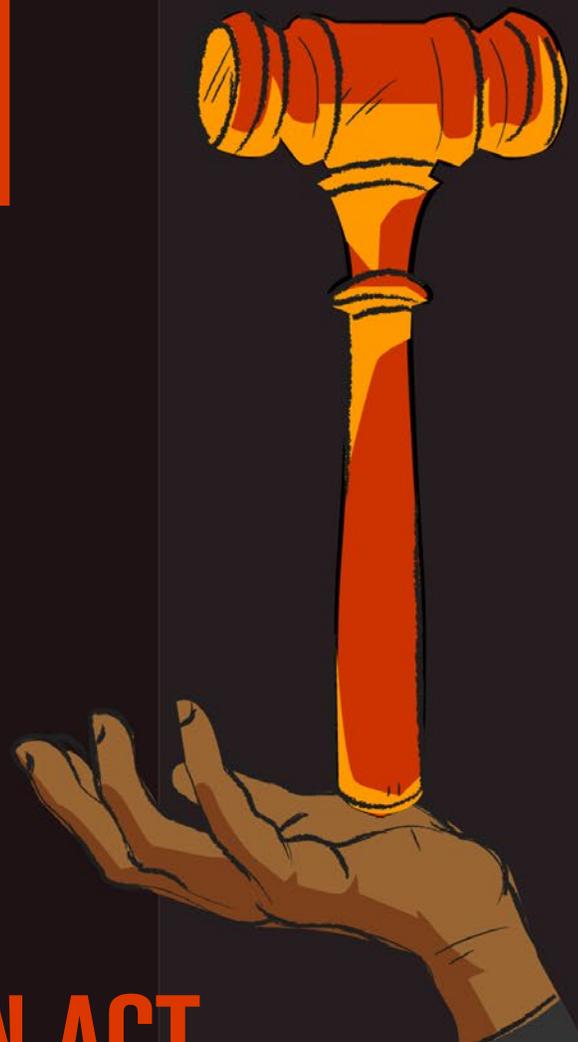


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IT'S TIME TO MARTIN ACT

Why New York State Attorney General Letitia James should investigate the Wall Street players behind Puerto Rico's Debt Crisis

The root cause of Puerto Rico's debt crisis, as well as the banks and other key players that fueled and profited from it, have never received a proper legal examination. The New York State Attorney General is in a position to bring transparency and accountability to the financial institutions that have profited from Puerto Rico's pain.

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INTRODUCTION

The root cause of Puerto Rico's debt crisis, as well as the banks and other key players that fueled and profited from it, have never received a proper legal examination. Various authorities, including the Financial Oversight and Management Board and ousted Puerto Rico Governor Ricardo Rosselló, have stopped well short of the kind of comprehensive investigation that is warranted.

With more than a million Puerto Ricans living in New York, the state has forged a close relationship with the island and its residents for decades. In the wake of Hurricane María, New York State stepped up and extended various forms of support, helping channel resources to the people of Puerto Rico and ensuring that those who came had the necessary support to live with dignity. In this same spirit of support and solidarity, the New York State Attorney General is in a position to bring transparency and accountability to the financial institutions that have profited from Puerto Rico's pain.



AG James at press conference — Office of the Attorney General ag.ny.gov

The New York State Attorney General's office has broad powers to investigate and prosecute financial crimes. Key aspects of Puerto Rico's debt crisis and restructuring have strong ties to New York: many of the entities involved in creating and speculating on Puerto Rico's debt are based in New York City or have a major presence there, and New York State law governs significant portions of current and restructured Puerto Rico debt. Additionally, more Puerto Ricans live in New York than in any other state, and the diaspora has historically been a major part of New York City and communities throughout the state.

The New York State Attorney General also has an important tool with which to pursue accountability related to Puerto Rico's debt: the Martin Act. New York State law grants the attorney general broad latitude to investigate securities fraud, and it has been used by previous attorneys general to police Wall Street to great effect. James should appoint a special counsel to explore avenues for legal inquiry and accountability related to Puerto Rico's debt.

This report outlines some potential legal tools and areas for an investigative focus, though a dedicated special counsel would be able to identify a range of possible approaches that leverage the full capabilities of the attorney general's office.

BACKGROUND ON THE DEBT CRISIS, RESTRUCTURING, AND ACCOUNTABILITY EFFORTS

Puerto Rico is currently in the process of restructuring its debt. Between the central government and its public corporations, it has around \$74 billion in principal outstanding from municipal bond issuances. To address the crisis created by this extremely high and unsustainable level of debt, in the summer of 2016 Congress enacted the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA).

