



Volume 78 | Issue 3

Article 7

May 1976

Municipal Bonds--The Need for Disclosure

Daniel R. Schuda

West Virginia University College of Law

Follow this and additional works at: <https://researchrepository.wvu.edu/wvlr>



Part of the [Banking and Finance Law Commons](#), and the [Securities Law Commons](#)

Recommended Citation

Daniel R. Schuda, *Municipal Bonds--The Need for Disclosure*, 78 W. Va. L. Rev. (1976).

Available at: <https://researchrepository.wvu.edu/wvlr/vol78/iss3/7>

This Student Note is brought to you for free and open access by the WVU College of Law at The Research Repository @ WVU. It has been accepted for inclusion in West Virginia Law Review by an authorized editor of The Research Repository @ WVU. For more information, please contact ian.harmon@mail.wvu.edu.

MUNICIPAL BONDS—THE NEED FOR DISCLOSURE

I. INTRODUCTION

Municipal securities have long been thought of as an ideal form of financing for the issuer and the perfect investment for the purchaser. From the issuer's point of view, it is generally thought (although not completely true)¹ that, unlike corporate securities issues, no registration with the Securities and Exchange Commission under the Securities Act of 1933² (1933 Act) and no continuing disclosure requirements under the Securities Exchange Act of 1934³ (1934 Act) are imposed. As seen from the purchaser's side of the transaction, no federal income tax is assessed on the dividends derived from the municipal securities,⁴ and many states also decline to tax the dividends from securities issued by one of their own political sub-divisions or agencies.⁵

However, for the purchaser to gain the tax exemption by buying municipal securities, he must give up his right to the free flow of information demanded by the 1933 and 1934 Acts for almost all other types of securities.⁶ This lack of information can possibly lead to fraud or the intentional or unintentional withholding of important information on the part of the issuer, the very thing the legislation was designed to prevent.⁷ An action for fraud has been filed against the City of New York and certain of its officials following its recent financial difficulties⁸ and a quiet investigation by the

¹ See text accompanying notes 18-20 *infra*.

² Securities Act of 1933, § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1970).

³ Securities Exchange Act of 1934, § 3(a)(12), 15 U.S.C. § 78c(a)(12) (1970).

⁴ INT. REV. CODE OF 1954, § 103(a)(1) provides:

- (a) General rule—Gross income does not include interest on—
(1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia

⁵ See, e.g., W. VA. CODE ANN. § 8-16-11 (1976).

⁶ See text accompanying notes 118-127 *infra*.

⁷ The preamble to the 1933 Act reads: "To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes." Act of May 27, 1933, ch. 38, 48 Stat. 74. The 1934 Act devotes an entire section to the reasons for regulation including "to require appropriate reports and to impose requirements necessary . . . and to insure the maintenance of fair and honest markets . . ." Securities Exchange Act of 1934, § 2, 15 U.S.C. 78b (1970).

⁸ *Abrams v. The City of New York*, No. 75 Civil 3981 (S.D.N.Y., filed Aug. 13, 1975).

SEC has been launched on this same matter.⁹ Occurrences of this type raise the question of whether political issuers of securities should be exempted from informing the purchaser, through a complete disclosure of material information, of exactly what he owns or is buying.

Since most people are unfamiliar with the structure of the industry, the point of departure is to identify the municipal securities market by defining the types of securities involved and the parties to the transaction. Next, the present regulations (or lack of them) applicable to this market and the reasons for their absence will be presented. Third, a consideration of the possible constitutional limitations will be shown, followed by the basic question of whether there should be any regulation. A discussion of what is presently possible, through direct and indirect means, under the present legislation will then be presented, followed by a consideration of the relationship of the present requirements for corporate securities and possible requirements for municipal securities.

A listing of the different types of long-term municipal debt which could reasonably reach the market would include bonds, certificates of indebtedness and notes. The thrust of this note is directed against bond issues since they constitute the most common type of long-term municipal debt, but the arguments could be applied against all three and perhaps more. Also, while the term "municipal securities" is used to identify this particular segment of the market, it is meant to include not only securities issued by communities, but also states, special taxing districts and others which are included within the 1933 Act exemption.

II. THE MUNICIPAL SECURITIES MARKET

As was done in the 1933 and 1934 Acts, the method of identifying municipal securities is by identifying the issuer. Under the terms of the legislation defining these as "exempt securities" are generally included securities issued by the United States or its instrumentalities, states and territories, their political subdivisions and their agencies.¹⁰ This definition is not completely accurate without a consideration of the specific type of security.

⁹ See Wall Street Journal, Nov. 6, 1975, at 2, col. 2.

