THEORIES OF LIABILITY IN AN SEC ENFORCEMENT ACTION

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This panel will look at the standards that the U.S. Securities and Exchange Commission ("SEC") applies when pursuing an enforcement action including standards of fraud, control person liability and others. Panelists will cover precedent setting cases in the municipal securities markets with respect to these standards as well as other landmark SEC cases that inform our approach in a municipal securities transaction.

I. OVERVIEW

a. **Background**. Historically, the municipal securities market has not been as regulated as other capital markets. The Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act") were both enacted with broad exemptions for municipal securities from all of their provisions except for the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder." *See U.S. Securities and Exchange Commission Report on the Municipal Securities Market,* July 31, 2012 (the "2012 Report"), at 27 (available at www.sec.gov/news/sudies;2012/munireport073112.pdf). Pursuant to amendments adopted in 1975 (the "1975 Amendments"), Congress enacted a limited regulatory scheme for the municipal securities market by requiring firms transacting business in municipal securities and banks to register with the SEC as broker-dealers and municipal securities dealers, respectively. The 1975 Amendments also created the Municipal Securities Rulemaking Board (the "MSRB"), a self-regulatory organization subject to SEC oversight that is authorized, as expanded by the Dodd-Frank Act, to adopt rules regulating the sale of municipal securities. The 1975 Amendments did not give the SEC the authority to directly regulate municipal securities issuers and certain provisions of the 1975 Amendments (the "Tower Amendment") prohibit the SEC and the MSRB from directly or indirectly requiring municipal issuers to file documents with them or register prior to the sale of municipal securities. As a result, the SEC has largely relied on its express authority to regulate broker-dealers and municipal securities dealers, its oversight of the MSRB, and its enforcement authority under the antifraud provisions of the Securities Act and the Exchange Act as its regulatory tools.

The SEC Division of Enforcement will initiate an investigation when it has reason to suspect that the federal securities laws have been violated. An SEC investigation typically involves scrutiny of all persons involved in the conduct in question (the issuer, its officers and key employees (whether or not still employed), the underwriters, the municipal advisor, bond counsel and other legal counsel). SEC investigations are frequently conducted by its Enforcement Division's Public Finance Abuse Unit (the "Public Finance Abuse Unit"). In fiscal year 2022, the SEC brought 20 standalone enforcement cases in the muni-finance area — 3% of total enforcement cases.

Issuers of municipal securities are regulated, not by procedural rules, but by enforcement proceedings and litigation under the antifraud rules. Disclosure fraud is the component of the antifraud laws of most concern to bond lawyers and others involved in municipal securities offerings. Ponzi schemes, insider trading, and market manipulation, while they do occur and are the subject of enforcement actions in the municipal securities market, are unusual, in part because of the illiquid nature of the market, the heavy involvement of public servants, and the general unavailability of the profit motive to governmental issuers. Broker-dealer misconduct towards customers is generally also covered by other provisions of the securities laws. For example, Section 15(c)(2)(D) of the Exchange Act authorizes the SEC to adopt rules and regulations to *prevent* fraudulent acts and practices by broker-dealers in the *purchase* or *sale* of any security. This section is the basis for Rule 15c2-12.

Preventative rules are not authorized by Section 17(a) of the Securities Act or Section 10(b) of the Exchange Act. Section 10(b) makes it unlawful to engage in fraudulent conduct in contravention of rules and regulations of the SEC defining fraudulent conduct. Consequently, Rule 10b-5 defines fraudulent conduct in connection with the *purchase* and *sale* of a security, but does not dictate disclosure or other practices to prevent fraud.

Note that various states often have laws that mirror federal securities laws; those laws, however, may have differences in language that can result in additional potential liability.