PROMESA did two significant things. First, it created a presidentially-appointed, seven member board with power over the local executive and legislative branches. Second, since Puerto Rico is excluded from Chapter 9 of the United States Bankruptcy Code, PROMESA created a unique legal framework for the restructuring of its debt. PROMESA aimed to balance the Commonwealth's budget and ensure its return to the municipal debt markets.

The debt crisis is intrinsically related to Puerto Rico's economic depression, which started in 2006. It is impossible to understand the archipelago's economic and fiscal challenges without taking into consideration the role Congress has played. For example, the beginning of the economic depression coincided with the year that a major tax break for corporations with operations in Puerto Rico was fully repealed.

That tax break, section 936 of the Internal Revenue Code, was responsible for several decades of increased economic growth. When Congress decided to strike it down, the tax break-fueled bubble burst, and Puerto Rico's economic downward spiral began.¹

Puerto Rico's debt issuance increased significantly from 2000 onwards. Bonds continued to be issued, especially to refinance old debt, and Puerto Rico's government became increasingly dependent on debt as economic activity declined. These bonds were very attractive to investors because they have been triple tax exempt since 1917, when Congress approved the Jones Act, which also gave Puerto Ricans US citizenship.

Puerto Rico has also been excluded from important regulatory laws. Federal legislation regulating securities apply, and the Securities and Exchange Commission (SEC) has jurisdiction. But there is an important difference: the Commonwealth has been excluded from the Investment Company Act of 1940 since its enactment, making its market much less restrictive than in the United States. For example, investment firms can act as advisors to the government in the issuance of bonds while at the same time marketing those same bonds to investors.²

¹ Caraballo, José & Lara, Juan: "From deindustrialization to unsustainable debt: The Case of Puerto Rico" http://homes.chass.utoronto.ca/~bobonis/CaraballoLara_PR_debt_16.pdf

² <https://www.cnbc.com/2017/12/18/the-77-year-old-loophole-that-created-puerto-ricos-unique-market.html>



October 20th March Against Cuts to Pensions by Julio López Varona

This conflict of interest is totally prohibited in the 50 states. In Puerto Rico it's legal.

Puerto Rico's debt has never been audited, with strong opposition to an audit coming from the current local administration and the federal board. In 2015, Puerto Rico's legislature enacted Act 97, creating the Commission for the Comprehensive Audit of Puerto Rico's Public Credit. Its purpose was to organize a comprehensive audit of the debt, that is, an audit that would have investigated, among other things, if the money borrowed was in compliance with laws and regulations, the uses of the money borrowed, and if there were unlawful and fraudulent transactions. The commission was never funded and, in April 2017, Governor Rosselló signed a bill that repealed the commission altogether.³ José Carrión, the chairman of the federal board, told the press that public calls for a debt audit was a waste of time.⁴

This has left the people of Puerto Rico blind as to the origins, uses, and legality of the bond issuances.

Nevertheless, reacting to public pressure, plus requests for independent investigations by the Unsecured Creditors Committee in the Title III cases, the federal board hired white collar defense firm Kobre & Kim to perform a general investigation about the causes of the debt. This was not an audit, but rather a survey of possible legal conflicts related to some bond issuances, the context in which they were made, and how Puerto Rico's municipal bond issuers piled up debts over time.⁵

Following the release of the Kobre & Kim report, the federal board constituted a Special Claims Committee to look into the potential claims identified in the report. As of today around, close to \$9 billion of constitutionally-guaranteed bonds have been challenged in federal court by the PROMESA board for having violated Puerto Rico's constitutional and statutory restrictions on debt issuance.⁶ Other parties, like the Unsecured Creditors Committee, have challenged other portions of bonded debt over similarly alleged violations of Puerto Rico's laws.⁷

3 <http://periodismoinvestigativo.com/2018/06/puerto-rico-debt-audit-drags-on-as-creditor-negotiations-heat-up/>, for more background: <http://www.80grados.net/pausa-para-la-auditoria/>

4 <https://www.noticel.com/ahora/carrin-sobre-la-auditora-quotes-una-prdida-de-tiempoquot-video/609379956>

5 <https://drive.google.com/file/d/19-lauVo3w9MPS03xYVe0SWhQin-Q6FEf/view>

6 <https://www.nytimes.com/2019/05/02/business/puerto-rico-debt-banks.html>

7 <https://news.littlesis.org/2019/06/05/puerto-ricos-debt-battles-the-oversight-board-goes-on-a-suing-spreel/>

