National Federation of Municipal Analysts

White Paper on the Disclosure of Potential Conflicts of Interest in Municipal Finance Transactions

EXECUTIVE SUMMARY

This white paper discusses the importance of conducting due diligence regarding potential conflicts of interest of key participants involved in municipal finance transactions and making appropriate disclosure of the potential conflicts. The subject matter, which has the potential to affect each of the many sectors of the municipal securities market, has been a focus for analysts and investors, as well as regulators, for several decades. Potential conflicts of interest may call into question the impartiality and effectiveness of management and professionals participating in municipal finance transactions, and thereby may underscore a need for caution in considering investments that rely on those parties. Because of the wide variety of potential conflicts of interest, specific examples provided in white paper should be regarded as illustrative rather than comprehensive.

Since its inception in 1983, the National Federation of Municipal Analysts (NFMA) has been at the forefront of efforts to improve the disclosure of credit and market risks facing analysts and investors in the taxable and tax-exempt municipal bond markets. The NFMA is an organization of over 1,300 members, primarily research analysts who evaluate credit and other risks of municipal securities. These individuals represent mutual funds, insurance companies, broker/dealers, financial advisors, bond insurers, and rating agencies, among other stakeholders.

One of the NFMA's principal goals is the promotion of timely and materially complete and accurate disclosure of information needed to assess municipal securities risks. The organization's disclosure efforts have addressed broad areas of concern, ranging from industrywide topics to detailed work on specific credit sectors. Some of this work has been communicated to members of Congress and federal regulatory agencies. The NFMA's work has been recognized as authoritative market guidance by other industry associations and various regulatory bodies. For further information on continuing efforts to improve disclosure, see the Disclosure Guidelines and Position Statements in the Publications section of the NFMA's website (www.nfma.org).

In order to develop its white papers, seasoned NFMA analysts representing different types of companies work together to develop information and best practice suggestions on a particular topic. The NFMA provides the municipal securities industry with an opportunity to comment on proposed white papers. These papers provide other industry participants with specific information needed both to help analysts do their jobs better and to allow investors to make better-informed investment decisions. The NFMA believes that the best practice in disclosure will always be the one that provides a steady flow of timely material information from issuers, borrowers, and obligors to the entire market.

This *White Paper on the Disclosure of Potential Conflicts of Interest in Municipal Finance Transactions* applies to securities across multiple market sectors. It is not intended to supplant Securities and Exchange Commission (SEC) Rule 15c2-12 or Rule 2a-7, and should be used in conjunction with guidance provided in those rules. In addition, this white paper is not intended as a summary or discussion of the legal standards or laws/regulations governing conflicts or ethics in municipal finance transactions. It is important to note that the NFMA's disclosure efforts are a continuing process. The NFMA's white papers are not static documents; they will be revisited and changed as market conditions warrant. The NFMA encourages interested parties to submit comments at any time to lgood@nfma.org so that they can be considered in the development of future versions of this white paper.

Please note that this white paper does not constitute legal advice to any participant in the municipal bond market, including, among others, bond issuers, obligors, broker-dealers, and/or law firms. The white paper represents the NFMA's recommended primary market disclosure, based on the experience of its members, and informational needs of investors, as municipal credit analysts and market participants, of information that is important for assessing the credit features and security provisions of municipal bonds.

OVERVIEW: THE IMPORTANCE OF CONFLICTS OF INTEREST DISCLOSURE

This white paper identifies for municipal securities issuers, obligors, and other transaction participants the importance of disclosing potential conflicts of interest in municipal finance transactions. It highlights particular areas in which due diligence regarding conflicts of interest is warranted and disclosure is needed. The paper provides selected textual examples (as well as examples in the endnotes) that are intended to be illustrative but not comprehensive.

Municipal investors and analysts have long considered information about conflicts of interest to be essential and relevant for evaluating the integrity, competence, and independence of issuer and obligor managers, underwriters, counsel, municipal advisors, experts, and other professionals, as well as for assessing other bond risks.[1]

Potential and actual conflicts of interest may arise from a variety of sources; they are not limited to for-profit participants in a municipal financing. Despite the importance of disclosing conflicts of interest to investors and analysts, however, transaction participants in municipal securities offerings may fail to investigate, identify, or disclose actual or potential conflicts of interest. Those failures may occur as a result of one or more of the following: an inadequate identification of parties with interests in a transaction; a poor understanding of the roles, responsibilities, and relationships of those parties; a lack of due diligence concerning conflicts of interest; or an insufficient appreciation of the myriad potential conflicts of interest that may affect the underlying financing transactions and the sound structuring and underwriting of municipal securities.

As used in this white paper, the term *transaction participants* includes issuers, conduit borrowers, or other obligors and their key officials; counsel to issuers, borrowers, or obligors; bond counsel; disclosure counsel; municipal advisors; underwriters; underwriter's counsel; financial advisors; auditors; and engineers, appraisers, feasibility analysts, and other experts.

Potential conflicts may arise, among other things, from patterns of past, concurrent, or anticipated business or personal relationships among, for example, issuers and issuer officials,[2] obligors and underwriters,[3] and experts and underwriters,[4] as well as from patterns of relationships among other transaction participants.[5]

Additional areas in which conflicts of interest may arise include direct or indirect loans or other cash payments,[6] gifts to public officials or their charities or friends,[7] business relationships, close personal relationships affecting professional selection on a basis other than merit, expenditures of bond proceeds for personal purposes,[8] political contributions,[9] charitable contributions,[10] cash or in-kind contributions to bond elections,[11] compensation contingent upon completion of transactions or work products,[12] economic interests in financed projects or programs,[13] economic interests in related transactions (e.g., interest rate swaps or other derivatives, or investments, associated with bond issues) or fee sharing.[14] Any such arrangement may reflect unfavorably on the integrity or competence of issuer or obligor managements. The arrangements may indicate that the selection of professionals to perform bond structuring, due diligence, disclosure, municipal advisory, expert, and underwriting functions is made on a basis other than merit, with significant adverse implications for the municipal securities and their post-issuance performance.[15]

Material conflicts of interest historically generally have been disclosed by many transaction participants in municipal offering documents. The NFMA is publishing this white paper, however, to ensure that all transaction participants are aware of the importance of vigilance in uncovering and disclosing potential conflicts of interest that may affect adversely the independence and resolve of parties in the underlying finance transactions, even when the potential conflicts may not be apparent at first glance.

