulatory action, industry best practices, and any legislative changes necessary to permit appropriate regulatory oversight of this market.

There is no doubt that the SEC is serious about devoting significant regulatory and enforcement resources to oversight of the muni bond market. The case against New Jersey seems likely to open floodgates of enforcement action in this market: the question is not *whether* the SEC will uncover more fraud and corruption but *how much and where*. Many believe that the SEC is simply outmanned and outgunned in this effort, but the SEC is at least headed in the right direction. Moreover, the current climate of financial reform, with specific focus on protection of retail customers, would seem to be a supportive environment for this initiative. The SEC may not be able to catch every crook, but if its efforts cause some of the fraudsters lurking around the muni bond market to pack up their things and go home, the investing world will be a better place.

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