

# Chapman Client Alert

January 13, 2017

Current Issues Relevant to Our Clients

## Port Authority Settles SEC Charges of Inadequate Disclosure for \$400,000

On January 10, 2017, the Securities and Exchange Commission (SEC) issued a cease-and-desist order (Order) to the Port Authority of New York and New Jersey (Port Authority) under which the Port Authority acknowledged that it acted negligently in failing to disclose certain risks in official statements for over \$2.3 billion of bonds issued between January 2012 and June 2014.

The SEC's press release stated that the Port Authority is the first municipal issuer to admit wrongdoing in an SEC enforcement action.

The Port Authority historically has not hired outside bond counsel, relying instead on the Port Authority's general counsel for opinions as to the validity of Port Authority bonds.

Prior to the issuance of the bonds, attorneys in the Port Authority's Law Department raised concerns as to whether the Port Authority had legal authority under relevant statutes and existing bond covenants to finance some of the projects with bond proceeds. These legal concerns were ultimately resolved to the satisfaction of the general counsel. Unqualified opinions as to the validity of each of the bond issues, as well as standard Rule 10b-5 assurances, were delivered by the general counsel to the Port Authority.

The potential legal issues were never disclosed to the Port Authority's Board of Commissioners, which approved the projects under a "consent calendar" process without discussion. The legal concerns were also never disclosed in the official statements for the bond issues.

The SEC found that the Port Authority should have disclosed the Law Department's initial legal concerns in the official statements. By failing to do so, the SEC found that the Port Authority violated Sections 17(a)(2) and (3) of the Securities Act by failing to disclose "known material risks surrounding the potential lack of legal authority to fund those projects." Instead, the official statements contained statements that the Port Authority issued bonds only for legally authorized purposes. The Order states that the Port Authority "knew or should have known, that known but undisclosed risks surrounding the [projects] were material to potential investors in making investment decisions."

In a press release issued the same day as the Order, the Port Authority stated that independent legal opinions from outside law firms concluded that the Port Authority did in fact have legal authority to issue bonds for the disputed projects. In a footnote to the Order, the SEC refers to one such legal opinion and noted that the legal opinion did not address the Port Authority's obligation to disclose the risks surrounding the projects to investors.

After learning of the SEC's investigation, the Port Authority reallocated bond proceeds to other projects. The projects for which there were legal concerns were ultimately funded from other sources. There were no financial losses by bondholders.

The Port Authority waived certain evidentiary privileges in connection with the SEC's investigation of these matters.

The SEC noted that the Port Authority had already taken certain remedial actions, including retaining outside bond counsel for all new bond issues and eliminating the Board of Commissioners' process of approving projects through a consent calendar without debate.

The Order requires the Port Authority to pay a civil penalty of \$400,000 to the SEC. The penalty is the second largest paid by a governmental entity. (In 2016, the City of Miami agreed to pay \$1 million to settle a securities fraud charge in connection with several municipal enforcement actions.)

The Port Authority is required to hire an independent consultant to review its policies and procedures regarding disclosures of risks in connection with municipal securities offerings, and to implement such policies and procedures within 180 days of the Order. The Port Authority must adopt a policy that requires the Port Authority's Law Department to certify the legal authority for any proposed expenditure of funds presented to its Board of Commissioners for approval.

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