Appropriate conflicts of interest due diligence and disclosure practices will be promoted if transaction participants realize that they must: (1) more completely recognize and investigate the types and diversity of conflicts of interest that are important to municipal analysts and investors, and (2) understand that potential conflicts of interest may cause the underlying finance transactions to experience unforeseen fiscal, regulatory, compliance, and legal difficulties that potentially may harm investors. Such difficulties may include, among others, management disruptions, regulatory enforcement, violations of market expectations of integrity or of state ethics and licensing regulations, violations of state/federal grant awards, and tax risks, as well as financial stress, delinquency, contractual violations, or even default. The seriousness of risks associated with conflicts of interest can be assessed by the municipal investor or municipal analyst only if the conflicts and associated risks have been disclosed clearly and appropriately. Transaction participants are in the best position to identify and disclose these potential conflicts of interest to investors because the participants have greater access than investors do to relevant information.

As part of the municipal offering process, municipal investors and analysts should be informed about actual and potential conflicts of interest relevant to municipal finance transactions so that the investors and analysts can assess the significance and risks of those conflicts.

LEGAL AND REGULATORY PROHIBITIONS OF CONFLICTS OF INTEREST

Current laws, regulations, and professional standards recognize prohibitions against certain well-known forms of conflicts of interest. Among others, these include the following examples:

- Laws at all levels of government prohibit the bribery of public officials, and they also prohibit self-dealing and personal profit-making by public officials and by municipal finance professionals employed by municipal issuers.
- Legal, ethical, and self-regulatory standards applicable to lawyers, municipal advisors, engineers, accountants, and securities dealers prohibit undisclosed conflicts of interest, and at times prohibit even disclosed conflicts of interest.
- Rules regarding licensing and permitting, as well as rules of oversight and regulatory organizations, commonly prohibit or regulate conflicts of interest.

Of specific application to municipal offerings, the Municipal Securities Rulemaking Board (MSRB) has statutory rulemaking authority over dealers in municipal securities and over municipal advisors. The MSRB has adopted several conflict-of-interest rules, including:

- Fair dealing (MSRB Rule G-17)
- Gifts and gratuities (MSRB Rule G-20)
- Role-switching by dealers serving as financial advisors (MSRB Rule G-23)
- “Pay-to-play” practices (MSRB Rule G-37)
- Employment of consultants (MSRB Rule G-38)

These MSRB rules (and proposed rules and amendments) seek to prohibit deceptive, dishonest, and unfair practices by underwriters and municipal advisors. These rules and interpretations of the rules are available at http://www.msrb.org/Rules-and-Interpretations.aspx.

SPECIFIC AREAS FOR ATTENTION

This white paper recommends clear disclosure of specific conflicts of interest. Ambiguous or generalized disclosure of potential conflicts of interest is insufficient.

Specific areas for which conflicts of interest due diligence and disclosure attention are needed include:

- Limits of regulation
- Fee- and revenue-sharing arrangements
- Ownership, economic interests, and significant benefits
- Contingent payment arrangements
- Expert work products, projections, and feasibility studies
- Convictions, enforcement, and other proceedings

The following discussion expands on the discussion by providing selected illustrative examples regarding each of these conflicts of interest areas.

Limits of regulation. Many activities and relationships of the transaction participants in municipal securities offerings may not be covered by formal legal or regulatory standards that prohibit conflicts of interest. For example, the market responsibilities of transaction participants to investigate and disclose conflicts of interest involving third parties interested in a municipal securities offering or a program or project to be benefited are not fully addressed by MSRB rules, although general federal and state antifraud provisions apply. Further, MSRB rules do not regulate issuers, obligors, counsel, or certain other transaction participants.

Fee- and revenue-sharing arrangements. Potential conflicts of interest may arise in connection with fee- and revenue-sharing arrangements among transaction participants (these arrangements are termed *sharing payments*).[16] Such sharing payments could arise from the use of bond proceeds;[17] they could be funded by other transaction participants,[18] or by interested third parties; or they could be associated with projects or programs benefited by the successful sale of the municipal securities.[19] The cost of issuance disclosure may provide only minimal detail about the actual use of bond proceeds.[20] All existing and anticipated future fee- and revenue-sharing arrangements pertaining to municipal finance transactions should be disclosed regardless of whether the fees or revenues are paid prior to, at, or after closing the transaction.[21]

Ownership, economic interests, and significant benefits. Potential conflicts of interest may arise when transaction participants or third parties have ownership, management, or other economic interests in facilities, programs, or other assets involved in the municipal financing transaction, including in the securities offered, or in the underlying assets or program being financed.[22] Transaction participants (and their agents, affiliates, and owners) may act, or expect to act, as sellers, lessors, consultants, or advisors to the project or programs that would be benefitted by a municipal finance transaction.[23] Transaction participants or affiliated third parties may have financial interests in real estate or personal property to be purchased with bond proceeds or in property that is leased.[24] Transaction participants or third parties may also have financial interests in companies that are to receive new or increased funding, management fees, or other revenues from projects or programs benefiting from the municipal finance transaction.[25] Feasibility consultants, appraisers, engineers, or other transaction participants may have past or concurrent dealings with issuers, borrowers, underwriters,[26] and other transaction participants, or they may anticipate future employment. Affiliated companies to underwriters may have interests in interest rate swaps or other derivatives associated with bond issues, and underwriters or advisors may have interests in issuer investments or other services to issuers.

Contingent payment arrangements. Transaction participants may enter into contingent compensation arrangements with payments conditioned on the successful closing or funding of, or the size of, municipal finance transactions; the delivery of work products; or the sale, purchase, leasing, or licensing of property. Broker's fees are a common form of "success compensation."

