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# Federal Regulation of Municipal Securities

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## Note: Federal Regulation of Municipal Securities

Noninstitutional investors have doubled the value of their municipal securities<sup>1</sup> holdings in the past 15 years.<sup>2</sup> In 1974 alone, additional "household" investments accounted for nearly 70 percent of the total increase in the value of outstanding municipal securities.<sup>3</sup> Rising personal income has enhanced the attractiveness of higher yield, tax-free municipal securities to individuals,<sup>4</sup> while "tight" money has decreased the funds available to institutional buyers.<sup>5</sup> To enhance the marketability of their bonds, municipalities have reduced bond face value from the traditional \$5000 to amounts as low as \$500<sup>6</sup> and have used advertisements specifically designed to attract unsophisticated investors.<sup>7</sup> While noninstitutional investment in municipal securities has grown, the safety of that investment has deteriorated. Federal loan guarantees<sup>8</sup> were necessary to prevent New York City, with \$7.35 billion in bonds outstanding,<sup>9</sup> from defaulting on its obligations.<sup>10</sup> Similar, though less dramatic, financial

1. Throughout this Note the term "municipal securities" refers to long-term obligations of states, their political subdivisions, and agencies or instrumentalities of states or their political subdivisions.

2. S. REP. NO. 75, 94th Cong., 1st Sess. 41 (1975) [hereinafter cited as S. REP. NO. 75].

3. *Id.* "Households" include individual investors, personal trusts, and unincorporated businesses.

4. *Id.* at 42.

5. Doty, *Application of the Antifraud Provisions of the Federal Securities Laws to Exempt Offerings: Duties of Underwriters and Counsel*, 16 B.C. IND. & COM. L. REV. 393, 399 (1975) [hereinafter cited as Doty].

6. Wall St. J., June 12, 1975, at 22, col. 2 (Eastern ed.).

7. The following ad for New York City's Municipal Assistance Corporation was reported in NEWSWEEK, Sept. 22, 1975, at 27:

At over 10% TAX-FREE how come none of your savings are in "BIG M.A.C." Bonds? You don't have to be a Park Avenue millionaire to get in on BIG M.A.C. bonds. They're printed in \$1000 pieces. They pay twice as much as some banks. And they're free of federal, state and city income taxes. Send for our free information kit and start earning the highest tax-free interest rate in American history.

8. New York City Seasonal Financing Act, 1975, Pub. L. No. 94-143, 1976 U.S. CODE CONG. & ADM. NEWS 797.

9. McFadden, *Individual Bondholders Are Disillusioned*, N.Y. Times, Oct. 19, 1975, § 1, at 48, col. 2.

10. Redemption of \$1.6 billion of New York City notes, however, has been delayed for at least three years. New York State Emergency Moratorium Act for the City of New York, ch. 874, as amended ch. 875 (McKinney Spec. Pamphlet Jan. 1976). The constitutionality of this legislation was upheld in a class action suit instituted by

difficulties plague other cities.<sup>11</sup> And some states may be unable to make principal and interest payments on "moral obligation bonds"<sup>12</sup> issued by state agencies;<sup>13</sup> even certain general obligation bonds,<sup>14</sup> once considered nearly as safe as United States government bonds, have lost much of their respectability.<sup>15</sup>

The entry of less sophisticated investors into the municipal securities market and the increasing risk accompanying municipal securities call into question the failure of the securities laws to require issuers of municipal securities to disclose financial information to investors. This Note will briefly examine the existing structure of federal municipal securities regulation and discuss its inadequacies. The Note will propose that Congress, while allowing for the unique problems of municipal issuers, modify the structure by enacting a registration requirement for municipal issues that will promote full disclosure to investors.

## I. THE PRESENT STRUCTURE OF FEDERAL REGULATION

### A. BACKGROUND

The Securities Act of 1933<sup>16</sup> and the Securities Exchange Act of 1934<sup>17</sup> are the bases of federal securities regulation. Before securities are distributed to the public, the 1933 Act generally requires complete and accurate disclosure of the identity of and remuneration to the directors, principal officers, and underwriters of the issuer; the identity and holdings of major stockholders; the recent financial statements and material contracts of the issuer; the proposed use of the funds to be acquired through the issue; underwriting agreements; and other informa-

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the Flushing National Bank. *Flushing Nat'l Bank v. Municipal Assistance Corp.*, 39 Clark's Digest—Annot. 35 (N.Y. Sup. Ct. Dec. 1975).

11. Jensen, *Crisis Is Believed to Cost Other Borrowers Billions*, N.Y. Times, Oct. 19, 1975, § 1, at 1, col. 6, at 48, col. 7 (Detroit, Newark, and Boston).

12. See text accompanying note 107 *infra*.

13. BUS. WEEK, Oct. 13, 1975, at 80-82.

14. See text accompanying notes 102-03 *infra*.

15. BUS. WEEK, Oct. 13, 1975, at 84. Not all issues have lost their attractiveness. Pennsylvania recently sold \$100 million of general obligation bonds bearing an interest rate of 6.24 percent. 68 MOODY'S BOND SURVEY 1765 (1976).

16. 15 U.S.C. §§ 77a-77aa (1970) [hereinafter cited as Securities Act].

17. *Id.* §§ 78a-78hh [hereinafter cited as Securities Exchange Act].

tion relating to the issuer.<sup>18</sup> This disclosure is to be made in a registration statement that must be filed with the Securities and Exchange Commission (SEC) and in a prospectus that must be furnished to securities purchasers.<sup>19</sup> The Act prohibits fraudulent and deceptive practices in offering or selling securities and subjects those who violate these prohibitions or who fail to comply with its disclosure requirements to civil and criminal liabilities.<sup>20</sup>

The 1934 Act requires securities exchanges and over-the-counter brokers and dealers to register with the SEC and regulates business practices in the securities industry.<sup>21</sup> It sets standards for securities trading by corporate "insiders"<sup>22</sup> and for proxy solicitations,<sup>23</sup> and requires certain companies to register and file periodic reports with the SEC.<sup>24</sup> The Act also prohibits fraudulent, deceptive, and manipulative practices in securities transactions and provides penalties for violators.<sup>25</sup>

Municipal securities, for "obvious political reasons,"<sup>26</sup> were

18. Securities Act §§ 7, 10, Schedule A, 15 U.S.C. §§ 77g, 77j, 77aa (1970).

19. Section 5(a) prohibits the use of the mails or any means or instrumentality of interstate commerce for the sale or delivery of securities unless a registration statement is in effect. 15 U.S.C. § 77e(a) (1970). Section 5(b) requires that a prospectus accompany or precede delivery of sales literature as well as the security itself. *Id.* § 77e(b).

20. Section 17(a) prohibits fraudulent interstate transactions. *Id.* § 77q(a), *quoted in* note 56 *infra*. Civil liabilities are set forth in sections 11, 12, and 15. 15 U.S.C. §§ 77k, 77l, 77o (1970); *see* notes 91-92 *infra* and accompanying text. Section 24 prescribes criminal penalties for willful violations. 15 U.S.C. § 77x (1970); *see* notes 71-73 *infra* and accompanying text.

21. Section 5 prohibits the use of the mails or any means or instrumentality of interstate commerce to affect or report securities transactions on unregistered exchanges. 15 U.S.C. § 78e (1970). Section 15 requires registration of brokers and dealers. 15 U.S.C.A. § 78o (Supp. 1976), *amending* 15 U.S.C. § 78o (1970).

22. Securities Exchange Act § 16, 15 U.S.C. § 78p (1970).

23. *Id.* § 14, 15 U.S.C. § 78n (1970).

24. *Id.* § 12, 15 U.S.C. § 78l (1970).

25. *E.g., id.* §§ 9, 10, 15 U.S.C. §§ 78i, 78j (1970). Criminal penalties for willful violations are prescribed in section 32. 15 U.S.C. § 78ff (1970); *see* text accompanying note 74 *infra*. Civil penalties for willful violations are prescribed in section 9. 15 U.S.C. § 78i (1970).

26. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 39 (1959). Although Landis does not identify specific political pressures, it is reasonable to speculate that members of Congress might have been reluctant to impose stringent federal regulation on one of the means by which state and local governments financed their operations—especially since not a few senators and representatives

originally exempted from all but the general antifraud provision of the 1933 Act.<sup>27</sup> One witness at committee hearings on the Senate version of the 1933 Act strongly criticized the exemption, arguing unsuccessfully that municipal securities investors needed more information than was usually available.<sup>28</sup> The Port of New York Authority, meanwhile, secured an expansion of the exemption to include any "instrumentality of any State or States"<sup>29</sup> without even appearing before the committee.<sup>30</sup> In considering the 1934 Act, Congress was persuaded by extensive testimony that full application of the Act to municipal securities markets would unduly burden the securities industry and impair the fund-raising abilities of municipal issuers, so it once again granted an exemption.<sup>31</sup>

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owed their election to the same political "machines" that dominated these levels of government.

27. Securities Act § 3, 15 U.S.C. § 77c (1970), provides that:

(a) Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:

(2) Any security issued or guaranteed . . . by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of one or more States or territories . . . .

28. *Hearings on S. 875 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 65 (1933), reprinted in 2 *LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934*, Item 21 (J. Ellenberger & E. Mahar ed. 1973) (testimony of A.H. Carter, President, New York Society of Certified Public Accountants) [hereinafter cited as *Ellenberger & Mahar*].

29. Securities Act § 3(a) (2), 15 U.S.C. § 77c(a) (2) (1970).

30. *Hearings on S. 875 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 49-50 (1933), reprinted in *Ellenberger & Mahar*, *supra* note 28, Item 21 (letter of the Port of New York Authority). The Authority noted in a letter to the chairman of the Senate Committee that since it was an instrumentality of both New York and New Jersey, it was technically not covered by the exemption of "any State . . . or political subdivision or agency thereof." The language suggested by the Authority was incorporated into S. 875 and eventually into the Securities Act of 1933.

31. Securities Exchange Act § 3(a), ch. 404, § 3(a), 48 Stat. 882 (1934), as amended 15 U.S.C.A. 78c (Supp. 1976), provided that

When used in this chapter, unless the context otherwise requires—

(12) The term "exempted security" or "exempted securities" includes . . . securities which are direct obligations of or obligations guaranteed as to principal or interest by a State or any political subdivision thereof, or by any agency or instrumentality of a State or any political subdivision thereof, or by any municipal corporate instrumentality of one or more States . . . .

See *Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 Before the Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess.

Subsequent developments in the municipal securities markets, however, caused Congress to reconsider the exemption for municipal securities under the 1934 Act. Tax-free municipal bonds became increasingly attractive to the individual investor as his personal income rose, and certain municipal securities firms were able to prey on that investor's lack of sophistication. High pressure sales of low quality bonds by inadequately trained and supervised personnel characterized these "boiler room" operations. Salesmen whose jobs depended on high sales production attempted to induce hasty, ill-considered investment decisions.<sup>32</sup> They falsely told investors that bond supplies were limited or that sellers in particular transactions needed tax losses and were therefore anxious to dispose of their holdings. They misrepresented highly speculative revenue bonds as general obligations bonds, falsely claiming that principal and interest on some bonds were guaranteed. They recommended municipal bonds as good investments without knowing the financial condition and investment needs of their customers.<sup>33</sup> Firms sold bonds from their own accounts at inflated prices and delivered "fractionals" as substitutes for bonds ordered by customers.<sup>34</sup> They sent sales confirmations to people who had refused to order bonds over the telephone,<sup>35</sup> and, in some instances, they took payment for bonds that had never been purchased.<sup>36</sup>

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7037-46, 7441-55 (1934), reprinted in 6-7 Ellenberger & Mahar, *supra* note 28, Item 22; *Hearings on H.R. 7852 and H.R. 8720 Before the House Interstate and Foreign Commerce Comm.*, 73d Cong., 2d Sess. 415, 449, 817-25 (1934), reprinted in 8-9 Ellenberger & Mahar, *supra* note 28, Item 23.

32. S. REP. No. 75, *supra* note 2, at 43.

33. The wide range of fraudulent activities engaged in by some municipal securities dealers is illustrated in the following successful SEC injunctive actions: SEC v. R.J. Allen & Assoc., 386 F. Supp. 866, 871-77 (S.D. Fla. 1974); SEC v. Charles A. Morris & Assoc., 386 F. Supp. 1327, 1331-35 (W.D. Tenn. 1973); SEC v. Investors Assoc. of America, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,644, at 92,896 (W.D. Tenn. 1972) (complaint summary).

34. SEC v. R.J. Allen & Assoc., 386 F. Supp. 866, 874 (S.D. Fla. 1974); SEC v. Charles A. Morris & Assoc., 386 F. Supp. 1327, 1333 (W.D. Tenn. 1973). These bonds, bearing a stated interest rate of a fraction of one percent, would normally be sold at large discounts so that the buyer's only significant return—the difference between face amount and purchase price—would be realized at redemption.

35. See SEC v. R.J. Allen & Assoc., 386 F. Supp. 866, 873 (S.D. Fla. 1974); SEC v. Charles A. Morris & Assoc., No. C-72-368 (W.D. Tenn. Feb. 4, 1974), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,431, at 95,480 (consent decree summary).

36. See SEC v. R.J. Allen & Assoc., 386 F. Supp. 866, 874 (S.D. Fla. 1974).

Because these firms were exempt from regulation under the Exchange Act<sup>37</sup> the SEC could not adequately supervise their business practices. Control over municipal securities professionals was limited to post hoc enforcement of the antifraud provisions of the securities acts.<sup>38</sup> If the Commission discovered a "boiler room" operation, it could do no more than seek an injunction to prevent further violations.<sup>39</sup> This case-by-case approach, however, was ineffective in deterring other firms from conducting similar operations.<sup>40</sup> Although only a small portion of municipal securities firms engaged in such practices, they presented great dangers to individual investors and the municipal securities industry as a whole.<sup>41</sup> Recognizing the interests of both investors and governmental issuers in sound municipal securities markets, Congress amended the Exchange Act in 1975 to prevent the continuation of fraudulent practices in the industry.<sup>42</sup>

## B. THE SECURITIES ACTS AMENDMENTS OF 1975

The Securities Acts Amendments of 1975 expand federal regulation of the securities industry by subjecting municipal securities brokers and dealers to the registration requirements of the Securities Exchange Act and by establishing an independent body authorized to set qualifications and standards of conduct for municipal securities professionals.

### 1. Registration

Congress has vested the SEC with broad powers over municipal securities brokers and dealers by requiring them to register with the Commission.<sup>43</sup> Unregistered brokers and deal-

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37. Securities Exchange Act § 3(a) (12), ch. 404, § 3(a) (12), 48 Stat. 882 (1934), as amended 15 U.S.C.A. 78c (Supp. 1976), quoted in note 31 *supra*.

38. S. REP. NO. 75, *supra* note 2, at 42.

39. See SEC v. Charles A. Morris & Assoc., 386 F. Supp. 1327, 1336 (W.D. Tenn. 1973) (if defendants decided to reenter the securities business, "the public would have the protection of the injunctive decree").

40. S. REP. NO. 75, *supra* note 2, at 43.

41. *Id.* at 38.

42. Securities Acts Amendments of 1975 § 11, 15 U.S.C.A. § 78o (Supp. 1976) [hereinafter cited as 1975 Amendments]. Also amended were portions of the Securities Exchange Act not directly related to municipal securities, Securities Act of 1933, Investment Company Act of 1940, Investment Advisors Act of 1940, and others. *Id.* §§ 25-30, 89 Stat. 163-70 (codified in scattered sections of 15 U.S.C.A.).

43. *Id.* § 11, 15 U.S.C.A. § 78o (Supp. 1976).

ers may not conduct interstate operations,<sup>44</sup> and the SEC may deny registration to unqualified applicants on the basis of their prior conduct or failure to meet qualification standards.<sup>45</sup> Registrants must comply with record-keeping and reporting requirements prescribed by the Commission;<sup>46</sup> the SEC will inspect their operations within six months after registration to assess their conformance with the Act and the SEC's rules and regulations.<sup>47</sup> The Commission, by administrative order, can limit the activities, functions, or operations of any registered broker or dealer who violates the securities laws or fails reasonably to supervise persons who commit violations while subject to his supervision; it may also suspend his registration for up to 12 months or revoke it altogether.<sup>48</sup>

## 2. *Municipal Securities Rulemaking Board*

By the creation of the Municipal Securities Rulemaking Board (MSRB), the 1975 Amendments serve to maintain the self-regulatory structure of the securities industry.<sup>49</sup> The MSRB is authorized to establish standards of training, experience, competence, and other qualifications for municipal securities professionals and to require these professionals to pass appropriate qualification exams.<sup>50</sup> The Board is to prescribe the records municipal securities businesses must keep<sup>51</sup> and to require periodic examinations of these firms to determine their compliance with the securities laws.<sup>52</sup> The Amendments, in enumerating the objectives underlying the general rulemaking authority of the MSRB, require that the rules promulgated by the Board

be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to

44. *Id.*

45. *Id.*, 15 U.S.C.A. § 78o(b)(1)(B) (Supp. 1976).