¹⁰ The Securities Act of 1933, § 3(a), 15 U.S.C. § 77c (1970) provides: Except as hereinafter expressly provided, the provisions of this subchap-

There are many systems of classification of municipal debt. These would include classification by form (the type of instrument evidencing the debt), the purpose for which the debt was issued, the governmental functions for which the debt is used, the governmental entity incurring the debt, the period for which the debt is to be outstanding, and the nature of the security pledged for payment of the interest and principle.¹¹

Among these classifications perhaps the most important to the investor is the classification based upon the specific resource used

ter shall not apply to any of the following classes of securities:

. . . .

(2) Any security issued or guaranteed by the United States 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, or by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing; . . . or any security which is an industrial development bond (as defined in section 103(c)(2) of Title 26) the interest on which is excludable from gross income under section 103(a)(1) of Title 26 if, by reason of the application of paragraph (4) or (6) of section 103(c) of Title 26 (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security

The Securities Exchange Act of 1934, § 3(a)(12), 15 U.S.C. § 78c(a)(12) (1970) provides:

The term "exempted security" or "exempted securities" includes securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States; such securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as shall be designated for exemption by the Secretary of the Treasury as necessary or appropriate in the public interest or for the protection of investors; 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; or any security which is an industrial development bond (as defined in section 103(c)(2) of the Internal Revenue Code of 1954) the interest on which is excludable from gross income under section 103(a)(1) of such Code if, by reason of the application of paragraph (4) or (6) of section 103(c) of such Code (determined as if paragraphs (4)A, (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security. . . .

¹¹ L. MOAK, ADMINISTRATION OF LOCAL GOVERNMENT DEBT 39 (1970) [hereinafter cited as MOAK].

to guarantee repayment. The most often used system is one developed by the Securities Industry Association.¹² Under this system there are four types of bonds.

“General obligation” bonds are secured by the issuer’s full faith, credit and taxing power.¹³ It is the general promise to pay which is the guarantee given to the purchaser. General obligation bonds generally require authorization of the taxpayers¹⁴ and may be further limited by a maximum legal tax rate which is set by some higher authority.¹⁵ In this case, the bonds are still general obligation bonds, but are termed “limited tax” bonds.

A second class is the “special tax” bond which is repaid from the proceeds of a particular tax.¹⁶ A part of this class is the “special assessment” bond which is repayable from an assessment against those who benefit from the facilities built with the bond revenues. If special tax bonds are also secured by the full faith, credit and taxing power of the issuer, they are classified as general obligation bonds.

“Revenue” bonds are secured by the proceeds derived from the facilities constructed with the bond issue.¹⁷ Like the previous class, if the full faith, credit and taxing power of the issuer are also pledged, the bonds are termed general obligation bonds.

The SEC originally held the use of the proceeds from the sale of bonds for the construction of facilities to be used by private, profit-making enterprise not to be a municipal bond within the exemption of the 1933 or 1934 Acts even if the issuer was one included in the exemption section.¹⁸ Congress responded by passage of an additional section of the 1933 Act, returning the exemption if the proceeds were used for the purposes specified in section 103(c) of the Internal Revenue Code, defining an industrial development bond.¹⁹ This finally resulted in an SEC Act Release which

¹² See A. RABINOWITZ, MUNICIPAL BOND FINANCE AND ADMINISTRATION 137 (1969).

¹³ SECURITIES INVESTORS ASSOCIATION, FUNDAMENTALS OF MUNICIPAL BONDS 3 (9th ed. 1973) [hereinafter cited as FUNDAMENTALS].

¹⁴ See, e.g., W. VA. CODE ANN. § 13-1-4 (1972).

¹⁵ See, e.g., W. VA. CODE ANN. § 13-1-14 (1972).

¹⁶ FUNDAMENTALS, *supra* note 13, at 3.

¹⁷ *Id.*

¹⁸ Securities Act Rule 131, 17 C.F.R. § 230.131 (1975).

¹⁹ 15 U.S.C. 77c(a)(2) (1970); see note 10 *supra*.

defines the limits a revenue bond may reach and still retain its exemption.²⁰

The fourth class is the "New Housing Authority" bond.²¹ They are issued by local public housing authorities and secured by the net rental revenues so, in one sense, they are similar to revenue bonds. However, they are also secured by the full faith of the United States since the Public Housing Authority must make contributions which, together with the local funds, will be sufficient to pay the principle and interest on the bonds.²²

Under the system used by the Bureau of the Census there are only two classes.²³ Full-faith and credit debt is long-term debt for which the credit of the government, implying the power of taxation, is unconditionally pledged. It includes debt payable from specific taxes or nontax sources, but also represents liability payable from any other available resources if the pledged sources are insufficient. Nonguaranteed debt consists of long-term debt payable solely from earnings of revenue producing activities, from special assessments, or from specific nonproperty taxes.

The actual selling of municipal securities is usually handled by bond dealers who act as underwriters.²⁴ Very few municipal issues, unlike corporate securities, are privately placed.²⁵ Also, many states require competitive bidding in the issuance of general obligation bonds.²⁶ The underwriters do not charge a commission, but their profits come from the "spread," which is the difference between the price they pay to the issuer and the price they receive from the purchaser.²⁷ In corporate bond issues this spread is usually between 1 and 2 per cent of the face value of the bonds.²⁸ In the municipal bond market, due to the inability to equate even bonds of the same issue because they are often offered serially or

²⁰ Securities Act Release No. 33-5103, November 6, 1970, CCH Fed. Secur. L. Rep. ¶ 77,924.