Contingent compensation is especially undesirable for experts,[27] or for municipal advisors or other professionals who are expected to be independent in the provision of advice or services to issuers or in the structuring of municipal securities.[28] In addition, underwriters and placement agents should disclose all of their anticipated compensation arrangements, contingent or otherwise, with issuers or other interested parties in conjunction with municipal securities offerings or the uses of proceeds.

Payment arrangements that are contingent on the "success" of a financial transaction clearly pose credit and other risks because these arrangements often entangle the opinion or advice required to complete municipal finance transactions, removing its independence.[29] Historically, compensation arrangements in municipal finance transactions that hinged on transactional completion have been associated with poorly structured bond issues and overly optimistic appraisals, unrealistic fiscal and economic projections, too-confident feasibility studies, overly optimistic construction budgets and timetables, and the like, to the detriment of municipal investors, as well as issuers and obligors.

Expert work products, projections, and feasibility studies. The failure of transaction participants to disclose the following information regarding expert work products is considered by municipal investors and analysts to evidence potential conflict of interests: (1) peer reviews;[30] (2) unfavorable expert work products, feasibility studies, economic or fiscal projections or appraisals;[31] (3) prior or contemporaneous studies by the same or other experts using more conservative or different assumptions or reaching less favorable conclusions; (4) the assumption, sources of information and professional standards used in preparing the work products; (5) whether transaction participants believe those assumptions to be reasonable; (6) less-favorable alternative analyses in expert work products;[32] and (7) the sources and manner of compensation or potential compensation of experts.[33] Essentially, transaction participants' economic interest in the successful closing of the municipal finance transactions may lead those participants to discount improperly the significance of conflicting reports, studies, projections, or alternative conclusions that are relevant and important to the success of those transactions. Clearly, the failure to disclose prior or conflicting studies, reports, and projections may also constitute material omissions, but this failure also presents real, significant risks for investors. Expert work products are only as good as the reasonableness of the assumptions and sources of information supporting them.

For more complete discussions of potential conflicts of interest and other matters involving experts and expert work products associated with municipal securities offerings, see the NFMA's White Paper on Expert Work Products (2011) and its White Paper on Project Finance Risk Assessment and Disclosure (2006), available at www.nfma.org.

Convictions, enforcement, and other proceedings. Conflicts of interest may also arise when key parties involved in a bond issue, or in the existing or future management of the underlying project, program, or activity being funded by the municipal finance transaction, have had criminal indictments,[34] convictions, enforcement proceedings,[35] or sanctions for actions involving dishonesty, fraud, misrepresentation, misappropriation, breach of fiduciary duty, conversion, or conflicts of interest, or when they may have had bankruptcies, insolvencies, receivership or other similar proceedings indicating unsuccessful business activities calling into question management capabilities.[36] Municipal investors and analysts consider such matters to be in and of themselves, or to be closely related to, conflicts of interest. Once again, transaction participants seeking to achieve successful closings may discount improperly the importance of such information.

The risks of such matters come in several forms. These include adverse project or program publicity or performance, heightened regulatory scrutiny of the project or program finances or operations by applicable regulatory authorities, the inability to qualify for federal or state grants, and difficulty in obtaining bank loans or other needed forms of credit or cash flow.[37]

SUMMARY

Conflicts of interest can present a serious hindrance to accomplishing well-founded municipal finance transactions. To mitigate this concern, transaction participants should apply clear, documented disclosure about potential conflicts of interest. To do this, one of the first steps is to identify areas in which these conflicts might appear. The NFMA's goal in presenting this white paper is to identify for transaction participants certain examples of important and relevant information deserving of their attention.

ENDNOTES: EXAMPLES OF INADEQUATE CONFLICTS OF INTEREST DISCLOSURE

NOTICE: The following notes provide selected examples of legal cases and releases in enforcement actions that discuss certain potential conflicts of interest that may arise in municipal finance transactions. The examples are not intended to be exhaustive or complete. Rather, the examples are illustrative of conflicts of interest issues that have been identified in the past through January 2015 as needing to be addressed by transaction participants through due diligence and disclosure to investors.

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[1] Illustrating the significant longstanding interest in the subject of conflicts of interest in the municipal securities market, in the early 1990s the Government Finance Officers Association (GFOA)'s *Disclosure Guidelines for State and Local Government Securities* recommended disclosing conflicts of interest of issuer, enterprise, and conduit borrower officials; contingent compensation paid to counsel, and parties preparing opinions, analyses, projections, or other expert work products; and interests of professionals working in bond offerings for issuers, borrowers, and other obligors. This white paper, the *Disclosure of Potential Conflicts of Interest in Municipal Finance Transactions***,** reiterates and re-emphasizes the continued importance of conflict of interest information.

In 1994, the SEC placed a spotlight for market participants on the dangers of conflicts of interest, stating:

> Information concerning financial and business relationships and arrangements among the parties involved in the issuance of municipal securities may be critical to an evaluation of an offering. Recent revelations about practices used in the municipal securities offering

> process have highlighted the potential materiality of information concerning financial and business relationships, arrangements or practices, including political contributions, that could influence municipal securities offerings. For example, such information could indicate the existence of actual or potential conflicts of interest, breaches of duty, or less than arm's-length transactions. Similarly, these matters may reflect upon the qualifications, level of diligence, and disinterestedness of financial advisers, underwriters, experts and other participants in an offering. Failure to disclose material information concerning such relationships, arrangements or practices may render misleading statements made in connection with the process, including statements in the official statement about the use of proceeds, underwriters' compensation and other expenses of the offering. In addition, investors reasonably expect participants in municipal securities offerings to follow standards and procedures established by such participants, or other governing authorities, to safeguard the integrity of the offering process; accordingly, material deviations from those procedures warrant disclosure. …
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> Beyond existing specific disclosure requirements and guidelines, the range of financial and business relationships, arrangements and practices that need to be disclosed depends on the particular facts and circumstances of each case. If, for example, the issuer (or any person acting on its behalf) selects an underwriter, syndicate or selling group member, expert, counsel or other party who has a direct or indirect (for example, through a consultant) financial or business relationship or arrangement with persons connected with the offering process, that relationship or arrangement may be material. Areas of particular concern are undisclosed payments to obtain underwriting assignments and undisclosed agreements or arrangements, including fee splitting, between financial advisers and underwriters. If the adviser is hired to assist the issuer, such relationships, financial or otherwise, may divide loyalties. Similarly, affiliations between sellers of property to be used in a financed project and conduit borrowers raise questions regarding, among other things, the determination of fair market value of the property and self-dealing. SEC Rel. Nos. 33-7049; 34-33741, 59 FR 12748, 12751 (March 17, 1994). [Footnotes omitted.]