In considering Section 17(a) and Section 10(b), the SEC, in its February 7, 2020 Staff Legal Bulletin No. 21 (OMS) – *Application of Antifraud Provisions to Public Statements of Issuers and Obligated Persons of Municipal Securities in the Secondary Market,* noted that it does and can proceed against municipal issuers for disclosure violations under Section 17(a). Different than requiring intent like Rule 10b-5, Section 17(a) only requires a finding of negligence or gross negligence to determine that an antifraud violation has occurred. Section 17(a) applies to offer and sale of securities, so typically applicable to primary offering activities and not typically available in continuing disclosure cases in which the subject matter is ongoing disclosure(s) and not necessarily offer and sale activity. Section 10(b) and Rule 10b-5 apply to any statements, with equal applicability in primary offerings and secondary market disclosures. While Section 10(b) and Rule 10b-5 would be the typical standard applied to secondary market disclosures, recent, other enforcement actions regarding disclosure violations by municipal issuers have been based on Section 17(a) negligence, a lesser standard than Section 10(b) scienter.

b. **Section 17(a) of the Securities Act**. Section 17(a) of the Securities Act states that "[i] shall be unlawful for any person in the *offer* or *sale* (italics added) of any securities . . . directly or indirectly (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or

property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

Negligence is sufficient to establish a violation of Sections 17(a)(2) and (3). No finding of scienter (intent) is required. Negligence may be established by showing that the individual should have known or failed to conform to industry standards. Federal courts have not found an implied private cause of action in the language of Section 17(a); consequently, only the SEC can bring an action under Section 17(a). Recent enforcement actions in the municipal securities market have demonstrated the SEC's willingness to use Section 17(a). See, e.g. *Securities and Exchange Commission vs. Ruben James Rojas,* November, 2022, in which the defendant school chief business officer admitted to a violation of Section 17(a)(3).

c. **Rule 10b-5**. Under Rule 10b-5 promulgated under the Exchange Act, "[i]t shall be unlawful for any person, directly or indirectly . . . to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, ... in connection with the purchase or sale of any security."

Rule 10b-5 has a scienter (a mental state embracing *intent* to deceive, manipulate or defraud) requirement, which may be established by a showing of recklessness. Recklessness is highly unreasonable conduct that is an extreme departure from the standards of ordinary care. Specific danger need not be known to the individual in question, but the danger must at least be so obvious that any reasonable person would have known of it. Both the SEC and private litigants can bring claims under Rule 10b-5.

While there is no private cause of action for aiding and abetting under Rule 10b-5, any person can be found liable under Section 10(b) as a primary actor. The SEC can bring actions against aiders and abettors (secondary actors) who recklessly or knowingly provide substantial assistance to securities fraud.

d. **What is Material?** Initial disclosure, post-issuance disclosure, voluntary disclosure and any other communications to the market (which may include electronic or social media) must be materially accurate and complete. "In fact, whenever a municipal issuer releases information to the public that is reasonably expected to reach investors and the trading markets, such disclosure is subject to the antifraud provisions." 2012 Report, at 30. *See also Application of Antifraud Provisions to Public Statements of Issuers and Obligated Persons of Municipal Securities in the Secondary Market: Staff Legal Bulletin No. 21 (OMS), February 7, 2020:* "The Commission's principles-based approach to the application of the antifraud provisions applies to all statements of municipal issuers that are reasonably expected to reach investors and the trading markets notwithstanding changes in municipal issuer disclosure practices, technology, investor expectations, and regulatory framework." Case law defines materiality as there being a substantial likelihood that a reasonable bond investor would consider it important in making an investment decision. "Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the `total mix' of information made available." *See TSC Industries v. Northway,* 426 U.S. 438, 449 (1976).

II. APPLICATION OF THEORIES OF LIABILITY IN SEC ENFORCEMENT MATTERS

a. **Overview**. Since the 2012 Report, there have been a number of "first-of-their-kind" enforcement actions in the municipal arena, including imposing financial penalties, finding individuals liable under a "control person" theory, obtaining emergency injunctions halting a bond offering in progress, prohibiting issuers from issuing bonds in the future without satisfying conditions precedent, barring issuer officials from future bond issues, criminal charges, and an increased willingness in the municipal arena to file charges in federal district court.