²¹ FUNDAMENTALS, *supra* note 13, at 4.

²² 42 U.S.C. § 1421a (1970).

²³ U.S. BUREAU OF THE CENSUS, GOVERNMENT FINANCES IN 1965-66, 53 (1966).

²⁴ *Hearings on H.R. 4570 before the Subcommittee on Consumer Protection and Finance of the House Committee on Interstate and Foreign Commerce*, 94th Cong. 1st Sess., ser. 14, at 53 (1975) [hereinafter cited as *1975 House Hearings*].

²⁵ *Id.*

²⁶ See, e.g., W. VA. CODE ANN. § 13-1-21 (1972).

²⁷ FUNDAMENTALS, *supra* note 13, at 9.

²⁸ *1975 House Hearings*, *supra* note 24, at 9.

at a discount or premium,²⁹ no accurate computations can be made. One estimate is that the spread runs from ¼ of 1 per cent to 2 per cent of the face value depending on the expected difficulty the underwriter will have in placing the bonds with purchasers.³⁰ Some few issues may exceed this 2 per cent figure. Because of the risk involved in estimating this difficulty and the heavy capital commitment, dealers often participate as a syndicate and submit a collective bid.³¹

There are presently estimated to be 510 firms and 173 banks dealing in the municipal bond market³² serving the 78,267 governmental units in this country (excluding the United States government and governmental agencies at all levels).³³ In 1973 these dealers handled over \$22,735,000,000 of new long-term issues and \$24,640,000,000 of new short-term issues for the various municipal issuers.³⁴

The secondary municipal securities market is relatively unknown.³⁵ Due to the nature of the security, there is no national quotation system³⁶ and the only quantity figures, those of a trade publication, are considered misleading since most transactions are carried out using personal methods of communication and also, there is no real advantage to a dealer in accurately reporting his sales and inventory figures.³⁷

The ownership of municipal bonds rests primarily in three groups. In 1971 commercial banks held 49.8 per cent of the more than \$166.6 billion of outstanding municipal debt or \$82.9 billion. Households (individuals) held 31.4 per cent or \$52.3 billion, while fire and casualty insurance companies held 11.6 per cent or \$19.3

²⁹ A "serial" bond issue is one in which each bond or groups of bonds mature at a date different from the others. A "discount" or "premium" is the difference in the price paid for the bond which is less than or greater than the bond's face value. This difference is usually caused by a change in the interest rate demanded by the investors between the time the bonds are printed and the time they are sold.

³⁰ FUNDAMENTALS, *supra* note 13, at 10.

³¹ 1975 House Hearings, *supra* note 24, at 53.

³² *Id.* at 79.

³³ *Id.* at 82.

³⁴ *Id.* at 84-5.

³⁵ The last complete study was, apparently, I. FRIEND, THE OVER-THE-COUNTER SECURITIES MARKETS (1958).

³⁶ See note 29 and accompanying text *supra*.

³⁷ 1975 House Hearings, *supra* note 24, at 57.

billion.³⁸ The figure for individual investors fell in percentage terms during the previous ten year period from about 39.4 percent to the 31.4 per cent figure cited, but in dollar terms rose from \$28.3 billion to \$52.3 billion.³⁹ During this same period, the total outstanding volume of municipal debt rose from \$71 billion to \$166.6 billion for an increase of 135% while the national debt (the debt of the federal government alone) rose 50% and corporate debt rose 150%.⁴⁰

III. PRESENT REGULATIONS

Aside from distinctions between the municipal and corporate securities markets based upon taxation of dividends and the mechanics of underwriting, the major difference is in the regulation by the federal government and the resulting flow of information to the purchaser. A corporate securities issuer must file a registration statement with the SEC prior to selling his securities on the public market⁴¹ which is highly structured as to content,⁴² give a portion of this statement (the prospectus) to each purchaser,⁴³ be closely regulated as to advertising the sale,⁴⁴ be held strictly liable for any material misstatement of fact in the registration statement,⁴⁵ (all under the 1933 Act), and be subject to continuing disclosure requirements⁴⁶ (under the 1934 Act). However, the municipal securities issuer is expressly excused from complying with these regulations.⁴⁷ The 1933 Act is only applicable to municipal issues in an after-the-fact manner under the general fraud provisions⁴⁸ and the 1934 Act follows suit with an exemption of similar effect.⁴⁹ The information which a municipal issuer must provide is primarily controlled by industry custom.⁵⁰ To date, there has been no federal legislation on the subject.

³⁸ *Id.* at 50.

³⁹ See, FUNDAMENTALS, *supra* note 13, at 25.