[2] *See SEC v. Washington County Utility District, et al.*, 1982 U.S. Dist. LEXIS 17316 (ED TN Dec. 2, 1982) (In an action relating to several defaulted bond issues, "Bonds or a part thereof received by [the District Manager] … were transferred to the Commissioners without consideration ... . Bondholders were never advised of this fact"), SEC Lit. Rel. No. 7868 (Apr. 14, 1977) (settled final orders): "The complaint also alleged numerous omissions to state material facts including the following: … that proceeds from the sale of bonds were used for purposes other than represented in prospectuses or authorized in the bond resolutions, such as loans to [the District's Manager] and companies controlled by [the Manager] or his relatives … ." *See also* nn. 20 and 24.

See also SEC v. Reclamation District No. 2090, et al., Civ. Action No. 76-1231-SAW (ND CA), SEC Lit. Rel. No. 7460 (June 22, 1976) (complaint) ("The Complaint alleges that [three Trustees] are each members of a group which, in 1971, privately purchased approximately 80 per cent of the land encompassed by the District. Subsequently, in 1973, acting in their capacity as Trustees of the District, they jointly authorized the District to purchase that land at a profit to the owning group of approximately $395,000. Thereafter, they voted to authorize the issuance by the District of the bond anticipation notes and promissory notes for the purpose of raising revenues, in part to be used to repay the District's obligation to the selling group. Defendants [Trustees] each received a portion of the proceeds from the sale of the said promissory notes."); *SEC v. Reclamation District No. 2090, et al.*, SEC Lit. Rel. No. 7551 (Sept. 8, 1976) (settled final order against District); *SEC v. Reclamation District No. 2090, et al.*, SEC Lit. Rel. No. 7547 (Sept. 2, 1976) (settled final order against officials).

See also SEC Lit. Rel. No. 23180, *Court Enters Default Judgment Against SEC Defendant Joseph T. Letke, Bars Him from Participating in Municipal Securities Offerings, and Orders Him to Pay Over $200,000* (Jan. 27, 2015) (municipal advisor to issuer (who also served as the issuer's comptroller) allegedly received undisclosed compensation from bond proceeds).

[3] *See SEC v. San Antonio Municipal Utility District No. 1, et al.*, Civ. Action No. H-77-1868 (SD TX), SEC Lit. Rel. No. 8195 (Nov. 18, 1977) (settled final order) ("The Complaint alleges that the disclosure documents used in connection with the offering and sale to the public of the District's Bonds omitted to disclose a multifaceted financing agreement entered into in April, 1976, by the Developer and [the underwriter] and omitted to disclose financial information about the Developer. The financing agreement included commitments by [the underwriter] to bid and purchase the Bonds, to make land refinancing ($6.5 million) and development ($2.5 million) loans to the Developer and affiliates, and to purchase $3,000,000 in notes or securities from the Developer or its designees … .").

[4] *See In the Matter of McKay*, SEC Rel. Nos. 33-7536, 34-40225 (July 17, 1998) ("On March 23, 1990, the underwriter solicited proposals for the appraisal of Wildwood Estates. The appraisal was required to determine the value-to-lien ratio. Of the five appraisers solicited, two did not respond, one replied that it could not submit a bid within the time allowed, one bid $20,000 and [the appraiser] bid $4,000. At the time, [the appraiser] was already working with the underwriter on [another issuer's] bond offerings … . [The appraiser] was not an MAI, but he had a fee-splitting arrangement with an appraiser who was an MAI. Under this arrangement, the MAI co-signed the appraisal reports in exchange for a 10 percent cut of [the appraiser's] fees."). *See also In the Matter of County of Nevada*, SEC Rel. No. 33-7535 (May 5, 1998); *SEC v. First California Capital Markets Group, Inc., et al.*, Civ. No. 97-2761-SI (ND CA), SEC Lit. Rel. No. 16107 (Apr. 7, 1999) (settled final orders). *See also* n. 32.

[5] *See SEC v. Aiken, et al.*, Civ. Action No. CA 5:11-1018 (SD WV), SEC Lit. Rel. No. 22214 (Jan. 3, 2012) ("According to the SEC's complaint, … [the 'sole principal' of the borrowing company in an industrial development bond issue] failed to disclose material information about a $200,000 loan to [the principal and the company] from an entity partially owned by their attorney, in order to facilitate the closing of the transaction. This loan required a $100,000 interest payment, and gave the lender a twenty percent equity interest in [the company] if the loan plus interest was not fully repaid within six months. [The principal's]

failure to disclose … the loan rendered certain statements in the bonds' Official Statement materially misleading. For example, [a] section of the Official Statement contained projected financial statements for [the company], but failed to take into account the repayment of the $200,000 loan plus $100,000 interest.") *See also In the Matter of Detling*, SEC Rel. No. 34-66161 (Jan. 17, 2012) (Action against borrower counsel). *See also* nn. 13 and 34 regarding failures to disclose a criminal indictment and pending plea agreement.)