THE FEBRUARY 2020 DEBT ADJUSTMENT DEAL

In June 2019, as a result of negotiations spurred by this lawsuit, the PROMESA board reached a tentative agreement with bondholders of the disputed debt, offering 35 cents on the dollar to holders of the general obligation bonds issued in 2014.⁸ (See below for a summary of irregularities related to the issuance of this debt that the New York Attorney General can investigate.) On February 9, 2020, the FOMB announced a different restructuring plan from the one they announced in June 2019, encompassing \$35 billion of the debts held by the central government of Puerto Rico.⁹ This agreement increases the offer to this group of bondholders to an estimated 65.4 cents, giving hedge funds a bigger return on their investment in questionable debt they bought at a steep discount.¹⁰ The deal also cuts pension payments, commits sales tax to debt payments, and secures payments in the event of a bankruptcy. The plan still needs to be approved by the legislature of Puerto Rico and the federal judge overseeing the restructuring process.

The debt deal is currently opposed by the Puerto Rico legislature and the governor of Puerto Rico, who have expressed concerns about the impact this deal would have on pension holders. Moreover, in February, over 60 groups in Puerto Rico and the diaspora opposed the deal, raising concerns about the impact it would have in the most vulnerable populations in Puerto Rico and its implications for the island's recovery.¹¹ The bonds that the New York State Attorney General could investigate are included in this deal.

NEW YORK STATE MECHANISMS FOR ACCOUNTABILITY

The New York State Attorney General is the state's top legal officer, and has a wide range of tools at her disposal to investigate financial crimes.

The most important of these is the Martin Act, which grants the Attorney General broad powers to investigate securities fraud. Passed in 1921, it pre-dates the federal Securities Exchange Act of 1934 and is far more expansive than similar anti-fraud legislation on the state level.

To prove a violation under the act, the Attorney General must prove deceptive or misleading conduct in the sale or promotion of securities in New York. Unlike anti-fraud laws in other states and on the federal level, the Martin Act does not require proof of intent to deceive.¹² It also does not require purchase, sale, or damages (what is known as "reliance").

Though the Martin Act has been on the books for nearly a century, it was not aggressively used by most New York State attorneys general until Eliot Spitzer's tenure. Spitzer used it to launch major investigations of big banks related to their role in inflating and profiting from the dot com bubble, and subsequent attorneys general have used it to pursue accountability around the mortgage crisis and climate crisis.

Notably, a 2018 decision issued by the New York State Court of Appeals temporarily limited the statute of limitations for Martin Act inquiries to three years, instead of six years.¹³ At the behest of Attorney

8 Page 12: https://drive.google.com/file/d/1uyS9_npXsV7cUfMI0cwxENUuc0A5hboG/view

9 <https://www.nytimes.com/2020/02/10/business/puerto-rico-debt.html>

10 Page 12: https://drive.google.com/file/d/1uyS9_npXsV7cUfMI0cwxENUuc0A5hboG/view

11 <https://cpdaction.org/over-50-organizations-puerto-rico-and-diaspora-reject-fomb-debt-restructuring-agreement-and-demand>

12 More precisely, from *Practical Law*: "To prove a violation under the Act, the state must prove a misrepresentation or omission of a material fact or other conduct which deceives or misleads the public, or even tends to deceive or mislead the public, in the sale or promotion of a security within or from New York." https://www.jonesday.com/files/Publication/cc6cfc9e-1517-4707-958d-8ea80d2042c2/Presentation/PublicationAttachment/9be275fc-e882-499c-9045-9a429519ab82/FebMar15_%20NYSupplement_MartinActFeature.pdf

13 <https://www.nytimes.com/2018/06/12/business/wall-street-martin-act.html>

General Letitia James, the state legislature passed and Governor Cuomo signed into law a bill that reinstated the six-year statute of limitations for both the Martin Act and Executive Law 63(12), which relates to “persistent fraud or illegality in the carrying on, conducting, or transaction of business.”¹⁴

Following its enactment, James said that “this law strengthens two of our most critical tools in holding corporate greed accountable and delivering justice for victims of financial fraud.”¹⁵



The New York State Senate

Section 352-C

Prohibited acts constituting misdemeanor; felony

General Business (GBS)

1. It shall be illegal and prohibited for any person, partnership, corporation, company, trust or association, or any agent or employee thereof, to use or employ any of the following acts or practices:
 - (a) Any fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale;
 - (b) Any promise or representation as to the future which is beyond reasonable expectation or unwarranted by existing circumstances;
 - (c) Any representation or statement which is false, where the person who made such representation or statement: (i) knew the truth; or (ii) with reasonable effort could have known the truth; or (iii) made no reasonable effort to ascertain the truth; or (iv) did not have knowledge concerning the representation or statement made; where engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase within or from this state of any securities or commodities, as defined in section three hundred fifty-two of this article, regardless of whether issuance, distribution, exchange, sale, negotiation or purchase resulted.