⁴⁰ 1975 House Hearings, *supra* note 24, at 49.

⁴¹ Securities Act of 1933, § 5(a), 15 U.S.C. § 77e(a) (1970).

⁴² Securities Act of 1933, § 10, 15 U.S.C. § 77 (1970).

⁴³ Securities Act of 1933, § 5(b), 15 U.S.C. § 77e(b) (1970).

⁴⁴ Securities Act of 1933, § 5(c), 15 U.S.C. § 77e(c) (1970).

⁴⁵ Securities Act of 1933, § 11, 15 U.S.C. § 77k (1970).

⁴⁶ Securities Exchange Act of 1934, § 13, 15 U.S.C. § 78m (1970).

⁴⁷ See note 10 *supra*.

⁴⁸ 1975 House Hearings, *supra* note 24, at 60.

⁴⁹ See note 10 *supra*.

⁵⁰ While there is sometimes a requirement under state law for advertising the bond sale the content of the advertisement is not controlled. See, e.g., W. VA. CODE ANN. § 13-1-21 (1972).

The primary reason for the absence of municipal bond regulation (in the 1933 Act) is politics.⁵¹ It is indeed strange that Congress, while stating such an inspiring purpose for the 1933 Act regulations,⁵² applying it to such a broad range of money instruments⁵³ and facing the knowledge that fraud and misrepresentation had occurred in the municipal securities markets,⁵⁴ would withhold protection from the investors in municipal securities. However, when faced with the objections of state and local governments, this is exactly what occurred.

When reading the legislative history of the 1934 Act, the indications of strong opposition by the issuers are again evident.⁵⁵ While many of the objections to specific terms of the regulatory scheme, which originally did not exempt municipal securities at

⁵¹ Dean James A. Landis, Chairman of the Federal Trade Commission at the time the 1933 Act was enacted by Congress has written that the draftsmen had originally contemplated no exemption at all for municipal bonds, but they "were made exempt for obvious political reasons." Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 39 (1959).

⁵² See note 7 *supra*.

⁵³ As originally defined by Congress, the term security included: any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of interest in property, tangible or intangible, or, in general, any instrument commonly known as a security, or any certificate of interest or participation in, temporary or interim certificate for, receipt for or warrant or right to subscribe to or purchase any of the foregoing.

Securities Act of 1933, § 3(a)(2), 48 Stat. 74 (1933), as amended 15 U.S.C. § 77c(a)(2) (1970).

As amended the term security means:

any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security" or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Securities Act of 1933, § 3(a)(2), 15 U.S.C. 77c(a)(2) (1970), formerly ch. 38, Title I, § 3(a)(2), 48 Stat. 74 (1933).

⁵⁴ *Hearing on S. 875 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. at 232 (1933).

⁵⁵ *Hearings on H.R. 7852 and H.R. 8720 before the House Comm. on Interstate and Foreign Commerce*, 75th Cong. 3rd Sess. at 12 (1934).

all, appeared quite valid, the arguments which possibly resulted in the complete exemption dealt with the cost of filing registration statements.⁵⁶ Conspicuously lacking in the discussion was any indication of a major concern for the protection of the investor.

The next opportunity for change came in 1938 with the passage of the Maloney Act, which created section 15A of the 1934 Act requiring self-regulation of over-the-counter markets through a national securities dealers' organization.⁵⁷ Again came the arguments from the issuers and again came an exemption.⁵⁸ This time the exemption applied to the municipal securities dealers who had been exempted under the 1933 and 1934 Acts. The apparent reasons given were that there was such a close connection that regulation would strongly affect the municipal issuers themselves.⁵⁹

Finally, in 1975, came the first attempt to regulate the market. The Municipal Securities Exchange Act of 1975⁶⁰ brought the dealers engaged solely in transactions in municipal securities (who had been exempted before) within section 15 of the 1934 Act and created the Municipal Securities Rulemaking Board (under the SEC) to oversee their activities. There is, amazingly, no indication in the legislative history of the 1975 Act of any of the broad based opposition that was apparent in the previous securities enactments. Indeed, there is some sign of a desire to go further and regulate the issuers themselves.⁶¹

IV. THE CONSTITUTION

Constitutionality is a basic issue in any discussion of a federal activity. In the area of municipal securities regulations there is no case law to guide the discussion since there has been no previous regulation. Also, very few, if any, activities of a state or local government are analogous to their participation in the securities market. However, the argument on a related subject, that the federal government lacks the power to tax municipal securities, may be applicable. The doctrine of "reciprocal immunity", first stated in

⁵⁶ Comment, *Municipal Bonds and the Federal Securities Laws: The Results of Forty Years of Indirect Regulation*, 28 VAND. L. REV. 561, 585 (1975).

⁵⁷ 15 U.S.C. § 78oA(m) (1970).

⁵⁸ *Hearings on S. 3255 and H.R. 9634 before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 75th Cong., 3d Sess. at 12 (1938).