[6] *See SEC v. Langford, et al.*, Case No. cv-08-B-0761-S (ND AL), SEC Lit. Rel. Nos. 20545 (Apr. 30, 2008) (Complaint filing), 21595 (July 20, 2010) (Permanent injunction against dealer and lobbyist), 22104 (Sept. 26, 2011) (Voluntary dismissal of certain claims for financial remedies against the former President of the issuer's governing body in view of his conviction and imposition of other remedies in the criminal action), and 22068 (Aug. 16, 2011) (Summary judgment and permanent injunction against the issuer official) ("The Commission's complaint against [the official] alleged he accepted approximately $156,000 in cash, loans, and other benefits in exchange for steering County bond and swap business to a long-time friend and local broker dealer."); *U.S. v. Langford, et al.,* Case No. 2:08-CR-00245-LSC-PWG (ND AL), SEC Lit. Rels. Nos. 20821 (Dec. 5, 2008) (Indictment).

See also SEC v. O'Dell, Civ. Action No. 98-948-CIV-ORL-18A (MD FL), SEC Lit. Rel. No. 15858 (Aug. 24, 1998) (settled final order) ("Complaint against … the former Director of Public Works for Osceola County, Florida, for failing to disclose his receipt of bribes for assisting a brokerage firm in its selection to sell County bonds … . The Complaint … alleges the following: [t]he arrangement provided that, in exchange for [the Director's] assistance with the brokerage firm's selection as one of the firms to sell the … bonds, … , the consultant would share his compensation from the firm with [the Director]."); *SEC v. Busbee, et al*., SEC Lit. Rel. No. 14508 (May 24, 1995) (settled final order) ("According to the Complaint, [an issuer official] and [an individual underwriter] entered into certain financial arrangements, pursuant to which [the official] received certain benefits from [the underwriter], during a time when [the official] had responsibility for selecting the underwriter for municipal securities issued by the [issuer]. The Complaint alleges that [the underwriter] caused the following benefits to be conferred on [the official]: 1) the extension and guarantee of four loans totaling $36,700 from an Arkansas bank; 2) repayment of approximately $27,000 in principal and interest on three of the loans; and 3) payment of approximately $3,500 to [the official] directly."); *SEC v. Bethea*, Civ. Action No. 3:98CV-457-LAC-MD (ND FL), SEC Lit. Rel. No. 15985 (Nov. 23, 1998) (settled final order) (Action against "the former head" of an underwriter's public finance department "for giving secret payments to certain Florida public officials in exchange for municipal securities business. … In addition, [the former head] endorsed the conferral of an undisclosed favor upon a third Florida public official; and enlisted third parties to serve as conduits for campaign contributions … ." *See also SEC v. Cochran, et al*., 214 F.3d 1261 (10th Cir. 2000) (underwriter's receipt of undisclosed payments from investment providers); *SEC v. Mark S. Ferber*, Civ. Action No. 96-12653 (EFH) (D. Mass.), SEC Lit. Rel. No. 15193 (Dec. 19, 1996) (financial advisor's undisclosed fee agreement with provider of interest rate swaps); *In the Matter of Lazard Freres & Co., LLC*, SEC Rel. Nos. 33-7671, 34-41318 (Apr. 21, 1999) (financial advisor's undisclosed fee agreement with provider of securities for refunding escrow). *See also* n. 18.

[7] *See In the Matter of City Securities Corp., et al*., SEC Rel. Nos. 33-9434, 34-70056, IC-30632 (July 29, 2013) (SEC found that the underwriter "provided improper gifts and gratuities to personnel of certain municipal securities issuers, including multi-day, out-of-state golf trips and tickets to multiple sporting events.") *See also* nn. 6 and 10.

See also FINRA Dept. of Enforcement v. L.J. Hart and Co., Order Accepting Offer of Settlement (Sept. 24, 2013) ("During the Relevant Period, the [underwriter's] ticket-gifting program resulted in the firm improperly gifting over 2,000 tickets valued at $183,546.00 to Municipal Issuer Representatives. Specifically, on 598 distinct occasions throughout the Relevant Period, [the underwriter] gifted tickets to various sporting events valued in excess of $100 to individual Municipal Issuer Representatives within a one-year period. In each such case, [the underwriter] did not host the Municipal Issuer Representatives at the sporting events and, in fact, there were no [underwriter] employees present at the events.")

[8] *See In the Matter of RBC Capital Markets Corp*., SEC Rel. No. 34-59439 (Feb. 24, 2009) ("As part of the process of regularly issuing bonds to raise capital to fund its operations, the City obtained credit ratings for its bond offerings from rating agencies based in New York City. City officials traveled to New York on a nearly annual basis to meet with analysts from the rating agencies ('Rating Trip'). On Rating Trips taken in 2004 and 2005, City officials were accompanied by family members, dined at upscale restaurants, attended Broadway shows and sporting events, and had access to a private car service. These two trips lasted six days, even though meetings with the ratings agencies were held on one or two days. After receiving instructions from a representative of the City regarding activities of interest to City officials and family members, [the underwriter] organized the activities for each trip, and then advanced the payment for nearly all of the expenses incurred by the City officials and their family members. [The underwriter] then obtained, with the knowledge and approval of certain City officials, reimbursement for all expenses incurred on the Rating Trips as a cost of issuance, directly from bond proceeds at closing.") *See also In the Matter of Merchant Capital, L.L.C*., SEC Rel. No. 34-60043 (June 4, 2009) (allegedly, the rating trip and related entertainment expenses—including for friends and family of issuer officials—were charged to issuers as costs of issuance).

[9] *See In the Matter of Morrison*, SEC Rel. Nos. 34-67935, IC-30223 (Sept. 27, 2012) (Banker "participated extensively in [the] gubernatorial campaign [of the then State Treasurer] and did so at times from his [employer's] office, during his … work hours and using [company] resources, such as phones, e-mail and office space. [The banker's] campaign work gave him complete access to [the Treasurer] and his staff, who often provided him with information about the office's internal deliberations involving underwriter selection.")