¹⁴ <https://codes.findlaw.com/ny/executive-law/exc-sect-63.html>

¹⁵ <https://www.law.com/newyorklawjournal/2019/08/26/cuomo-signs-bill-reinstating-6-year-statute-of-limitations-under-martin-act/?sreturn=20190811180413>



Governor Cuomo & Attorney General Letitia James James. — Photo by the Governor's Office

OPENINGS FOR INVESTIGATION

Though there are many openings for investigating Wall Street players behind Puerto Rico's financial crisis, legal authorities have yet to pursue the kind of intensive inquiry that is called for.

At the federal level, the SEC has initiated some inquiries, but so far they have ended with no major findings or repercussions.¹⁶ On the other hand, the Financial Industry Regulatory Authority (FINRA), a private regulatory authority, has imposed fines in the past.¹⁷ While these efforts are positive, much more can be done.

Puerto Rico's regulatory agencies, such as the Office of the Commissioner of Financial Institutions, are plagued with revolving door conflicts and have done

next to nothing to explore the serious concerns regarding potentially fraudulent transactions, and have been criticized for their soft approach to financial institutions.¹⁸

New York State's attorney general could step into this void, bringing much-needed transparency and accountability to the debt. The following section identifies openings for legal inquiry around the Puerto Rico's 2014 junk bond issuance, a particularly problematic bond that falls within the Martin Act's six-year statute of limitations.

A special counsel appointed by the attorney general could explore these and other avenues for legal inquiry.

¹⁶ <https://www.reuters.com/article/us-puertorico-debt-sec/sec-ends-probe-into-puerto-ricos-3-5-billion-2014-bond-issuance-sources-idUSKBN1HH05C>

¹⁷ https://files.brokercheck.finra.org/firm/firm_13042.pdf

¹⁸ <https://www.elnuevodia.com/negocios/consumo/nota/unapalmaditalamultadelaocifaubs-1870849/>

2014 JUNK BOND ISSUANCE

In March 2014, in its final foray into the bond market prior to entering into the restructuring process, Puerto Rico went ahead with what would become the biggest junk bond issuance in the history of the United States municipal market, a \$3.5 billion general obligation bond sale. This offering has been the focus of a great deal of litigation, public scrutiny, and criticism; the many red flags it raised present clear openings for investigation.

Since the 2014 bonds were governed by New York State law and sold and marketed within the state, the attorney general would certainly have jurisdiction to investigate.

Several aspects of the issuance raise questions about whether the underwriters and other parties to the issuance, such as bond counsel, undertook the due diligence and disclosures required of them – which could point to major issues of fraud and misrepresentation. The Kobre & Kim report highlighted these issues in section XVI, its overview of potential causes of action (the report did not evaluate any potential cause of action, or recommend action on any of them):

- **Lack of disclosure of the hiring of restructuring experts shortly before the issuance.** Puerto Rico's Government Development Bank (GDB) hired three firms with significant restructuring expertise shortly before the issuance, in early 2014. These hires included Millco, Cleary Gottlieb, and Proskauer Rose.¹⁹ With the exception of Millco, these contracts were not disclosed prior to or as part of the issuance, even though they would seem to be material and worthy of consideration by potential purchasers of the bonds. Such a lack of disclosure could point to misrepresentation or fraud on the part of the GDB, underwriting banks, and/or other parties to the bonds, though an adequate investigation has not yet been undertaken. Additionally, it is important to note that Proskauer Rose serves as chief bankruptcy counsel to the PROMESA board, and may be significantly conflicted in this role.²⁰
- **Popular's underwriting of the issuance, after recommending that the Government Development Bank not go forward with it.** In 2014, Popular, along with Citi, advised then chair of the board of directors of the Government Development Bank, David Chafey (himself an ex-official from Popular) against another Commonwealth bond issuance. The financial situation of Puerto Rico was already critical. According to a witness interviewed, "a long term GO issuance did not make sense."²¹ Both private banks prepared a memorandum proposing another

¹⁹ <https://caribbeanbusiness.com/puerto-rico-may-be-liable-for-incomplete-cofina-go-bond-disclosures/>

²⁰ <https://www.elnuevodia.com/noticias/politica/nota/juntadesupervisionfiscalrechazaconflicto deintereses-2267147/>

²¹ Page 542: <https://drive.google.com/file/d/19-lauVo3w9MPS03xYVe0SWhQin-Q6FEf/view>



Climate Action Day November 30th 2019 action against Santander by Julio López Varona

type of approach. The GDB did not follow their advice, opting to go ahead with the bond issuance.