46. Securities Exchange Act § 17, 15 U.S.C. § 78q (1970).

47. 1975 Amendments § 11, 15 U.S.C.A. § 78o(b)(2)(C) (Supp. 1976).

48. *Id.*, 15 U.S.C.A. § 78o(b)(4) (Supp. 1976).

49. *Id.* § 13, 15 U.S.C.A. § 78o-4(b)(1) (Supp. 1976).

50. *Id.*, 15 U.S.C.A. § 78o-4(b)(2)(A) (Supp. 1976). The MSRB has proposed rules providing for exams and apprenticeships for new municipal securities professionals, setting personnel and bonding standards for municipal securities businesses, requiring municipal securities businesses to comply with restrictions imposed by regulatory agencies, and prohibiting certain individuals and firms from engaging in municipal securities business. BNA SEC. REG. & L. REP., Jan. 7, 1976, at A-8.

51. 1975 Amendments § 13, 15 U.S.C.A. § 78o-4(b)(2)(G) (Supp. 1976).

52. *Id.*, 15 U.S.C.A. § 78o-4(b)(2)(E) (Supp. 1976).



foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest.<sup>53</sup>

The sole function of the MSRB is to promulgate rules; the Amendments delegate inspection, examination, and disciplinary responsibilities to existing regulatory bodies.<sup>54</sup>

### C. ENSURING DISCLOSURE TO MUNICIPAL SECURITIES INVESTORS

The Securities Acts Amendments of 1975 did nothing to significantly alter the Securities Act of 1933; thus, municipal securities issuers remain exempt from the registration and prospectus requirements of that Act.<sup>55</sup> Brokers, dealers, and municipal issuers are subject to a limited disclosure obligation,

53. *Id.*, 15 U.S.C.A. § 78o-4(b) (2) (C) (Supp. 1976).

54. These bodies include the SEC, federal banking agencies, and the National Association of Securities Dealers.

55. Securities Act § 3(a) (2), 15 U.S.C. § 77c(a) (2) (1970), *quoted in* note 27 *supra*. The registration requirement for nonexempt securities is found in section 5:

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of section 77j of this title; or

(2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 77j of this title.

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order to (prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.

15 U.S.C. § 77e (1970).

however, since the municipal securities exemption does not extend to the general antifraud provisions of the securities acts.<sup>56</sup> Section 17(a)<sup>57</sup> of the Securities Act and rule 10b-5,<sup>58</sup> promulgated under section 10(b) of the Exchange Act, both prohibit persons engaged in the distribution and sale of securities from making any untrue statement of a material fact and from omitting any material fact "necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." These prohibitions may be enforced through SEC administrative procedures, injunctive and criminal

56. Section 17 of the Securities Act provides:

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

...  
(c) The exemptions provided in section 77c of this title shall not apply to the provisions of this section.

15 U.S.C. § 77q (1970).

Section 10 of the Securities Exchange Act provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

...  
(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

*Id.* § 78j.

57. *Id.* § 77q(a).

58. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of a national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1975).

proceedings initiated by the SEC, and actions for disgorgement initiated by the Commission or injured investors.

### 1. *Administrative Actions*

A registered securities professional who fails to provide adequate information to municipal securities investors may thereby violate section 17(a) of the Securities Act, rule 10b-5, and the rules under section 15(c)(1) of the Exchange Act regulating broker and dealer conduct.<sup>59</sup> A Commission finding that such violations were willful exposes the professional to administrative sanctions ranging from censure to revocation of his registration with the SEC.<sup>60</sup> Moreover, the professional may not avoid the sanctions by relying on information provided to him by others involved in the distribution of the securities:

It is incumbent on firms participating in an offering and on dealers recommending municipal bonds to their customers as "good municipal bonds" to make diligent inquiry, investigation and disclosure as to material facts relating to the issuer of the securities and bearing upon the ability of the issuer to service such bonds. It is, moreover, essential that dealers offering such bonds to the public make certain that the offering circulars and other selling literature are based upon an adequate investigation so that they accurately reflect all material facts which a prudent investor should know in order to evaluate the offering before reaching an investment decision.<sup>61</sup>

The SEC may also censure attorneys and experts, such as accountants and engineers, under whose authority material facts are misrepresented or omitted in sales literature. It may suspend or prohibit them from appearing or practicing before the Commission.<sup>62</sup> These sanctions are comparable to suspension or revocation of a broker's registration.<sup>63</sup> They preclude preparing registration statements, prospectuses, and other documents filed with the Commission as well as transacting business directly with

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59. 1975 Amendments § 11, 15 U.S.C.A. § 77o(c) (Supp. 1976).

60. *Id.*, 15 U.S.C.A. § 78o (b) (4) (D) (Supp. 1976).

61. *In re Walston & Co. and Harrington*, SEC Securities Exchange Act Release No. 8165 (Sept. 22, 1967), in [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,474, at 82,944-45 (1967); see *Sanders v. John Nuveen & Co.*, 524 F.2d 1064 (7th Cir. 1975) (underwriter who relied on false financial statements prepared by certified public accountants held liable for failing to investigate further).

62. SEC Rules of Practice 2(e), 17 C.F.R. § 201.2(e)(1) (1975). While SEC censure may have no immediate legal effects, it may be taken into account if future violations are committed. See text accompanying note 72 *infra*.

63. See note 60 *supra* and accompanying text.

the SEC.<sup>64</sup> Moreover, municipal bond counsel who assume legal responsibility for reviewing municipal offering circulars may have greater obligations to investors than do other experts. The Commission has concluded that, in such situations, counsel have a duty to investigate the completeness and accuracy of statements made not only by themselves, but by others as well, at least if there is reason to suspect that material facts have been omitted.<sup>65</sup>

## 2. Injunctions

The Commission may seek injunctive relief to enforce the disclosure obligations of issuers as well as of those persons subject to SEC administrative sanctions.<sup>66</sup> An injunction against further violations of the securities laws subjects a defendant to criminal contempt prosecution if he commits subsequent violations<sup>67</sup> and exposes those under direct SEC supervision to immediate disciplinary action by the Commission. Thus, the SEC may sanction a registered broker or dealer enjoined from engaging in or continuing any conduct or practice in connection with his business just as it may one it finds to have violated a securities law.<sup>68</sup> An attorney or expert under injunction may be censured or suspended or disqualified from practicing before the Commission unless he can show that such penalties should not be imposed.<sup>69</sup> Furthermore, an injunction may adversely affect the ability of a businessman to carry on normal business operations.<sup>70</sup>

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64. SEC Rules of Practice 2(g), 17 C.F.R. § 201.2(g) (1975).

65. *In re Furguson*, SEC Securities Exchange Act Release No. 5523 (Aug. 21, 1975), in 5 SEC Dock. 37-38 (1974).

66. Securities Act § 20(b), 15 U.S.C. § 77(b) (1970); 1975 Amendments § 17, 15 U.S.C.A. § 78u(d) (Supp. 1976).

67. Mathews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 GEO. WASH. L. REV. 901, 946 (1971) [hereinafter cited as Mathews]; see *Frank v. United States*, 384 F.2d 276 (10th Cir. 1967), *aff'd*, 395 U.S. 147 (1969) (defendant placed on three years' probation for criminal contempt of injunction prohibiting further violations of sections 5 and 17(a) of the 1933 Act).

68. 1975 Amendments § 11, 15 U.S.C.A. § 78o(b)(4)(C) (Supp. 1976).

69. 17 C.F.R. § 201.2(e)(3) (1975). See also *SEC v. Ezrine*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,579 (S.D.N.Y. 1972) (summary of SEC complaint, in action to enjoin attorney suspended from practice before the SEC from continuing his securities practice).