[10] For example, extraordinary contributions may be made by a professional to a favorite charity of a local official as a means of gaining employment. *See In the Matter of City Securities Corp., et al*., SEC Rel. Nos. 33-9434, 34-70056, IC-30632 (July 29, 2013) (SEC found that the underwriter failed to investigate the failure of the issuer to provide continuing disclosure, and that during "the relevant time period," the underwriter "mischaracterized expenses such as charitable donations and entertainment expenses, and then billed these expenses and other purported 'miscellaneous' costs back to various municipal securities issuers as costs of the 'Printing, Preparation and Distribution of Official Statements,' without the issuers'

knowledge"; the charitable donations cited were: "A donation of $2,500 to a charity favored by an issuer; A donation of $1,500 to an educational scholarship favored by an issuer; $1,000 to sponsor of a golf outing hosted by an issuer; and $2,500 to sponsor an education foundation event hosted by an issuer which featured a 'Colts Town Hall' breakfast with high profile professional football players from the Indianapolis Colts"). Similarly, most municipal securities professionals would decline making payments at the request of an issuer official to friends of that official.

[11] For example, a financial advisor to an issuer might provide staff to conduct a bond election campaign that the issuer is prohibited from funding. An underwriter or bond counsel might make cash contributions to the costs of the bond election that are used to compensate the financial advisor for its work. In such circumstances, an issuer's selection of underwriter, bond counsel, and financial advisory professionals may be based upon the degree of services for or contributions to the bond election, rather than upon professional merit. The financial advisor who received the payments may recommend that the issuer employ the other professionals. Professionals may seek to recover all or part of their contributions through their fees charged to issuers.

[12] *See* n. 1 above.

[13] *SEC v. Detling*, Civ. Action No. 1:11 cv 4565 (ND GA), SEC Lit. Rel. No. 22215 (Jan. 3, 2012), *In the Matter of Detling*, SEC Rel. No. 34-66161 (Jan. 17, 2012) (Action against borrower counsel). *See* n. 5 above regarding loan from counsel to conduit borrower at substantial interest rate with a right under certain conditions to receive equity in company. *See also* n. 34.

See also SEC v. Senex Corp., et al., 399 F. Supp. 497 (ED KY 1975) ("[The expert] report was prepared by an individual who would share 50% of the developer's profits … . This court is convinced that the defendants should have disclosed the relationship of [the expert and the company]. Whatever the claimed scope of the [expert] report, the study was widely publicized as demonstrating the desirability of the project. The presumed accuracy of the report does not abrogate the obligation to explain that [the expert's] profits were dependent upon the success of the project. Although consultants are normally compensated, the constructive bias of [the expert's] position was a matter which should have been revealed."); *see also In the Matter of Ferguson*, SEC Rel. No. 33-5523 (Aug. 21, 1974) (bond counsel preparing the official statement). *See also* n. 31.

[14] *See SEC v. Martin, et al.*, Civ. Action No. C 03-2646 C (WD WA), SEC Lit. Rels. Nos. 18315 (Aug. 28, 2003) (Complaint filing) and 19814 (Aug. 28, 2006) (Entry of judgment by consent against individual banker who had been an underwriter official in an offering of bonds that defaulted. The SEC alleged in its Complaint that "The bonds were intended to finance the building of certain public purpose portions of a private office-building complex. … When the bonds were sold to investors in October 2000, approximately half of the proceeds were used to acquire land and for professional fees. The balance of the proceeds remains in escrow." The SEC also alleged, among other things, that the private developer of the office building "failed to disclose kickbacks to several of the offering participants," which had included fees alleged to have been paid to issuer counsel and bond counsel. The developer also paid a fee to the bond issuer, which was not the jurisdiction in which the building was located. Other

allegations included that "the developer and others lied to investors about how bond proceeds would be used to acquire land for the project; falsely claimed that a prominent investment bank was involved in providing additional private financing for the project; [and] falsely claimed that the project was already fully leased to a 'Triple A' credit-rated company."); *see also In the Matter of Martin*, SEC Rel. No. 34-54402 (Sept. 5, 2006).

[15] *See SEC v. R.J. Allen & Assocs., Inc.*, 386 F. Supp. 866 (SD FL 1974) ("As a part of its business, [the underwriter], through its principals, … , and certain salesmen … engaged in the offer, sale, and underwriting of Industrial Development Revenue Bonds ('IDR's') of numerous issuers. … While engaging in their solicitation activities, the defendants … failed to inform the prospective purchasers of the speculative nature of the IDR'S, that they were not general obligations of or backed by the full faith and credit of any governmental body, or that the bonds purportedly held in trust were not so held. In connection with one particular IDR, … the defendants failed to disclose to the investors that [a principal and the underwriter also] were principals of [the conduit borrower] and would derive substantial benefits from any sales of that bond issue. The evidence discloses that [the conduit borrower] received in excess of $550,000 from that bond issue on requisitions put in by [an underwriter principal] which were not verified by the [issuer]."). *See also* SEC Lit. Rel. No. 6653 (Dec. 7, 1974) (Settled final order).

[16] *See SEC v. Kasirer, et al.*, Case No. 04-C-4340 (ND IL), SEC Lit. Rels. Nos. 18774 (July 1, 2004) (Complaint filing), 19131 (Mar. 11, 2005) (Settlement with certain Respondents), and 20358 (Nov. 5, 2007) (Final settlement) (Lawyer serving as underwriter counsel allegedly "wrote a check to [CEO of parent organization of several conduit borrowers] in the amount of $18,000 pursuant to an undisclosed agreement under which [the lawyer] shared a portion of the underwriter's counsel fees with [the CEO] … purportedly … to compensate [the CEO] for time spent by [the CEO] and employees of [the parent company] in assisting in the preparation of the Official Statements. In effect, [the CEO] was receiving a portion of the fees of the lawyer who was supposed to be conducing due diligence … ." In addition, the lawyer's firm "wire transferred monies" to the wife of the CEO.) *See also* n. 20.

[17] *See* nn. 2, 8, and 20.

[18] *See In the Matter of Poirier*, SEC Rel. Nos. 33-8741, 34-54492 (Sept. 25, 2006) (The SEC found that, in connection with the selection of an underwriter, a banker "caused" his firm "to issue a check" to an "outside consultant" who then split his fee with financial advisory personnel assisting an issuer in the underwriting firm's employment); *see also In the Matter of deVegter*, SEC Rel. Nos. 33-8645, 34-53009, IA-2465, IC-27196 (Dec. 22, 2005) (financial advisor).