⁵⁹ *Id.*

⁶⁰ 15 U.S.C.A. § 780-84 (Supp. 1976).

⁶¹ 1975 House Hearings, *supra* note 24, at 62, 65.

*McCulloch v. Maryland*⁶² in 1819, states that the state government cannot interfere in the affairs of the federal government⁶³ through the imposition of taxes on federal revenues and activities, and implies that the federal government cannot interfere in the affairs of the state government in this manner.⁶⁴ Each is sovereign. Later cases considered this argument that the power to tax state activities would give the federal government the power to control them.⁶⁵ In the municipal securities area an argument of excessive control due to registration requirements: might be answered in several ways. First, the area of control is specifically given to Congress under the commerce clause of the Constitution. That the securities market falls within this clause as affecting interstate commerce has been repeatedly stated by the courts.⁶⁶ Secondly, the specific prohibition against the use of the mails for the purpose of selling or offering securities has also been upheld by the courts under the Constitutional authority to create and regulate the postal system.⁶⁷ Third, legislation requiring a municipal issuer to register gives no power of control, although some of the present "undertakings" (promises) which the SEC requires corporate issuers to make⁶⁸ might have this effect and be unconstitutional if applied to municipal issuers. Finally, the present application of section 12(a) liability under the 1933 Act, which removes the "protection" of requiring the difficult charge of common law fraud to be proved against a municipal issuer, is a minimal type of regulation which is already in existence. The application of this section to municipal issuers has been upheld by the courts,⁶⁹ so it should be constitutionally permissible to place municipal issuers in the same class as corporate issuers for all registration and regulation purposes if they can now be placed there for a limited purpose. The final adjudication of this problem will require a determination of the extent of the tenth amendment reservation of power to the states as opposed to the extent of power given Congress under the commerce clause.

⁶² 17 U.S. (4 Wheat.) 316 (1819).

⁶³ *Id.* at 436.

⁶⁴ *Id.* at 430, 436.

⁶⁵ *See, e.g.*, *The Collector v. Day*, 78 U.S. (11 Wall.) 113 (1871); *National Life Insurance Co. v. United States*, 277 U.S. 508 (1928).

⁶⁶ *See, e.g.*, *Oklahoma-Texas Trust v. SEC*, 100 F.2d 888 (10th Cir. 1939).

⁶⁷ *See e.g.*, *Bogy v. United States*, 96 F.2d 734 (6th Cir. 1938).

⁶⁸ 15 U.S.C. § 771(a) (1970).

⁶⁹ *See, e.g.*, *Thiele v. Shields*, 131 F. Supp. 416 (S.D.N.Y. 1955).

V. THE NEED FOR REGULATION

In determining whether municipal securities should be regulated, the basic question should be "What makes them different from other types of securities?" rather than "What makes them the same?" Aside from distinctions which may be drawn in the mechanics of the distribution process or those based upon legislative action such as exemption from registration or the tax exemption, which have no real effect on the nature of the instrument itself, there is no substantive difference. Regardless of the identity of the issuer, the security still represents money invested by an individual or institutional investor with the expectation of a profit. These expectations can only be based upon a knowledge by the investor of the apparent abilities and reputation of the issuer, the purposes for which the input of money is sought, and an educated guess as to the future ability of the issuer to repay the debt under the terms originally set forth. As applied to corporate securities, these requirements for information were recognized and set forth in Schedule A of the 1933 Act.⁷⁰ The importance of information from governments is shown by the inclusion of Schedule B, although this was limited in application to foreign governments.⁷¹

Assuming the Congress was correct in not including municipal securities within the provisions of the 1933 and 1934 Acts, the sheer volume of the present market would now require a re-examination. In 1933 new issues of long-term debt of state and municipalities totaled \$1.1 billion.⁷² This figure did not change significantly until 1947 at which time it had doubled.⁷³ Almost every year since 1947 has represented growth and the 1973 level reached almost \$23 billion.⁷⁴ In just the period from 1960 to 1971 the outstanding debt rose from \$71 billion to almost \$167 billion.⁷⁵

The change in ownership of municipal issues has not undergone any substantial changes—at least not since 1947.⁷⁶ During this period individual ownership has stayed around the 35 per cent

⁷⁰ 15 U.S.C. § 77aa, Schedule A (1970).

⁷¹ *Id.* Schedule B.

⁷² 1975 *House Hearings*, *supra* note 24, at 84.

⁷³ *Id.* at 85.

⁷⁴ *Id.*

⁷⁵ *Id.* at 49.