70. See, e.g., *SEC v. Thermodynamics, Inc.*, 319 F. Supp. 1380 (D. Colo. 1970). The defendant contended unsuccessfully that a permanent

### 3. *Criminal Proceedings*

Persons who willfully breach their disclosure duties may be subjected to criminal prosecution. The SEC may transmit evidence of such violations "to the Attorney General who may, in his discretion, institute the necessary criminal proceedings."<sup>71</sup> In determining whether to recommend criminal action, the Commission normally considers such factors as previous securities laws violations and whether the current violation was particularly flagrant.<sup>72</sup> Convicted section 17(a) violators may be imprisoned for up to five years and fined up to \$10,000.<sup>73</sup> Rule 10b-5 violations are similarly punishable, unless the violator proves he had no knowledge of the rule, in which case he may not be imprisoned.<sup>74</sup>

### 4. *Disgorgement*

Neither section 17(a) nor rule 10b-5 expressly allows investors to recover losses caused by inadequate disclosure, but the SEC and investors have several ways of securing a return of funds. First, the SEC can encourage defendants in administrative proceedings to reimburse investors by considering such action as mitigating the violations.<sup>75</sup> Second, the Commission, when seeking injunctive relief, can request the court to order disgorgement as an additional equitable remedy.<sup>76</sup> Finally, investors may initiate suits based on an implied right of action

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injunction should be vacated because (1) it probably caused a bank to deny him loans; (2) it prevented him from becoming a member of a board of directors since it hampered his ability to authorize the issuance of stock; and (3) it prevented him from raising capital needed for his business since the SEC refused to grant a waiver that would allow him to make a "Regulation A" offering.

71. Securities Act § 20(b), 15 U.S.C. § 77t(b) (1970); 1975 Amendments § 17, 15 U.S.C.A. § 78u(d) (Supp. 1976).

72. Mathews, *supra* note 67, at 916.

73. 1975 Amendments § 27(a), 15 U.S.C.A. § 77x (Supp. 1976).

74. *Id.* § 27(b), 15 U.S.C.A. § 78ff(a) (Supp. 1976).

75. *In re Walston & Co. and Harrington*, SEC Securities Exchange Act Release No. 8165 (Sept. 22, 1967), in [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,474, at 82,943 (1967) (registrant offered to repurchase bonds at prices paid plus interest and to return any contributions to the bondholder's committee).

76. *See SEC v. R.J. Allen & Assoc.*, 386 F. Supp. 866, 881 (S.D. Fla. 1974); Treadway, *SEC Enforcement Techniques: 881 Expanding and Exotic Forms of Ancillary Relief*, 32 WASH. & LEE L. REV. 637 (1975); Comment, *Equitable Remedies in SEC Enforcement Actions*, 123 U. PA. L. REV. 1188, 1194-96 (1975).

under section 17(a) or rule 10b-5.<sup>77</sup> This right, at least in its application to rule 10b-5 violations, extends to municipal securities investors even though they are excluded from the express cause of action afforded to investors by the 1933 Act.<sup>78</sup> Successful plaintiffs may rescind their purchases,<sup>79</sup> or they may recover the difference between the purchase price and either the actual value of the securities at the time of purchase<sup>80</sup> or the value at the time the fraud was, or reasonably should have been, discovered.<sup>81</sup>

## II. INADEQUACY OF PRESENT REGULATION

Regulation of municipal securities professionals under the Exchange Act should reduce the incidence of fraudulent practices in the municipal securities industry. And when violations do occur, remedial administrative actions, while possibly neither swifter nor more economical than the court proceedings previously required, can be taken by the agencies charged with enforcing the securities laws.<sup>82</sup> Nevertheless, this expansion of municipal securities regulation offers less protection to municipal securities investors than to corporate securities investors. Disclosures made in corporate securities offerings must conform to the spe-

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77. The Supreme Court recognized the existence of an implied private right of action under rule 10b-5 in *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971), and *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). The Court has not yet ruled on the existence of an implied right of action under section 17(a) of the 1933 Act. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 734 n. 6 (1975). Judge Friendly, however, has stated that "[o]nce it had been established . . . that an aggrieved buyer has a private action under § 10(b) of the 1934 Act, there seemed little practical point in denying the existence of such an action under § 17—with the important proviso that fraud, as distinct from mere negligence, must be alleged." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (concurring opinion). *Contra*, *Russell v. Travel Concepts Corp.*, No. 74-198 NA-CV (M.D. Tenn. 1975), CCH FED. SEC. L. REP. ¶ 95,230, at 98,218 (1975) (no private action exists under section 17(a) since the 1933 Act contains express civil remedies under section 12(2)).

78. *Texas Continental Life Ins. Co. v. Bankers Bond Co.*, 187 F. Supp. 14 (W.D. Ky. 1960), *rev'd on other grounds sub nom. Texas Continental Life Ins. Co. v. Dunne*, 307 F.2d 242 (6th Cir. 1962); *Thiele v. Shields*, 131 F. Supp. 416, 420 (S.D.N.Y. 1955).

79. *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965).

80. *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.) (dictum), *cert. denied*, 382 U.S. 879 (1965).

81. *Esplin v. Hirschi*, 402 F.2d 94 (10th Cir.), *cert. denied*, 394 U.S. 928 (1968).

82. See Auerbach, *Should Administrative Agencies Perform Adjudicatory Functions?*, 1959 Wis. L. Rev. 95, 108-12.

cifications of the 1933 Act,<sup>83</sup> and the SEC can delay or suspend public distribution of the securities if the disclosures appear incomplete or inaccurate.<sup>84</sup> Municipal securities investors, on the other hand, must rely on the threat of administrative actions, injunctions, criminal prosecution, and disgorgement to motivate full disclosure in municipal securities offerings. Moreover, these remedies may not always be available. In any event, they cannot ensure that investors will have the information they need to formulate rational investment decisions.

#### A. ADMINISTRATIVE ACTION, INJUNCTIONS, AND CRIMINAL PROSECUTIONS

The SEC can discipline a municipal securities professional who breaches his duty to investigate an issuer and the statements made in sales literature only after a default has demonstrated the inadequacy of the investigation.<sup>85</sup> Even then, the Commission must find that the failure to conduct a sufficient inquiry constitutes a "willful" violation of the securities laws.<sup>86</sup> Administrative proceedings sanctioning an expert also must follow discovery of defective disclosures and therefore cannot logically be used to compel more complete disclosure before distribution. Since municipal securities offerings do not normally involve appearance or practice before the Commission,<sup>87</sup> an expert who confines his business to this field will be immune from SEC disciplinary actions. The Commission may seek injunctive relief,<sup>88</sup> but even if it establishes a securities law violation, the court may refuse to issue an injunction unless the Commission can also demonstrate that the violator is likely to commit further violations.<sup>89</sup> The possibility of criminal prosecution may deter

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83. Securities Act § 7, 15 U.S.C. § 77g (1970).

84. *Id.* § 8(d), 15 U.S.C. § 77h(d) (1970).

85. See, e.g., *In re Walston & Co. and Harrington*, SEC Securities Exchange Act Release No. 8165 (Sept. 22, 1967), in [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,474, at 82,945 (1967).

86. 1975 Amendments § 11, 15 U.S.C.A. § 78o(b)(4)(D) (Supp. 1976).

Doty concludes that the Commission's determination that failure of an underwriter to investigate constitutes a "willful" violation, see case cited in note 85 *supra*, means that the "extent of the obligation [to investigate] is probably set at a negligence level—at least in commission disciplinary and enforcement actions." Doty, *supra* note 5, at 416.

87. Doty, *supra* note 5, at 441.

88. See text accompanying notes 66-70 *supra*.

89. See *SEC v. Harwyn Indus. Corp.*, 326 F. Supp. 943, 957 (S.D.N.Y. 1971).

some persons from flagrantly violating the securities laws, but will not, in itself, foster proper disclosures.<sup>90</sup>

#### B. DISGORGEMENT

Municipal securities investors not only must tolerate less disclosure than corporate securities investors, but they may also experience greater difficulty in recovering losses caused by inadequate disclosure. The 1933 Act expressly imposes civil liabilities on those who participate in the distribution of nonexempt securities where material misrepresentations or omissions are made in the registration statement or prospectus.<sup>91</sup> The defendants bear the burden of proving that, after reasonable investigation, they did not know of the defect and could not reasonably have discovered it.<sup>92</sup> On the other hand, exempt securities investors, relying on an implied right of action,<sup>93</sup> must, in addition to proving that disclosure was materially defective, prove that the defendant was negligent and that their loss was the proximate result of that negligence.<sup>94</sup> Those courts that generally require a showing of some form of scienter in implied actions under the securities laws, rather than mere negligence, place an additional obstacle in the path of the investor in exempt securities.<sup>95</sup>

#### C. LACK OF PREVENTIVE MEASURES

The 1933 and 1934 Acts embody a single comprehensive scheme for the protection of securities investors. They include measures to prevent the use of unfair practices in the distribution and trading of securities and to provide compensation to investors who suffer losses because of such practices.<sup>96</sup> The preventive provisions of the 1933 Act, however, are not applicable to municipal securities. Unlike corporate securities registration statements and prospectuses, municipal securities sales litera-

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90. Cf. J. HALL, *GENERAL PRINCIPLES OF CRIMINAL LAW* 137-41 (2d ed. 1968).