Citi decided not to underwrite the transaction, citing concerns about the Commonwealth's dire financial situation, but one of its New York subsidiaries, Citigroup Global Markets Limited - New York, did purchase several millions worth of these bonds immediately upon issuance.²² Popular, despite advising against it, actually underwrote the offering as part of the underwriters' syndicate through a subsidiary, Popular Securities.²³

- **Violation of constitutional debt limit.** In a lawsuit filed in May 2019, the federal management board argued that this issuance (and two other issuances, in 2012) were in violation of Puerto Rico's constitutional debt limit.²⁴ If the federal board made this argument, there is a significant chance that legal opinions existed prior to the issuance that made a similar case – and that underwriting banks, law firms, and other parties to the issuance were aware of them and decided to move forward, anyway, without disclosing these opinions in the context of the issuance.

CONCLUSION

With more than a million Puerto Ricans living in New York, the relationship between the state and the Island is one that cannot be understated. In the wake of Hurricane María, the State of New York did not hesitate to step up to support incoming refugees and give them a home. To this day, many of these refugees are still in New York as the island struggles to rebuild.

As this happened, New York hedge funds forced and continue to force austerity and suffering on Puerto Rico to ensure that they get paid back exorbitant amounts of money from questionable debt deals. The New York Attorney General has an opportunity to once again stand up for the people of Puerto Rico and bring transparency and accountability to the financial institutions that have profited from Puerto Rico's pain.

²² <http://periodismoinvestigativo.com/2016/08/275-firmas-de-inversion-se-lanzaron-sobre-la-deuda-chatarra-de-puerto-rico/>

²³ http://www.gdb.pr.gov/investors_resources/documents/CommonwealthPRGO2014SeriesA-FinalOS.PDF

²⁴ <https://cases.primeclerk.com/puertorico/Home-DownloadPDF?id1=OTAYMTY2&id2=0>

WHO ARE THE HEDGE CLIPPERS?

Every day, the most unscrupulous hedge fund managers, private equity firms and Wall Street speculators impact the lives of Americans. They play an outsized role in our political process, our education system, and our economy. Hedge Clippers is a national campaign focused on unmasking the dark money schemes and strategies the billionaire elite uses to expand their wealth, consolidate power and obscure accountability for their misdeeds. Through hard-hitting research, war-room communications, aggressive direct action and robust digital engagement, Hedge Clippers unites working people, communities, racial justice organizations, grassroots activists, students and progressive policy leaders in a bold effort to expose and combat the greed-driven agenda that threatens basic fairness at all levels of American society.

The Hedge Papers are researched, written, edited, reviewed and designed by a distributed, networked team of researchers, writers, academics, attorneys, industry experts, community organizers and designers from around the United States, with contributions from international activists.

We welcome contributions from whistleblowers, industry insiders, journalists, lawmakers and regulatory officials as well as from regular Americans who have felt the destructive impact of hedge funds, private equity funds and the billionaire class in their daily lives.

Our collective includes individuals associated with labor unions, community organizations, think tanks, universities, non-governmental organizations, national and international organizing and advocacy networks, student and faith groups as well as non-profit and for-profit organizations.

The Hedge Clippers campaign includes leadership and collaborative contributions from labor unions, community groups, coalitions, digital activists and organizing networks around the country, including: the Strong Economy for All Coalition, New York Communities for Change, Alliance for Quality Education, VOCAL-NY and Citizen Action of New York; Make the Road New York and \Make the Road Connecticut; New Jersey Communities United; the Alliance of Californians for Community Empowerment (ACCE) and Courage Campaign; the Grassroots Collaborative in Illinois; the Ohio Organizing Collaborative; ISALAH in Minnesota; Organize Now in Florida; Rootstrikers, Every Voice, Color of Change, 350.org, Greenpeace, the ReFund America Project and United Students Against Sweatshops; the Center for Popular Democracy and the Working Families Party; the United Federation of Teachers and New York State United Teachers; the American Federation of Teachers, the National Education Association, and the Communication Workers of America.

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