⁷⁶ *Id.* 50; FUNDAMENTALS, *supra* note 13, at 25.

figure, rising as high as 43 per cent and falling as low as 30 per cent.⁷⁷

That Congress is unaware of any problem cannot be argued since the need for disclosure has been presented to them. It has been implicitly recognized by the SEC⁷⁸ and explicitly stated in testimony by investors.⁷⁹ The only group that resists the enactment of regulations is the issuers.⁸⁰ Even the dealers showed concern over the wording of the Municipal Securities Act of 1975, apparently on the ground that the specific language denying the newly created Board any power to require issuers to provide more information would restrict the flow of information already available by reaffirming the issuer's unique status.⁸¹

In the absence of more accurate information, one test for the existence and extent of misrepresentation by municipal issuers is the record of judicial decisions. A survey of this record indicates that, unlike the corporate securities industry, fraud or misrepresentations were not numerous until recently. The first major occurrence of misrepresentation was not adjudicated until 1954 and 1955. It involved the sale of revenue bonds of the Bellevue Nebraska Bridge Commission and was decided in a series of five cases.⁸² The investors had purchased the bonds relying on false and misleading information contained in an offering circular prepared by the Commission and on oral statements made by an individual seller.

In a 1962 case, *Texas Continental Life Insurance Co. v. Dunne*, the municipal issuer sold a revenue bond issue in exchange for a cash payment and a promissory note payable by installments. The note also contained a provision allowing the payments to be made in cash or by transfer of the bonds to the holder of the note. The plaintiff subsequently purchased a portion of the bonds from the original buyer and, when the original buyer defaulted the city

⁷⁷ FUNDAMENTALS, *supra* note 13, at 25.

⁷⁸ 1975 House Hearings, *supra* note 24, at 62.

⁷⁹ *Id.* at 107.

⁸⁰ *Id.* at 103.

⁸¹ *Id.* at 95.

⁸² *Barrons v. Shields*, 131 F. Supp. 370 (S.D.N.Y. 1954); *Connecticut Mutual Life Insurance Co. v. Shields*, 131 F. Supp. 363 (S.D.N.Y. 1954); *Citizens Casualty Co. of New York v. Shields*, [1954 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 90,683 (S.D.N.Y. 1954); *Greenwich Savings Bank v. Shields*, 131 F. Supp. 368 (S.D.N.Y. 1955); *Thiele v. Shields*, 131 F. Supp. 416 (S.D.N.Y. 1955).

was without funds to build the facilities whose revenues would have allowed repayment of the bonds. The plaintiff then brought suit since he had not been told of the repayment provisions and the ordinance authorizing the bond issue made no mention of it.⁸³ Other recent cases involve misrepresentation by both the issuer and the dealer.⁸⁴

While the reported cases are few in number, tending to indicate the fraud problem is not widespread, this is possibly not an accurate assessment of the situation. In testimony before a House Committee the SEC characterized the problems at all levels of the municipal securities industry as "substantial" and cited its own small staff as the reason it did not bring more enforcement actions.⁸⁵

While active or inadvertent misrepresentation on the part of the issuer is cause for alarm, the most disastrous experience for the investor must be a "default" in the payment of the principle or interest. In the postwar period, until 1965, there have been an estimated 30 defaults⁸⁶ of which three, West Virginia Turnpike Commission bonds, Chicago Skyway bonds and Chesapeake Bay Bridge and Tunnel bonds have been considered major.⁸⁷ "Major" must be considered a relative term since the first two named amounted to \$234 million.⁸⁸

The primary argument raised against any required disclosure is that the cost of public facilities would be increased by the added expense. While this is undoubtedly true over the short run, over a greater period of time the information released (if favorable) would reduce the underwriter's risk by making placement much easier and lower the "spread" they now demand.⁸⁹ Secondly, the information investors require is, for the most part, not that type which would have to be developed specifically for the purposes of selling bonds. It is information already in existence, but located in diverse

⁸³ 307 F.2d 242 (6th Cir. 1962).

⁸⁴ See, e.g., *In Re Walston & Co. and Harrington*, [1966-1967 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,474 (SEC 1967).

⁸⁵ 1975 House Hearings, *supra* note 24, at 62.

⁸⁶ JOINT ECONOMIC COMMITTEE, STATE AND LOCAL PUBLIC FACILITY NEEDS AND FINANCING, 89th Cong. 2d Sess., Vol. 2, 243-247 (1966).

⁸⁷ 1975 House Hearings, *supra* note 24, at 47.

⁸⁸ A. RABINOWITZ, MUNICIPAL BOND FINANCE AND ADMINISTRATION 78 (1969).

⁸⁹ See text accompanying note 27 *supra*.

sources, some of which are available only to the issuer.⁹⁰ Finally, under the present terms of the 1933 Act certain small issues,⁹¹ privately placed issues,⁹² and issues sold only within one state⁹³ are excused from registration. These same exemptions could be applied to municipal securities just as they are presently applied to corporate issuers.

In discussing whether federal disclosure standards are required it is important to consider the present, unofficial, systems. Potentially the most important are the private bond rating companies which include such nation-wide rating firms as Moody's Investors Service and Standard and Poor's Corporation⁹⁴ and many smaller regional and state bond rating firms.⁹⁵ Even though private bond rating companies exert a great deal of influence over bond sales⁹⁶ and interest rates,⁹⁷ their ability to force disclosure must be

⁹⁰ 1975 House Hearings, *supra* note 24, at 103.