91. Securities Act §§ 11-12, 15 U.S.C. §§ 77k-77l (1970).

92. This burden, known as the "due diligence defense" is set out in sections 11(b)(3) and 12(2) of the Securities Act. 15 U.S.C. §§ 77k(b)(3), 77l(2) (1970).

93. See notes 77-81 *supra* and accompanying text.

94. *Herzfeld v. Laventhol*, 378 F. Supp. 112, 121 (S.D.N.Y. 1974).

95. See *Clegg v. Conk*, 507 F.2d 1351 (10th Cir. 1974); *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (en banc).

96. See notes 16-25 *supra* and accompanying text.



ture is not subject to predistribution review,<sup>97</sup> and there is no established disclosure standard comparable to that for corporate issues.<sup>98</sup> Moreover, the 1975 Amendments expressly prohibit the MSRB from requiring municipal issuers to furnish any information to investors.<sup>99</sup> The remedial actions available to the SEC and investors cannot be used prospectively to compel full disclosure, but must be employed on a case-by-case basis as defective disclosures in particular securities offerings are discovered. Disclosures made in these post hoc proceedings can be of no value as bases for investment decisions. Thus investors in municipal securities are not assured that issuers will furnish information sufficient to allow an accurate appraisal of the risks involved in the purchase of their securities.

### III. REGISTRATION OF MUNICIPAL SECURITIES

While the exemption of municipal securities from the registration requirement of the 1933 Act may have been politically motivated,<sup>100</sup> several rationales have been advanced to support it. First, the inherent safety of municipal securities investments provides adequate investor protection, and, therefore, elaborate disclosure is unnecessary. Second, the typical municipal securities investor is sophisticated and thus capable of protecting his own interests. Third, registration would increase the cost of issuing municipal securities, thereby limiting the ability of local governments to raise needed capital. Fourth, registration would involve increased federal interference in local government. In view of recent developments in the municipal securities field, however, these rationales have lost much of their vitality. Moreover, there are fundamental benefits in registration that outweigh any detrimental effects. Registration would protect investors through full disclosure, restore investor confidence in municipal securities, encourage more responsive government, and better allocate capital resources.

#### A. RATIONALES FOR EXEMPTION

##### 1. *Safety of Municipal Securities Investments*

Historically, municipal securities have been considered nearly

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97. 1975 Amendments § 13, 15 U.S.C.A. § 78(d) (1) (Supp. 1976).

98. Securities Act Schedule A, 15 U.S.C. § 77aa (1970).

99. 1975 Amendments § 13, 15 U.S.C.A. § 78(d) (2) (Supp. 1976).

100. See note 26 *supra* and accompanying text.

as safe as United States government bonds.<sup>101</sup> While municipal general obligation bonds are normally supported by taxes levied on the real property within the boundaries of a municipality,<sup>102</sup> bondholders have first claim to all revenues of the issuer and are therefore protected to the full extent of the issuer's taxing powers.<sup>103</sup> This protection, however, does not extend to holders of revenue or moral obligation bonds. Revenue bonds are serviced by the income from the project funded by the bond issue.<sup>104</sup> If a project fails to produce revenues sufficient to cover bond payments, investors have no claim to other funds of the issuer.<sup>105</sup> Moral obligation bonds are normally issued by state agencies and serviced by agency revenues.<sup>106</sup> The state has no legal obligation to make back payments; it merely assumes a "moral obligation" to appropriate funds if agency revenues are insufficient.<sup>107</sup> Moreover, the right of general obligation bondholders to first claim to tax revenues of the issuer may be illusory. For example, the New York legislature subordinated New York City bondholders' claims to those of the Municipal Assistance Corporation.<sup>108</sup> Furthermore, one of the city administration's first responses to a near default on October 17, 1975 was to secure a writ permitting it to use city revenues to meet city payrolls before servicing bonds.<sup>109</sup> Further, the ability of municipal issuers to service debt by raising taxes is limited by the level of tax rates tolerated by the electorate.<sup>110</sup> This limitation is compounded by the development of overlapping

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101. Speer, *What Every Lawyer Should Know About Municipal Bonds*, 44 ILL. B.J. 146, 151 (1955).

102. L. CHERMAK, *THE LAW OF REVENUE BONDS* 59 (1954) [hereinafter cited as CHERMAK].

103. *Id.*

104. G. HEMPEL, *THE POSTWAR QUALITY OF STATE AND LOCAL DEBT* 93-97 (1971) [hereinafter cited as HEMPEL].

105. *Id.*

106. MOODY'S INVESTORS SERVICE, INC., *ANALYTICAL FACTORS IN MUNICIPAL BOND RATINGS 6-7* (undated pamphlet) [hereinafter cited as MOODY'S].

107. *Id.*

108. N.Y. STATE FINANCE LAW § 92-d (McKinney Supp. 1975). The constitutionality of this legislation, which diverted city use and sales tax revenues to MAC and its bondholders to the extent necessary to support MAC bonds, was upheld in a class action instituted by the Flushing National Bank. *Flushing Nat'l Bank v. City of New York*, 39 Clark's Digest—Annot. 40 (N.Y. Sup. Ct. Dec. 1975).

109. Jensen, *Crisis Is Believed to Cost Other Borrowers Billions*, N.Y. Times, Oct. 19, 1975, § 1, at 1, col. 6, at 48, col. 5.

110. R. ROBINSON, *POSTWAR MARKET FOR STATE AND LOCAL GOVERNMENT SECURITIES* 39 (1960) [hereinafter cited as ROBINSON].

independent taxing districts that provide services beyond the financial ability of local governmental units.<sup>111</sup> Thus, while the taxes imposed by one municipal entity may be reasonable when compared to the value of taxable property, the aggregate burden of all overlapping districts may be excessive.<sup>112</sup> Municipal governments experiencing financial difficulties are simply more likely to default on their obligations than place intolerable burdens on their citizens.<sup>113</sup>

## 2. *Type of Investors*

Investors in municipal securities historically have been considered capable of protecting their own interests. In past years, the purchasers of municipal securities "tended to be sophisticated and small in number, and frequently [were] institutions or individuals from the same 'locality' as the issuing governmental body."<sup>114</sup> "Today, [however,] a new class of investors, primarily consisting of individuals who are unsophisticated in securities matters has developed for municipal securities . . ."<sup>115</sup> For example, nearly two-thirds of the value of New York City's outstanding bonds is held by individuals or families; the typical investor, with an average holding of approximately \$35,000, files a joint tax return declaring annual income of \$25,000.<sup>116</sup> These investors have neither the sophistication nor the concentrated economic power of large institutional investors to ensure that issuers will fully disclose pertinent information.<sup>117</sup>

Of course, investors in most municipal issues have sources of information other than the issuer. Bond-rating services evaluate the creditworthiness of the bonds of most municipal issuers.<sup>118</sup> They gather and analyze information concerning

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111. CHERMAK, *supra* note 102, at 74.

112. For example, Cook County, Illinois has been burdened by as many as 392 governmental taxing units at the same time. *Id.* at 87.

113. ROBINSON, *supra* note 110, at 60.

114. Doty, *supra* note 5, at 396.

115. *Hearings on H.R. 4570 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 94th Cong., 1st Sess., ser. 14, at 42 (1975) (testimony of J. Evans, Commissioner, SEC), reported in BNA SEC. REG. & L. REP., Apr. 23, 1975, at A-6.

116. McFadden, *Individual Bondholders Are Disillusioned*, N.Y. Times, Oct. 19, 1975, § 1, at 48, cols. 2-3 (testimony of James A. Lebenthal, Executive Vice President, Lebenthal, Inc., before the Senate Banking Committee).