b. **Individual Liability.** Since 2018, an increase in finding of individual liability has been occurring. *See, e.g., SEC v. Malachi Financial Products, Inc. and Porter B. Bingham,* Civil Action No. 3:18-cv-00001, Litig. Rel. No. 24025 (S.D. MS., filed January 2, 2018 (civil injunction action alleging that Malachi Financial Products, Inc, a municipal advisor firm, and its principal defrauded the City of Rolling Fork, Mississippi by overcharging the city for municipal advisory services and failing to disclose certain related-party payments in connection with a municipal bond offering, violating their fiduciary duty and duty of fair dealing to the city). *See also* In the Matter of *Montebello Unified School District and Anthony James Martinez,* Securities Act Rel. No. 10691(September 19, 2019); *Securities and Exchange Commission v. Ruben James Rojas,* 5:19-cv-0199 (C.D. CA, September 19, 2019).

c. **Financial Penalties**. Historically, the SEC had not sought financial penalties against municipal issuers. Beginning with *In the Matter of The Greater Wenatchee Regional Events Center Public Facilities District, Allison Williams, Global Entertainment Corporation, and Richard Kozuback,* Sec. Act. Rel. No. 9471 (Nov. 5, 2013), the SEC began imposing financial penalties against issuers. The SEC has also increasingly asked for financial penalties against individuals (including employees and former employees of issuers). *See In the Matter of Westlands Water District, Thomas W. Birmingham, and Louie David Ciapponi*, Sec. Act. Rel. No. 10053 (March 9, 2016) (imposing $125,000 penalty on water district, $50,000 on general manager, and $20,000 on assistant general manager); SEC v. Gary J. Burtka, No. 14-cv-14278, Litig. Rel. No. 23229 (ED Mich. Apr. 6, 2015) (imposing $10,000 penalty on former city mayor); *In the Matter of the Port Authority of New York and New Jersey*, Sec. Act. Rel. No. 10278 (January 10, 2017) (imposing $400,000 penalty on the Port Authority of New York and New Jersey).

d. **Control Person Liability**. Under Section 20(a) of the Exchange Act, any person who directly or indirectly "controls" another person found liable for a violation of the Exchange Act is jointly and severally liable, to the same extent as the controlled person, to any person to whom the controlled person is liable. In 2014 the SEC brought fraud charges against the City of Allen Park, Michigan and two former city officials, former mayor Gary Burtka and former city administrator Eric Waidelich, in connection with an offering of municipal securities issued to finance a movie studio project in the city. This case was the SEC's first enforcement action against a former mayor under Section 20(a) of the Exchange Act. The former mayor was held liable as a "control person" for the city and the city administrator's violations of the antifraud laws. The complaint stated that the former mayor was "an active champion of the project and in a position to control the actions of the city and [the former city administrator] with respect to the fraudulent bond issuances. Based on this control, the SEC charged Burtka with liability for violations committed by the city and [the former city administrator]." *SEC Press Release 2014-249,*

November 6, 2014. As a result, the former mayor was held jointly and severally liable with, and to the same extent as, the city and the city administrator.

e. **Court Order to Halt Bond Offering**. In 2014 the SEC obtained an emergency court order against the City of Harvey, Illinois (U.S. *Securities and Exchange Commission Litigation Release No. 23149, Securities and Exchange Commission v. City of Harvey, Illinois, et al., Civil Action No. 1:14-cv-4744, December 5, 2014)* and its comptroller to stop a city bond offering. The SEC asserted that the city and its comptroller had been involved in a scheme for a number of years to divert bond proceeds for improper uses. The judge in the matter issued a restraining order preventing the city from offering or selling bonds for a specified period of time.

f. **Bars from Participating in Future Municipal Bond Offerings**. In 2016 the SEC settled with Juan Rangel, the former President of UNO Charter School Network Inc. and former CEO of United Neighborhood Organization of Chicago ("UNO"), for materially misleading investors by failing to disclose terms of certain outstanding obligations in its offering documents, including certain conflicts of interest. *See SEC Press Release 2016-125, June 21, 2016, available at www.sec.gov/news/pressrelease/2016-125.html.* The SEC had settled with UNO in 2014. As part of the settlement, Rangel agreed to pay a $10,000 fine, to be permanently enjoined from future violations of Section 17(a)(2) and to be barred from participating in any future municipal bond offering (other than for his personal account).

