SEC Charges Rhode Island Agency and Wells Fargo With Fraud in 38 Studios Bond Offering

FOR IMMEDIATE RELEASE
2016-37

Washington D.C., March 7, 2016 —
The Securities and Exchange Commission today charged a Rhode Island agency and its bond underwriter Wells Fargo Securities with defrauding investors in a municipal bond offering to finance startup video game company 38 Studios.

The Rhode Island Economic Development Corporation (RIEDC, now called the Rhode Island Commerce Corporation) issued $75 million in bonds for the 38 Studios project as part of a state government program intended to spur economic development and increase employment opportunities by loaning bond proceeds to private companies.

According to the SEC's complaint filed in federal district court in Providence:

- The RIEDC loaned $50 million in bond proceeds to 38 Studios. Remaining proceeds were used to pay related bond offering expenses and establish a reserve fund and a capitalized interest fund.
- The loan and, in turn, bond investors would be repaid from revenues generated by video games that 38 Studios planned to develop.
- The bond offering document produced by the RIEDC and Wells Fargo failed to disclose to investors that 38 Studios had conveyed it needed at least $75 million in funding to produce a particular video game.
- Therefore, investors weren't fully informed when deciding to purchase the bonds that 38 Studios faced a funding shortfall even with the loan proceeds and could not develop the video game without additional sources of financing.
- When 38 Studios was later unable to obtain additional financing, the video game didn't materialize and the company defaulted on the loan.

"Municipal issuers and underwriters must provide investors with a clear-eyed view of the risks involved in an economic development project being financed through bond offerings," said Andrew Ceresney, Director of the SEC Enforcement Division. "We allege that the RIEDC and Wells Fargo knew that 38 Studios needed an additional $25 million to fund the project yet failed to pass that material information along to bond investors, who were denied a complete financial picture."

The SEC also charged Wells Fargo's lead banker on the deal, Peter M. Cannava, and two then-RIEDC executives Keith W. Stokes and James Michael Saul with aiding and abetting the fraud. Stokes and Saul agreed to settle the charges without admitting or denying the allegations and must each pay a $25,000 penalty. They are prohibited from participating in any future municipal securities offerings. The SEC's litigation continues against Cannava, Wells Fargo, and RIEDC.

The SEC's complaint further alleges that Wells Fargo and Cannava misled investors in an additional way in bond offering materials:

- Wells Fargo disclosed its bond offering compensation as a share of the placement agent fee plus a $50,000 payment from 38 Studios. No other fees or compensation to Wells Fargo were disclosed, and the bond placement agreement stated that no other money was anticipated.
- Investors weren't informed that Wells Fargo had a side deal with 38 Studios that enabled the firm to receive nearly double the amount of compensation disclosed in offering documents.

- This additional compensation, totaling $400,000 and paid from bond proceeds, created a conflict of interest that Wells Fargo should have disclosed to bond investors.
- Cannava was responsible for Wells Fargo's failure to disclose its additional fees.

"An underwriter's 'skin in the game' is material information to investors," said LeeAnn Ghazil Gaunt, Chief of the SEC Enforcement Division's Municipal Securities and Public Pensions Unit. "We allege that Wells Fargo failed to fully disclose its own economic interest in this bond transaction."

The SEC's complaint charges the RIEDC and Wells Fargo with violations of Sections 17(a)(2) and (a)(3) of the Securities Act of 1933, and charges Stokes, Saul, and Cannava with aiding and abetting those violations. Wells Fargo also is charged with violations of Section 15B(c)(1) of the Securities Exchange Act of 1934 and Rules G-17 and G-32 of the Municipal Securities Rulemaking Board (MSRB). Cannava is charged with aiding and abetting those violations.

In a separate administrative proceeding, the RIEDC's financial advisor for the bond offering – First Southwest Company LLC – agreed to settle charges that it violated MSRB rules by failing to document in writing the scope of the services the firm was providing in the bond offering until seven months after the financial advisory relationship began. Without admitting or denying the findings, First Southwest agreed to pay disgorgement of $120,000, prejudgment interest of $22,400, and a penalty of $50,000.

The SEC's investigation was conducted by its Municipal Securities and Public Pensions Unit, including Louis Randazzo, Joseph Chimienti, Jonathan Wilcox, Kevin B. Currid, and Deputy Chief Mark Zehner. The SEC's litigation is being led by Kathleen B. Shields of the Boston Regional Office and Mr. Randazzo.

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