[19] *See* n. 14.

[20] *See SEC v. Kasirer, et al.*, Case No. 04-C-4340 (ND IL), SEC Lit. Rels. Nos. 18774 (July 1, 2004) (Complaint filing), 19131 (Mar. 11, 2005) (Settlement with certain Respondents), and 20358 (Nov. 5, 2007) (Final settlement) ("The Commission's Complaint alleged that from February 1996 through August 1999, [the organization's CEO] and others ('the Defendants'), acting in concert, fraudulently offered and sold over $131 million of municipal revenue bonds to members of the public to finance the development of ten healthcare facilities … . The

Defendants offered and sold the bonds in question through a series of eleven offerings underwritten by the now-defunct [underwriter]. … [The CEO] was the president of the company that selected the properties to be developed and then managed the … facilities. The Complaint further alleged that [the CEO] directed the wrongful commingling and diversion of millions of dollars of bond proceeds and concealed that practice from investors.") *See also* n. 16.

See also SEC v. Cole, Case No. CV 12-8024 ABC (SHx) (CD CA), SEC Lit. Rel. No. 22484 (Sept. 18, 2012) ("According to the complaint, prior to the close of the bond offering, [borrower's principal] directed [borrower] employees and consultants to create false documentation for a nonexistent company to falsely justify fictitious expenses for the sucralose project. The complaint alleges he then instructed [borrower] employees to wire his wife … $900,000 in bond proceeds, which were used to pay among other things, their mortgage, credit card debt, homeowners and auto insurance, and household employees, in part, under the false pretense that she was an agent of the sham company.").

See further SEC v. Sutliffe, Civ. Action No. 95-0867-CV-W-BD (WD MO), SEC Lit. Rel. No. 14658 (Sept. 28, 1995) (complaint) and SEC Lit. Rel. No. 14707 (Nov. 1, 1995) (settled final order) ("The Commission's Complaint … alleged, among other things, that during the years 1984 through 1989, [the promoter] was the undisclosed promoter and control person of two not-for-profit corporations, … which participated in 26 public offerings of municipal and corporate bonds raising over $107 million. The purpose of these offerings was to acquire, renovate and operate nursing homes. The Complaint further alleged that, in connection with two such offerings, … [the promoter] promoted the offerings and participated in the preparation of false and misleading offering circulars. Specifically, the Complaint alleged that [one] offering circular contained material misrepresentations and omissions concerning: [the promoter's] role as a promoter of the offering; [the promoter's] control over [the organization] as well as … the commingling of revenues from existing … nursing homes and the resulting financial interdependence of all [of the organization's] nursing homes; and [the organization's] ongoing ponzi scheme."); *see also SEC v. Goodman*, *et al*., Civ. Action No. 95CV 71563 (ED MI), SEC Lit. Rel. No. 14471 (Apr. 19, 1995) (settled final order) (underwriter and underwriter counsel); *In the Matter of Blaine*., SEC Rel. Nos. 33-7224, 34-36277, AAE-717 (Sept. 26, 1995) (auditor's engagement partner).

See SEC v. Washington County Utility District, et al., 1982 U.S. Dist. LEXIS 17316 (ED TN Dec. 2, 1982) (In action relating to several defaulted bond issues, "Despite the fact that the bonds issued by the CATV Division and the Garbage Division are revenue bonds payable solely from revenues generated by the appropriate Division, monies have been advanced from one Division of the District to another Division of the District without the payment of interest by the borrower Division. In fact, no interest has ever been paid on advances from one Division to another.") *See also* n. 2.

[21] *See* nn. 14, 15, 16, and 18.

[22] *See* nn. 5, 13, 15, 20, and 34.

[23] *See* n. 2.

[24] For example, the management organization for a charter school might lease or sell facilities or equipment to the charter school, might have consulting or employment arrangements with members of the governing body of the school or with professionals working on the bond offering, or might be the effective party selecting members of the governing body that approves the management contract. *See, e.g.*, SEC Rel. No. 2014-110, *SEC Charges Charter School Operator in Chicago With Defrauding Bond Investors* (June 2, 2014) (allegedly, while disclosing one conflict and claiming a robust conflicts policy, the school failed to disclose that the brother of a senior officer of the charter school operator had a contract with the charter school relating to construction funded with bond proceeds, which the school also failed to report, as required, to a state agency providing grants; according to the SEC "investors also weren't informed about the potential financial impact the conflicted transaction had on [the school's] ability to repay the bonds."). *See also* n. 2.

[25] *See* n. 15.

[26] *See* n. 4.

[27] *See* the NFMA's *White Paper on Expert Work Products* (2011), which recommends disclosure of "The amount and form of compensation paid or to be paid to the Expert in connection with the preparation of the Expert Work Product; whether payment to the Expert is contingent on sale and delivery of the bond issue in question; and whether significant amounts remain unpaid as of the completion of the Expert Work Product."

[28] *See* the GFOA's Best Practice, *Selecting and Managing the Engagement of Municipal Advisors* (2008, 2014): "Fees paid to municipal advisors should be on an hourly or retainer basis, reflecting the nature of the services to the issuer. Generally, municipal advisory fees should not be paid on a contingent basis to remove the potential incentive for the municipal advisor to provide advice that might unnecessarily lead to the issuance of bonds." The GFOA's Best Practice is available at www.gfoa.org/selecting-and-managing-municipal-advisors.

[29] *See* n. 1.