g. **Criminal Charges**. In 2016 the SEC brought fraud charges against the Town of Ramapo, New York (U.S. Securities and Exchange Commission Litigation Release No. 23521, Securities and Exchange Commission v. Town of Ramapo, et al., Civil Action No. 16-cv-2779 (S.D.N.Y., filed April 14, 2016), the town's local development corporation, and town officials for failing to adequately disclose the town's failing financial condition. The US Department of Justice ("DOJ") also brought criminal charges against Christopher St. Lawrence, the town supervisor, and Aaron Troodler, the assistant town attorney and executive director of the local development corporation, consisting of 22 counts of securities fraud, wire fraud, and conspiracy—the first criminal securities fraud case brought against city officials for accounting fraud in connection with the sale of municipal bonds. Troodler pled guilty in March 2017 and was ordered to pay a $20,000 fine and a special assessment of $200, and was sentenced to three years of probation. Troodler was also disbarred as a result of his felony conviction. St. Lawrence was found guilty by jurors in May 2017 of securities fraud, wire fraud, and conspiracy. In November 2017 the US District Court for the Southern District of New York permanently enjoined the Town and the local development corporation from violating the antifraud provisions and ordered them to retain independent consultants to review and recommend improvements to financial reporting procedures and controls and disclosure practices and to adopt such recommendations, to retain independent auditing firms, and for a period of three years, to retain separate disclosure counsel (unaffiliated with bond counsel) prior to proceeding with the offering or sale of municipal securities. In January 2018 St. Lawrence was sentenced to 2 1/2 years in prison. The SEC actions against Troodler, St. Lawrence and other individuals in the matter have been put on hold pending the final outcome of the criminal proceedings.

h. **More Actions Brought in Federal District Court**. In the municipal securities context the SEC as shown a willingness to bring more cases in federal district court. The SEC has more remedies available in that forum, including control person liability and injunctions. In a case

brought against the City of Miami, Florida *(SEC v. City of Miami, Florida and Michael Boudreaux, Case No. 13-cv-22600 (United States District Court of the Southern District of Florida, December 6, 2016)* , and its former budget director, Michael Boudreaux, the SEC sought enforcement through a federal jury trial against a municipality and its officers for federal securities laws violations. Miami and Boudreaux were found liable for multiple counts of violating the antifraud laws and were assessed $1,000,000 and $15,000 (reduced from $450,000), respectively, in civil fines. Boudreaux's motion for a new trial was denied.

i. **"Makers" of False Statements and 10b-5 Liability; Claims of Reliance on Professionals**. In recent decisions, the U.S. Supreme Court has considered and expanded the universe of actors who can be held liable for a false statement under the federal securities laws. In *Janus Capital Group, Inc. v. First Derivative Traders, 564 U.S. 135 (2011),* the Court held that one who prepares a statement on behalf of another is not its maker under Rule 10b-5(b). Rather the maker is the person or entity with ultimate authority over the content of the statement and how to communicate it. (The Court followed the rationale of its 1994 decision in *Central Bank of Denver*, in which the Court held that Rule 10b-5's private right of action does not include suits against aiders and abettors.) However, in *Lorenzo Securities v. SEC, 139 U.S. 1094 (2019)*, the Supreme Court held that a person who did not "make" a false statement under Rule 10b-5(b) may nonetheless be liable under Rule 10b-5(a) or (c) if he or she disseminates a false statement with intent to defraud, expanding the scope of "scheme liability" under antifraud provisions. Both cases are of interest to lawyers involved in disclosure preparation. On a related theme of professional responsibility and potential liability, the burden to demonstrate good faith reliance on professional advice lies with the defendant. *See The Bond Buyer,* "*SEC: What Issuers and Lawyers Should Know About the Miami Case,*" March 17, 2017, by Jack Casey. Miami and Boudreaux argued that they relied on auditors in connection with the alleged fraud and misrepresentations. Such defense was not accepted by the jury which found that neither defendant met the tests for a reliance on professionals defense. Each of four tests must be answered in the affirmative: (1) Did the issuer completely disclose the facts about the conduct at issue to its advisor; (2) Did the issuer seek advice from its advisor as to whether the specific course of conduct was appropriate; (3) Did the issuer receive advice from the advisor that the specific course of conduct was appropriate; and (4) Did the issuer rely on that advice and follow it in good faith.