⁹¹ Securities Act of 1933, § 3(b), 15 U.S.C. 77c(b) (1970).

⁹² *Id.*

⁹³ Securities Act of 1933, § 3(a)(11), 15 U.S.C. 77c(a)(11) (1970).

⁹⁴ Moody's Investors Service generally rates bonds of more than \$600,000 with some additional exceptions. Their rating symbols are:

Aaa	Best quality
Aa	High Quality
A	Higher medium quality
Baa	Lower medium grade
Ba	Contains speculative elements
B	Lacks qualities of a desirable investment
Caa	Poor
Ca	Very speculative
C	Lowest rating.

FUNDAMENTALS, *supra* note 13, at 26.

Standard and Poor's Corporation will rate government bonds for a fee. Their symbols are:

AAA	Prime
AA	High grade
A	Upper medium grade
BBB	Medium grade
BB	Lower medium grade
B	Speculative
CCC	Defaults
CC	
C	

Id. at 27.

⁹⁵ For example, Municipal Advisory Council of Michigan, Ohio Municipal Council, and the Tennessee Taxpayers Association. MOAK, *supra* note 11, at 152.

⁹⁶ The most direct sales result of the rating occurred when the Controller of the Currency, controlling national banks, the Federal Deposit Insurance Corporation,

questioned, due to their small staffs of personnel which lack the ability to determine the accuracy of the information upon which the ratings are based.⁹⁸

The second major unofficial system suggested as a possible solution to the disclosure problem is that of the national dealer's organization.⁹⁹ The motivating force behind this system is simply that access to the market place would be limited if strict compliance if there was not strict compliance. A list of items that should be disclosed for revenue bonds¹⁰⁰ and a separate listing for all other types is provided.¹⁰¹ Also given are forms for continuing disclosure divided in this same manner.¹⁰² The issuers' organization, the Municipal Finance Officers Association, recognizing the effect of bond ratings and reputation on sales and interest rates, has adopted these check lists in large part¹⁰³ and adds a list of people and organizations to whom the information should be sent.¹⁰⁴ Unfortunately, this disclosure is apparently not required by the deal-

controlling its member banks, the Federal Reserve System, controlling member banks, and the Executive Committee of the National Association of Supervisors of State Banks, who influence everything else, announced a joint policy in 1949 which limits bank investments to the bonds given the top four ratings (Aaa, Aa, A, and Baa, or AAA, AA, A, and BBB). FUNDAMENTALS, *supra* note 13, at 27. Of course, a low rating or even a lack of a rating would influence most buyers.

⁹⁷ FUNDAMENTALS, *supra* note 13, at 28.

⁹⁸ 1975 House Hearings, *supra* note 24, at 53.

⁹⁹ Securities Investment Association, publishers of FUNDAMENTALS. This was previously published by the Investment Bankers Association which merged with the SEA in 1972.

¹⁰⁰ FUNDAMENTALS, *supra* note 13, at 158.

¹⁰¹ *Id.* at 154.

¹⁰² *Id.* at 92.

¹⁰³ MOAK, *supra* note 11, at 352.

¹⁰⁴ *Id.* at 446, n.10. The list includes:

- a. The Bond Buyer.
- b. The Wall Street Journal.
- c. The public press in the community and nearby metropolitan areas.
- d. Standard and Poor's Corporation.
- e. Moody's Investors Services.
- f. Dun & Bradstreet.
- g. Committee on Valuation of Securities of the National Association of Insurance Commissioners.
- h. Any statewide bond or debt reporting service.
- i. Banking Commissions and state insurance departments.
- j. Governments Division, Bureau of the Census.
- k. Each investment banking firm that has bid on bonds of the issuer within the past 5 years.

ers and is apparently not voluntarily given by all issuers.¹⁰⁵

In passing the Securities Act of 1933 Congress created three sections which create liability for the issuance of securities under fraudulent conditions. The first of these, section 11, applies to those who must file a registration statement prior to the selling effort.¹⁰⁶ Since municipal issues are exempted from this requirement¹⁰⁷ this section is inapplicable to them. Section 12 would apply, by its terms, to everyone who sells or offers to sell a security; however, of all the groups exempted in section 3 of the Act, only municipal issuers are exempted from this section.¹⁰⁸ It is only under section 17(a) that municipal issuers share liability with everyone else.