117. Doty, *supra* note 5, at 399.

118. Moody's also has rated the short-term notes of 141 governmental units on a scale from MIG1 (the best) to MIG4. 68 MOODY'S BOND SURVEY 1739 (1976).

the issuer and any project to be funded by the issue. The analyst employs no established formula<sup>119</sup> but rather considers such factors as the amount of debt service charges, the revenues and expenditures expected during the life of the debt, any indications of the issuer's financial prudence and willingness to pay its debts, the capability of its administration, and probable future economic trends.<sup>120</sup> While these ratings are heavily relied on by investors, they are not an adequate substitute for full disclosure. The informal nature of the rating process makes it impossible to determine the precise basis of the rating.<sup>121</sup> Different analysts may disagree as to the relative importance of various factors,<sup>122</sup> thus making comparisons of issuers inaccurate.<sup>123</sup> Furthermore, the information on which the rating is based is furnished by the issuer and might not be independently verified by the rating service.<sup>124</sup> Even though the rating is generally an accurate analysis of the credit standing of the issuer,<sup>125</sup> heavy investor reliance on ratings by one or two services will magnify the effects of errors in judgment. A greater number of independent analyses, made possible by wider distribution of information, would lessen the effect of individual judgment errors.

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119. The question is how debt, financial, governmental and economic analyses are put together to determine a rating. Simply, it is a question of examining each area of information and their interrelations and making a judgment modified as necessary by evidence and experience. There is no way to cram them all into a single formula which invariably produces the right answer. The stumbling block is weighting.

Moody's, *supra* note 106, at 7.

120. *Id.* at 2-6.

121. These ratings have been described as follows:

[T]he ratings themselves resemble in a sense the ratings which you see in some of the better gastronomic guidebooks. Instead of stars they assign letters. Moody's assigns a triple A for the best credit, a double A for the second best, a single A for the third best, and so on down the scale, which is basically divided into eight gradations, and the Standard & Poor's system resembles this.

*Hearings Before the Joint Economic Comm. Subcomm. on Economic Progress, 90th Cong., 1st Sess. 10 (1967) (testimony of R. Goodman, Director of Finance, New York City) [hereinafter cited as 1967 Hearings].*

122. MOODY'S, *supra* note 106, at 7.

123. HEMPEL, *supra* note 104, at 106 n.5.

124. 1967 *Hearings, supra* note 121, at 60 (testimony of J.C. Hurlbert, Mayor of Aberdeen, S.D.). See also *id.* at 16 (testimony of R. Goodman, Director of Finance, New York City).

125. Cf. HEMPEL, *supra* note 104, at 106-09. Hempel notes that the accuracy of the ratings has not been tested by a major period of defaults since the depression when 78 percent of defaulting issuers were rated Aaa or Aa by Moody's. *Id.* at 109.

### 3. Cost of Registration

The major objection of municipal issuers to disclosure under the securities laws has been the increased expense certain to result from these requirements. It has been estimated, for example, that the average cost of issuing corporate debt securities, excluding compensation of underwriters, reaches four percent of a one to two million dollar issue;<sup>126</sup> however, this percentage is substantially reduced in larger issues.<sup>127</sup> Furthermore, municipal issuers already prepare some of the same information that would be required in registration statements for inclusion in sales literature and for presentation to the rating services.<sup>128</sup> And the increased costs of registration would be further offset if interest rates declined as a result of more comprehensive regulation of issuers.<sup>129</sup>

### 4. Federal Interference

Municipal issuers have also been concerned that federal regulation of their securities offerings would involve burdensome federal intrusion into the operation of local government.<sup>130</sup> The constitutionality of such regulation was questioned in 1933,<sup>131</sup> and more recently it has been argued that imposition of federal disclosure requirements would be a "radical incursion on states' prerogatives," which the lack of abuses by municipal securities

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126. SEC, COST OF FLOTATION OF REGISTERED ISSUES 1971-1972, at 29 (1974).

127. *Id.*

128. See text accompanying note 124 *supra*.

129. See text accompanying notes 136-42 *infra*; Stabler, *Creditable Cities*, Wall St. J., Jan. 6, 1976, at 1, col. 6, at 16, col. 4 (Eastern ed.). Although municipal underwriters would certainly demand compensation for the greater apparent risk of liability, it is probable that they will eventually make such a demand under the present structure as well, once the underwriter's potentially great liability under rule 10b-5 is generally recognized. See Doty, *supra* note 5, at 416.

130. See S. REP. NO. 75, *supra* note 2, at 44-45; cf. ATTORNEYS GENERAL OF STATES, THE CONSTITUTIONAL IMMUNITY OF STATE AND MUNICIPAL SECURITIES 20-52 (1939).

131. H.R. REP. NO. 85, 73d Cong., 1st Sess. 14 (1933), reprinted in Ellenberger & Mahar, *supra* note 28, Item 18 [hereinafter cited as H.R. 85]. Although the constitutional question is unresolved, it can be assumed that the interstate nature of the municipal securities markets would bring them within the reach of the commerce clause powers of Congress. Cf. Martori & Bliss, *Taxation of Municipal Bond Interest—“Interesting Speculation” and One Step Forward*, 44 NOTRE DAME LAW. 191, 196-200 (1968) (discussion of the related problem of the taxing powers of Congress under the sixteenth amendment).

issuers should make unnecessary.<sup>132</sup> This contention notwithstanding, hundreds of municipal defaults have occurred since 1945,<sup>133</sup> and New York City has demonstrated the potential for abuse by issuers.<sup>134</sup> Although few bondholders have suffered losses, payments have occasionally been delayed for years.<sup>135</sup>

## B. BENEFITS OF ADEQUATE DISCLOSURE

### 1. Restoration of Investor Confidence

The present lack of investor trust in municipal securities poses far-reaching economic dangers. Primarily a consequence of New York City's financial crisis, this loss of confidence has increased the interest rates that other municipal issuers must pay. Issuers credit the "ripple effect" of events in New York City with causing an increase in rates of from one-fourth to one-half of one percent.<sup>136</sup> It has been estimated that state and municipal government units will be forced to pay an additional two to three billion dollars a year in debt service charges as a result of these higher rates.<sup>137</sup> As the higher interest rates on municipal securities exert pressure on the rates of taxable bonds, the effects of competition may make nonmunicipal borrowing more expensive as well.<sup>138</sup>

The dominant congressional purpose in enacting the securities acts was to restore the confidence of investors after the market collapse of 1929.<sup>139</sup> President Roosevelt, in proposing the legislation, noted:

This proposal adds to the ancient rule of caveat emptor, the further doctrine "let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bringing back public confidence.<sup>140</sup>

Maintaining investor confidence was also an important moti-

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132. S. REP. No. 75, *supra* note 2, at 44.

133. HEMPEL, *supra* note 104, at 27.

134. See text accompanying notes 145-47 *infra*.

135. Jensen, *Crisis Is Believed to Cost Other Borrowers Billions*, N.Y. Times, Oct. 19, 1975, § 1, at 1, col. 6, at 48, col. 5.

136. Oregon state officials estimated an increase of one-fourth of one percent. *Id.* at 48, col. 8. Officials of Murfreesboro, Tennessee, estimated one-half of one percent. *Id.* at 1, col. 7.

137. *Id.* at 48, col. 6 (estimated by E. Renshaw, Professor of Economics and Finance, State University of New York at Albany).

138. BUS. WEEK, Oct. 13, 1975, at 84.

139. Dean Bayless A. Manning, in *ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES* 86 (H. Manne ed. 1969).

140. H.R. 85, *supra* note 131, at 2.

vation for subjecting municipal securities professionals to regulation under the Securities Acts Amendments of 1975:

The Committee is concerned that failure to provide adequate regulation may result in a loss of investor confidence in municipal securities and, consequently, an adverse effect on the capital-raising ability of municipal government.<sup>141</sup>

Extension of the Securities Act registration and prospectus requirements to municipal issuers should, in like manner, reduce investor distrust of municipal securities. With complete and accurate information, investors and brokers could better judge the merits of investment opportunities.<sup>142</sup> Moreover, registration would bolster investor confidence by affording the SEC full use of its powers to supervise the municipal securities market.

