Securities Regulation Daily Wrap Up, TOP STORY—D.R.I.: Video game startup bond offering disclosures failed to level up, (Mar. 7, 2016)

Securities Regulation Daily Wrap Up

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By Amanda Maine, J.D.

The SEC charged the Rhode Island Economic Development Corporation (RIEDC), Wells Fargo, and two former RIEDC executives and a Wells Fargo banker with securities fraud relating to a municipal bond offering for a video game startup company. The SEC alleged that the offering documents failed to disclose a known shortfall in funding and the full amount of compensation paid to Wells Fargo as the offering's lead placement agent (*SEC v. Rhode Island Commerce Corporation*, March 7, 2016).

Bond offering. According to the SEC, in 2010, Rhode Island was experiencing high unemployment. As a way to increase employment opportunities in the state, in November 2010, RIEDC issued $75 million of taxable revenue bonds, $50 million of which was loaned to 38 Studios, LLC. 38 Studios was a pre-revenue video gaming company headed by former Major League Baseball player Curt Schilling. The loan was intended to finance the development of a video game by 38 Studios. Revenues generated by the videogames developed by 38 Studios would be used to repay the loan and, in turn, bond investors.

Funding shortfall disclosure omission. The bond offering documents did not disclose that the $50 million loan would not be adequate financing for developing the video game, the SEC alleged. 38 Studios had conveyed that it actually needed $75 million to produce the video game described in the offering documents. 38 Studios was unable to obtain the additional funding needed to produce the game, and as a result, the video game was not produced, and the company ended up defaulting on the loan.

Compensation disclosure omission. The SEC also alleged that Wells Fargo failed to disclose a side deal with 38 Studios which would result in double the amount disclosed in the offering documents. This additional compensation, which totaled $400,000 and was paid from bond proceeds, created a potential conflict of interest which was material and should have been disclosed to the bond investors.

Charges. The SEC charged RIEDC (now called the Rhode Island Commerce Corporation) and Wells Fargo with securities fraud under the Securities Act. The complaint also charged two former RIEDC executives and the Wells Fargo lead banker on the bond offerings with aiding and abetting RIEDC's and Wells Fargo's fraud. The former RIEDC executives each agreed to pay a $25,000 civil penalty and to be barred from participating in future municipal securities offerings. The former executives settled the charges without admitting or denying the allegations. The SEC's case continues against RIEDC, Wells Fargo, and the lead banker.

The SEC also instituted settled administrative proceedings against RIEDC's financial advisor for the bond offering. The administrative order charges First Southwest Company, LLC with violating the fair dealing and financial advisory agreement rules of the Municipal Securities Rulemaking Board. According to the order, First Southwest rendered financial advisory services to the RIEDC for seven months without a written financial advisory agreement, in violation of MSRB rules. First Southwest agreed to pay $142,000 in disgorgement and prejudgment interest and a $50,000 penalty. In settling the matter, First Southwest did not admit or deny the SEC's charges.

The case is No. 16-cv-107.

Attorneys: S. Gale Dick (Cohen & Gresser) for RIEDC. Luke Cadigan (K&L Gates) for Wells Fargo. Brian Kelly (Nixon Peabody) for Peter M. Cannava. E. Scott Morvillo (Morvillo LLP) for Keith W. Stokes. Daniel Wenner (Day Pitney) for James Michael Saul. Michael Connolly (Hinckley Allen) for First Southwest Company.

Companies: Rhode Island Commerce Corporation f/k/a Rhode Island Economic Development Corporation; Wells Fargo Securities, LLC; First Southwest Company, LLC.

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