[30] *See In the Matter of Piper Jaffray & Co., et al.*, SEC Rel. No. 33-9472, 34-70804 (Nov. 5, 2013) (Action against underwriter and official); *In the Matter of The Greater Wenatchee Regional Events Center Public Facilities Dist., et al*., SEC Rel. No. 33-9471 (Nov. 5, 2013) ("[The facilities operator], led by its President, … was hired by the District to develop and operate the Regional Center. … [The operator] was perceived to be a competent operator of events centers, but had limited experience forecasting revenues and had hired a financial consultant to assist with the Regional Center financial projections. Over the course of the development and construction of the Regional Center, [the operator] prepared a series of financial projections for operation of the Regional Center to be used both for budgeting purposes and for inclusion in the District's Official Statement. While the Official Statement contained the most recent version of [the operator's] projections, the District, the District's Contracts Manager … , [the operator and the operator's President] all knew that an independent consultant had been asked to review [the operator's] earlier projections and had raised questions about the Regional Center's economic viability. Despite two separate reviews of [the] projections by the independent consultant, the Official Statement presented the most

recent version of [the] projections along with a false and misleading statement to the effect that no financial advisor, accounting or other firm had examined those projections to verify the reasonableness of [the operator's] assumptions or its conclusions. … The District, [the contract officer], [the operator, and the operator's President] also knew that the projections in the Official Statement had been revised upward from projections generated a few months earlier after a claim by the City's former Mayor and [the contract officer] that [the facilities operator's] projections were inconsistent with its prior projections and not sufficiently optimistic.").

The NFMA's *White Paper on Project Finance Risk Assessment and Disclosure* (2006) stated that "[i]nvestors and other interested parties should be made aware of any previous feasibility studies undertaken in support of a project. The discussion should set forth the summary conclusions of the prior Study and the reasons for the commissioning of a new study" and that "[d]isclosure as to whether the feasibility study was subject to a peer review process is very important."

Beginning in the mid-1970s, the GFOA's *Disclosure Guidelines for State and Local Government Securities* (4th ed. 1991) recommended the disclosure of "any relevant engineer's or financial feasibility reports or studies" and added that "[r]eference should also be made to any other reports or studies known to the issuer that may have a significant bearing on the conclusion of feasibility." The GFOA added: "All references should describe the relevant conclusions of the reports or studies that relate to the use of proceeds as set forth in the official statement. If no engineers' or financial feasibility report or study has been made on behalf of the issuer in connection with a construction project or acquisition of facilities, or if no demand study has been conducted, a statement should be made to that effect." *See also* the NFMA's *White Paper on Best Municipal Bond Issuance Practices* (available at www.nfma.org) at 13 (2014), which states: "The POS should disclose the existence of all Expert Work Products known to the issuer or underwriter."

[31] *See SEC v. Senex Corp., et al.*, 399 F. Supp. 497 (ED KY 1975) (Discussing feasibility reports prepared regarding a planned nursing home, including an adverse report prepared on behalf of "a competing nursing home:" "The mass of evidence indicting the [two other] reports as inaccurate and/or inadequate does not excuse the defendants' silence; regardless of the deficiencies, the adverse reports represented a difference of opinion among experts which should have been disclosed. The dispositive issue is not the relative merits of the surveys but the differing conclusions reflected; the informed judgment contemplated by the securities legislation was denied by an ex parte determination on the part of nonobjective controllers that the adverse conclusions were valueless."). *See also In the Matter of Ferguson*, SEC Rel. No. 33-5523 (Aug. 21, 1974) (bond counsel preparing the official statement). *See also* n. 13.

[32] *See In the Matter of McKay*, SEC Rel. No. 33-7536, 34-40225 (July 17, 1998) ("In [his] appraisal, [the appraiser] found values ranging from $2.98 million to $38 million. [The appraiser] also prepared a 14-page summary to be included in the Official Statement to be provided to investors. The summary appraisal only contained the three highest values, ranging from approximately $32 million to $38 million."). *See also* n. 4.

[33] *See* the NFMA's *White Paper on Expert Work Products* (2011; available at www.nfma.org), which recommends that: "The Expert's potential conflicts of interest, including any

relationships with parties having a significant financial or other interest in the subject matter or in the municipal securities offering" and "The amount and form of compensation paid or to be paid to the Expert in connection with the preparation of the Expert Work Product . . ." both be included in the information disclosed when an Expert Work Product is part of a municipal bond offering.

[34] *See SEC v. Aiken, et al.*, Civ. Action No. CA 5:11-1018 (SD WV), SEC Lit. Rel. No. 22214 (Jan. 3, 2012) ("According to the SEC's complaint, [the conduit borrower's 'sole principal'] concealed from key participants to the transaction, including the issuer, bond counsel, the underwriter, and the bondholders' trustee, that he had been indicted for felony financial fraud in late 2005. [The principal] also concealed the fact that he was in the process of negotiating a plea agreement just before the bonds were issued in October 2006, which included a term of imprisonment. … [The principal's] failure to disclose details about his criminal proceeding … rendered certain statements in the bonds' Official Statement materially misleading. For example, one section of the Official Statement contained information about [the principal's] background, but failed to mention his felony indictment for financial fraud."); *see also SEC v. Detling*, Civ. Action No. 1:11 cv 4565 (ND GA), SEC Lit. Rel. No. 22215 (Jan. 3, 2012), *In the Matter of Detling*, SEC Rel. No. 34-66161 (Jan. 17, 2012) (Action against borrower counsel). *See also* nn. 5 and 13.

[35] *See SEC v. Sutliffe*, Civ. Action No. 95-0867-CV-W-BD (WD MO), SEC Lit. Rel. No. 14658 (Sept. 28, 1995) (complaint), and SEC Lit. Rel. No. 14707 (Nov. 1, 1995) (settled final order) ("The Commission's Complaint … alleged, among other things, that … , in connection with two … offerings, … [the promoter] promoted the offerings and participated in the preparation of false and misleading offering circulars. Specifically, the Complaint alleged that [one] offering circular contained material misrepresentations and omissions concerning: [promoter's] … regulatory history … .") *See also* nn. 20 and 36.

[36] *See SEC v. Sutliffe*, Civ. Action No. 95-0867-CV-W-BD (WD MO), SEC Lit. Rel. No. 14658 (Sept. 28, 1995) (complaint), SEC Lit. Rel. No. 14707 (Nov. 1, 1995) (settled final order) ("The Commission's Complaint … alleged, among other things, … that [one] offering circular contained material misrepresentations and omissions concerning: [promoter's] … numerous prior bond and business failures … .") *See also* nn. 20 and 35.

[37] *See* nn. 5, 13, 24 and 34.