## 2. The "Housecleaning" Effect

Disclosure would not merely benefit investors in municipal securities; it would also serve the general public interest in the forthright administration of government through its "housecleaning" effect. If questionable business practices and conflicts of interest are exposed in the corporate registration process, they often arouse the criticism of investors and the general public.<sup>143</sup> Comparable disclosures by municipal issuers should have a similar effect. Thus disclosure would encourage closer scrutiny of state and local government operations by the electorate.<sup>144</sup>

141. S. REP. NO. 75, *supra* note 2, at 3-4.

142. The effect of nondisclosure under the present structure has been noted by a national public accounting firm:

Several large cities, states and other governmental units appear to be in serious financial difficulties . . . . All too often, the financial statements of governmental units have proven to be less than adequate for providing basic financial information. Decision-makers, investors and the public have been misled by not being alerted to the problems which were developing. When difficulty occurred, they were confused and frustrated in their attempts to deal with the emerging financial crisis.

ARTHUR ANDERSEN & Co., SOUND FINANCIAL REPORTING IN THE PUBLIC SECTOR 1 (1975) [hereinafter cited as ANDERSEN].

143. SEC, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS—THE WHEAT REPORT 511 (1969) (summary) [hereinafter cited as THE WHEAT REPORT].

144. In our democratic society, all citizens, groups and organizations need to speak out on issues which they consider important to maintain the effectiveness of our political and economic system. If this country is to maintain effective checks and balances in our political system, public officials must be held accountable for the financial affairs of the activities in the government for which they are responsible. To achieve accountability, effective accounting controls and sound financial reporting are essential.

ANDERSEN, *supra* note 142, Preface.

The circumstances leading to the financial crisis in New York City illustrate the need for such scrutiny. Audits conducted after investors and underwriters refused to purchase the city's short-term notes disclosed massive deficits hidden by "bookkeeping gimmicks."<sup>145</sup> These gimmicks included overstating federal and state aid receivables, entering the total property tax levy without allowing for uncollected taxes, and entering sewer and water charges for the year before they were paid.<sup>146</sup> A report compiled by New York City Controller Harrison J. Goldin concluded:

Our present accounting principles and practices produce three unacceptable results. They enable us to spend without taxing or otherwise generating recurring revenue; finance the resulting operating cash deficits with short- and long-term debt, and obscure the above facts in undecipherable financial statements.<sup>147</sup>

The report estimated that the cost of eliminating the resulting deficits over the next 15 years would be over \$5.5 billion.<sup>148</sup>

In view of the municipal services that were financed, it is an open question whether the New York City electorate would have willingly incurred these costs had disclosure been made. City officials, however, failed to furnish accurate financial information, thus depriving the electorate of the opportunity to make such a decision. Moreover, the obscurity of the financial records relieved these officials from accountability for the fiscal operation of the city. Registration of municipal securities would require issuers to conform to accounting standards set by the SEC<sup>149</sup> and could close the "serious gaps in the way in which municipalities maintain their books and account for their monies."<sup>150</sup> Investors and taxpayers alike would benefit from the more efficient and responsible government that would result from a registration requirement.<sup>151</sup>

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145. N.Y. Times, July 1, 1975, at 1, col. 7.

146. *Id.* at 16, cols. 7-8.

147. *Id.* col. 7.

148. *Id.* col. 4.

149. Section 19 of the Securities Act, 15 U.S.C. § 77s (1970), gives the SEC the power to set accounting standards to be followed by registrants.

150. Address by SEC Commissioner A.A. Sommer, Jr., ABA Annual Convention, Aug. 1975, in BNA SEC. REG. & L. REP., Aug. 13, 1975, at A-1.

151. As a result of our inquiry and our conviction that sound financial reporting is required to inform both shareholders in the private sector and the electorate in the public sector of the economic results for their specific groups, we have arrived at the following conclusions:



### 3. Allocation of Resources

The ability of investors to make rational decisions as to the merits of securities issues significantly affects the national economy.<sup>152</sup> The securities markets generally serve to allocate the capital available in the nation among those enterprises that have a present use for it. Without sufficient information, the municipal securities market cannot allocate capital efficiently since the true value of an issue might not be reflected by evaluations based on incomplete or inaccurate information.<sup>153</sup> Some issuers may pay a higher price for the use of investors' money than other issuers, even though the merits of the issue justify the same or lower cost. On the other hand, some investors may receive smaller returns than are appropriate for the risks involved. The principal function of the disclosure requirements of the Securities Act is to provide pertinent financial information to investors.<sup>154</sup> Sophisticated investors can use this information to evaluate the potential risks and benefits of a particular investment and thereby reach an intelligent decision to buy or not to buy. Less sophisticated investors must rely on the advice of securities professionals and analysts, but the worth of such advice is necessarily determined by the accuracy of the information on which it is based.<sup>155</sup> Disclosure would not ensure that the municipal securities markets would operate with complete efficiency since it would not eliminate the complex factors affecting investor decisions generally.<sup>156</sup> Disclosure could, however, reduce the effects of these forces by allowing more accurate evaluations of the merits of particular municipal securities issues.

### C. PROBLEMS OF IMPLEMENTATION

The Securities Act of 1933 was drafted to regulate issuers

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—The United States Government should provide annual consolidated financial statements on an accrual basis including all entities in the Government and all programs which may require future taxes for present liabilities.

—Cities, states and other political subdivisions should be required to publish similar statements annually and in connection with sales of securities to the public.

ANDERSEN, *supra* note 142, at 1.

152. THE WHEAT REPORT, *supra* note 143, at 60-61.

153. Friend, *The SEC and the Economic Performance of Securities Markets*, in *ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES* 185, 190 (H. Manne ed. 1969).

154. H.R. 85, *supra* note 131, at 8.

155. Cf. Kripke, *The Myth of the Informed Layman*, 28 *BUS. LAW.* 631 (1973).

156. Cf. Friend & Parker, *A New Slant on the Stock Market*, *FORTUNE*, Sept. 1956, at 121.

of corporate securities.<sup>157</sup> The registration and prospectus requirements of the Act were thus designed to elicit information useful in analyzing the finances of a business. An extension of the Act to cover municipal issuers would therefore require recognition of the unique structures, functions, and operations of municipalities.<sup>158</sup> Local governmental units in this country number over 80,000,<sup>159</sup> however, and their structures vary

157. See notes 16-20 *supra* and accompanying text.

158. The following bill was introduced by Senator Eagleton on October 28, 1975, and referred to the Committee on Banking, Housing and Urban Affairs:

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 3(a)(2) of the Securities Act of 1933 is amended—

(1) by striking out “or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or territory or by any public instrumentality of one or more States or territories;” and

(2) by striking out “or any security which is an industrial development bond” and all that follows through the semicolon following “does not apply to such security”.

(b) Section 3 of such Act is amended by adding at the end thereof the following new subsection:

“(d) The Commission may from time to time by its rules and regulations and subject to terms and conditions as may be prescribed therein add to the securities exempted as provided in this section any class of securities issued by a State of the United States or by any political subdivision of a State or by any territory of the United States or political subdivision of a territory or by any public instrumentality of one or more States or territories if it finds, having regard to the purposes of this title, that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors.”

(c) Section 15B(d)(1) of the Securities Exchange Act of 1934 is amended by striking out “Neither the Commission nor the Board is” and inserting in lieu thereof “The Board is not”.

S. 2574, 94th Cong., 1st Sess. (1975).

The Eagleton bill fails to recognize the problems unique to municipal securities. Although the Commission could tailor the 1933 Act's disclosure requirements to municipal securities (Securities Act § 7, 15 U.S.C. § 77g (1970)) and, under section (b) of the bill, grant exemptions to classes of municipal securities, the bill makes no allowance for basic differences in the accountability of corporate and municipal officials. Moreover, the bill fails to utilize the MSRB, the regulatory body best able to determine the informational requirements of municipal investors and the limitations of municipal issuers. Eliminating the municipal securities exemption in the manner proposed by Senator Eagleton, without considering the heterogeneous character of municipal securities and the diverse functions and capabilities of municipal officials, would leave both the courts and the SEC without congressional guidelines and could result in unnecessary disclosure expenses for municipal issuers and unwarranted liabilities for municipal officials.

159. U.S. BUR. OF THE CENSUS, GOVERNMENTAL UNITS IN 1967, at 23 (1967).

widely according to function, history, and geographic location. For example, some public officials are elected, while others are appointed or serve *ex officio*; the titular head of the government may exercise complete control over its operations or merely perform a ceremonial role.<sup>160</sup> Such wide disparities must all be considered in tailoring disclosure requirements to the municipal securities market.

