May 24, 2013

Securities and Exchange Commission Cease-and-Desist Order Against the City of South Miami, Florida

On May 22, 2013 the Securities and Exchange Commission imposed a Cease-and Desist Order against the City of South Miami, Florida for violations of the anti-fraud provisions of Section 17(a) of the Securities Act of 1933. The City had borrowed approximately $12 million in 2002 and 2006 through two pooled, conduit bond issues by the Florida Municipal Loan Council in order to finance a parking structure. The City had agreed not to use bond proceeds for those portions of the project that would be used by a private developer. However, after the 2002 bonds were issued, the City loaned a portion of the bond proceeds to the private developer, and subsequently leased the entire project to the developer. Nevertheless, the City officials continued to make annual certifications that the City was in compliance with its tax covenants, even though bond counsel had told City officials that such use of bond proceeds to benefit a private developer would cause the bonds to lose their tax-exempt status. In 2010, the City publicly acknowledged the potential adverse impact of these misrepresentations on the bonds and filed a material event notice on EMMA, as well as applying for a settlement with the IRS. In 2011, the City entered into a monetary settlement with the IRS and defeased the affected bonds.

The Commission determined that the City acted negligently when it made material misrepresentations and omissions in its annual tax representations relating to the use of bond proceeds. Although bondholders suffered no economic harm, the Commission stated that the City's misrepresentations and omissions were material because they directly jeopardized the tax-exempt status of the bonds, which *could have caused* investors to pay tax-related penalties resulting in financial harm to them. The City neither admitted nor denied the Commission's findings, but agreed to hire independent third party consultants to provide training and to develop policies and procedures for the City's disclosure obligations.

For additional information, see the Order at http://www.sec.gov/litigation/admin/2013/33-9404.pdf.

Items to Note

The Order reinforces well-established positions of the Commission with respect to the following:

- *Economic Harm Not Necessary for Enforcement Action.* Failure of an issuer or a conduit borrower to comply with tax covenants, even if there is no economic harm to bondholders, is a violation of the anti-fraud provisions of the Securities Act. Settlement with the IRS will not protect an issuer or conduit borrower from an enforcement action by the Commission. A Commission official commented, "The tax-exempt status of municipal bonds is vitally important to bond investors, and we will closely scrutinize any conduct by issuers or others that threatens that tax exemption."

- *Negligence Can Support Fraud Violations.* An issuer or a conduit borrower can be liable under Section 17(a) of the Securities Act for negligent misrepresentations for tax-exempt bonds, even if there is no intent to deceive or defraud bondholders.

- *Disclosure Policies, Procedures and Training Are Imperative.* The City's annual tax certifications were signed by finance directors who had no training or previous experience with reviewing tax or disclosure compliance. The Director of the Commission's Miami Regional Office stated, "Municipalities . . . cannot rely on a lack of internal procedures or experience in debt offerings to excuse fraudulent disclosures made to investors."

This enforcement action follows the recent enforcement action by the Commission against the City of Harrisburg. For our Client-Alert regarding that action, see http://www.chapman.com/media/publication/164_Alert.pdf.

For More Information

If you would like to discuss any of the topics covered in this client alert, please contact a member of our Public Finance Group or visit us online at chapman.com.