### 1. *Liability of Elected Officials*

A number of policy considerations preclude assigning responsibilities under the Securities Act to municipal officials in the same manner as they are assigned to corporate officials. Corporate officials are accountable to the owners of the corporation.<sup>161</sup> The potential liability of these officials to investors under the Securities Act<sup>162</sup> merely reinforces that accountability. Local governmental officials, on the other hand, are primarily accountable to the electorate. Stringent securities law liability for municipal officials could create conflicts of interest contrary to democratic principles of accountability. For example, decisions concerning capital expenditures might reflect municipal officials' appraisal of the risks of personal liability rather than the needs of their community; in order to reduce those risks, municipal securities sales literature might over-emphasize the negative aspects of an issue at the cost of higher interest rates. Moreover, the risk of liability might well reduce the number of those willing to seek public office.

Local governmental officials should, therefore, be exempted from those sections of the Securities Act expressly imposing civil liabilities for defective disclosures in registration statements and prospectuses.<sup>163</sup> This exemption would place the primary re-

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160. See C. ADRIAN, *STATE AND LOCAL GOVERNMENTS* (3d ed. 1972).

161. 3 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF CORPORATIONS* 142 (perm. ed. 1975).

162. See note 163 *infra*.

163. Section 11 provides:

(a) In case any part of the registration statement, when such part becomes effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the

sponsibility for ensuring complete and accurate disclosure on the municipal underwriter who would be subject to civil liability under the Act.<sup>164</sup> Municipal underwriters currently have this

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filing of the part of the registration statement with respect to which his liability is asserted;

(5) every underwriter with respect to such security.

(b) Notwithstanding the provisions of subsection (a) of this section no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof—

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of any expert, and not purporting to be a copy or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . .

(c) In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

15 U.S.C. § 77k (1970).

Section 12 provides:

Any person who—

(1) offers or sells a security in violation of section 77e of this title, or

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

*Id.* § 77l.

164. Securities Act § 11(a)(5), 15 U.S.C. § 77k(a)(5) (1970). Although corporate officials usually bear primary responsibility for disclosure, it seems appropriate in the context of municipal securities to impose that responsibility on the party most aware of the informational needs of investors and most knowledgeable of securities laws. Moreover, underwriters, engaged in a profitable enterprise, should bear the associ-

responsibility under the antifraud provisions of the securities acts,<sup>165</sup> and these more stringent requirements would merely encourage greater diligence in the performance of their duties.<sup>166</sup> While elected officials should remain subject to personal liability in actions brought under the antifraud provisions of the securities acts, plaintiffs in such cases should be required to prove more than mere negligence.<sup>167</sup>

## 2. *Liability of Municipal Issuers*

Municipalities, as issuers, should not be exempted from civil liability under the Securities Act, but should be jointly liable with the underwriter if municipal officials would have been liable except for their exemption. Imposing such liability would give holders of revenue or moral obligation bonds judgments affording recourse to the general revenues of the issuer rather than only to the revenues generated by a particular agency or project. Moreover, evidence that the conduct of municipal officials resulted in municipal liability would encourage closer scrutiny of governmental operations and increase the accountability of those officials to the electorate.

## 3. *Scope of Disclosure*

Regulation of municipal issuers should serve the purposes of disclosure with the least possible interference with their opera-

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ated risks. The underwriters would, in any event, have recourse to the due diligence defense. See note 92 *supra* and accompanying text.

165. See text accompanying note 61 *supra*.

166. Doty, *supra* note 5, at 416.

167. Liability in implied actions based on a negligence standard would, as noted by those courts that have adopted a "scienter" standard, differ little from that imposed under the express liability provisions of the securities acts. See *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1298-1309 (2d Cir. 1973) (en banc). To adopt a negligence standard would thus be to fail to recognize that many municipal officials are unaccustomed to the intricacies of the securities markets:

The mayor of today's American small town is commonly a moderately successful small businessman, long active in local politics and civic affairs and well liked by his neighbors. . . . Today our large cities seem to be producing an increasingly large number of capable chief executives. Still, many contemporary mayors are amiable mediocrities, lacking in ability and imagination and under obligation to a few interest groups that put them in office.

C. ADRIAN, *STATE AND LOCAL GOVERNMENTS* 280 (3d ed. 1972).

Moreover, it appears unlikely that investors would secure much additional protection from the liability of a "moderately successful" small businessman. Liability of municipal officials would thus serve a punitive function and should be imposed only where scienter is established.

tions and at the least possible cost. The heterogeneous nature of municipal issuers and their securities requires that the disclosure requirements of a registration statement be especially adapted for municipal securities. Issuers of revenue and moral obligation bonds should be required to disclose extensive information concerning the ability of funded projects to service the debt, including reports of all feasibility studies relating to the projects and information reflecting the experience and capabilities of project administrators. All issuers should disclose prior debt repayment records, current financial statements, and any factors that might affect their ability to service their debts.<sup>168</sup> The Municipal Securities Rulemaking Board should be empowered to determine the information requirements of investors in various types of municipal securities and to set registration standards that fulfill those requirements without forcing issuers to provide data of little value to investors. To so tailor disclosure requirements should reduce the effort and expense of compliance.<sup>169</sup> Additional savings could be realized by granting exemptions in cases where forced disclosures would have few beneficial effects. Thus traditional exemptions for distributions to institutional<sup>170</sup> or local investors<sup>171</sup> who are able to gather sufficient information on their own should be available to municipal issuers. An exemption should also be granted to securities adequately insured by private insurance companies.<sup>172</sup> Where the cost of complying with registration would unduly restrict the ability of small issuers to enter the market, requirements should be reduced or exemptions granted.<sup>173</sup>

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168. Cf. Taylor, *Municipal Securities*, in *FUNDAMENTALS OF INVESTMENT BANKING* 344, 374-76 (1949).

169. Cf. Carney, *Exemptions from Securities Registration for Small Issuers: Shifting from Full Disclosure—Part I: The Private Offering Exemption, Rule 14b and an End to Access for Small Issuers*, 10 *LAND & WATER L. REV.* 507 (1975).

170. Securities Act § 4(2), 15 U.S.C. § 77d(2) (1970); SEC Rule 146, 17 C.F.R. § 230.146 (1975).

171. Securities Act § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1970); SEC Rule 147, 17 C.F.R. § 230.147 (1975).

172. At a cost of one to two percent of their value, small issues may be insured as to principal and interest by private insurance groups. The insurer fully investigates the issuer to protect its own best interests. Insured issuers are able to obtain a high credit rating from the bond services and pay lower than normal interest rates. *BUS. WEEK*, Mar. 24, 1975, at 126.

173. This exemption would be comparable to the present Regulation A exemption, 17 C.F.R. §§ 230.251-263 (1975), which, under certain circumstances, exempts corporate issues of not more than \$500,000. *Id.* § 230.254.

Issuers' costs could be further reduced by federal subsidization of registration expenses and elimination of SEC filing fees.

#### IV. CONCLUSION

The federal securities regulatory scheme as originally conceived has not provided adequate protection to municipal securities investors. The entry of less sophisticated investors into the municipal securities market and the increasing risk accompanying these securities have increased the need for additional protective measures. Recognizing the deficiency of after-the-fact enforcement measures, Congress enacted the Securities Acts Amendments of 1975, which were designed to further curtail fraudulent practices in the municipal securities industry. The regulatory scheme is still incomplete, however, because it fails to guarantee municipal securities investors full disclosure of information necessary to formulate rational investment decisions. Congress should ensure that municipal securities issuers accept the burden of providing that information. As stated by the SEC:

The financial community, the accounting profession, the bar and industry generally have come not only to accept but to support the principle that those who make use of the public's money must supply the information essential to the formulation of intelligent investment decisions, and that it is a proper responsibility of government to keep an eye on the accuracy and adequacy of such information.<sup>174</sup>

Extension of the registration and prospectus requirements of the Securities Act of 1933 to municipal securities issuers would help to restore the confidence of investors in the municipal securities markets and, by promoting responsible government, secure benefits for noninvestors as well. Not only could this action be taken without impairing the fund-raising ability of municipal issuers, but it must be taken to prevent further damage to the municipal securities industry.

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174. THE WHEAT REPORT, *supra* note 143, at 45.