Under the terms of section 17(a),¹⁰⁹ the SEC could conceivably, by utilizing the definition powers granted it in section 19,¹¹⁰ require disclosure on the part of a municipal issuer. Simply by declaring the publication of any information without full and complete disclosure accompanying it to be an "omission of material fact,"¹¹¹ effective disclosure could be attained. This possible use of its powers has been noted by the SEC, but it recognizes the limitations set by the legislative history of the 1933 Act on any control of the municipal securities market.¹¹²

Under the terms of the Securities Exchange Act of 1934 every issuer is required to file with the Commission periodic disclosure

-
- l. Each of the principle banks in the region and in each financial center in the nation.
 - m. Associations of investors (e.g. banks, insurance companies, etc.)
 - n. Investment Bankers Association.
 - o. Municipal Finance Officers Association.
 - p. Local Chambers of Commerce, taxpayers associations and principle civic organizations in the community.
 - q. Bond counsel for all issues of outstanding debt.
 - r. State departments of municipal and community affairs.
 - s. Councils of governments, regional planning groups, and other local governments in the area—especially those with overlapping debt.

¹⁰⁵ 1975 House Hearings, *supra* note 24, at 68.

¹⁰⁶ 15 U.S.C. § 77k (1970).

¹⁰⁷ 15 U.S.C. § 77c(a)(2) (1970).

¹⁰⁸ *Id.*; 15 U.S.C. § 77l (1970).

¹⁰⁹ 15 U.S.C. § 77q(e) (1970).

¹¹⁰ 15 U.S.C. § 77s(a) (1970).

¹¹¹ Securities Act of 1933, § 17(a)(2), 15 U.S.C. § 77q(a)(2) (1970).

¹¹² 1975 House Hearings, *supra* note 24, at 60.

reports.¹¹³ However, municipal securities are again exempted¹¹⁴ and the legislative history prevents any other possible interpretations which would bring about disclosure.¹¹⁵

The Municipal Securities Act of 1975 places a burden upon dealers to give complete and accurate information to the purchasers in all municipal securities transactions.¹¹⁶ Indirect pressure could be placed upon the issuers by requiring certain information of the dealers and deeming it to be an omission of material information if not disclosed. Since the best, and perhaps only, source of information for the dealer would be the issuer of the particular security involved, the issuer's refusal to disclose information to the dealer would render the dealer powerless to sell the securities and, thus, make the securities unmarketable. However, the legislative history of the Act would preclude such indirect regulation.¹¹⁷

The development and discussion of the many different items of information for which an investor would have a reasonable need before purchasing municipal securities is beyond the scope of this note. In determining what information should be disclosed, the relationship between this type security and corporate securities, as relates to the informational needs of the investor, should be recognized. In both instances the basic concern of the investor is the ability of the issuer to generate funds and apply those funds to liquidate debts. The corporate issuer attempts to generate funds by providing goods and services and then charging its customers a price. In municipal terms, for an issue of general obligation bonds, the service provided is government and the price exacted is tax.

In the corporate world the factors which affect the issuer's ability to generate funds, all of which are items required by Congress or the SEC to be disclosed, include competitive conditions in the industry,¹¹⁸ the backlog of orders for the product or services,¹¹⁹ the dependence upon a single customer or supplier,¹²⁰ the seasonal nature of the business¹²¹ and the abilities and reputations

¹¹³ Securities Act of 1934, § 13, 15 U.S.C. § 78m (1970).

¹¹⁴ Securities Act of 1934, § 3(a)(12), 15 U.S.C. § 78c(a)(12) (1970).

¹¹⁵ See note 55 *supra*.

¹¹⁶ 15 U.S.C.A. § 780-84 (Supp. 1976).

¹¹⁷ See note 61 *supra*.

¹¹⁸ 17 C.F.R. § 239.11, Item 9(a)(1).

¹¹⁹ *Id.* Item 9(a)(4).

¹²⁰ *Id.* Item 9(a)(2), (5).

¹²¹ *Id.* Item 9(a)(4).

of the management.¹²² In determining the ability of the entity to apply the funds to liquidation of debts, factors such as structure and other outstanding debts,¹²³ and expected growth through development of new products¹²⁴ (possibly showing other needs for the funds), benefits given to promoters,¹²⁵ underwriters and others,¹²⁶ and the nature and extent of transactions between the management and corporation¹²⁷ (possibly showing a lack of desire or intent to repay the debts) become important. Obviously, these same factors, at least under the names given, cannot be applied to municipal securities of the general obligation type.

Since the investor must ultimately look to the taxable wealth of the citizens for repayment, he will be most concerned with those factors which will affect the size of this wealth. As a starting point the investor will use the present tax base. As important as the size of the tax base is the method used to determine value.¹²⁸ To this base figure will be applied information which will tend to indicate possible growth or decline in the tax base. The sources of wealth of the taxing district, whether it is a manufacturing, service or residential community, the age and physical condition of facilities, the relationship of the local industry to the regional and national economy, and population trends will reveal whether the area is growing or decaying. Community characteristics such as the education level of the citizens and the educational, cultural, and recreational opportunities offered, patterns of growth of the surrounding areas and social problems will indicate the ability of the community to attract new growth.

The investor is not only concerned with the wealth of the community, but also the issuer's ability to tax it. Such items of information as legal limits on taxation and liabilities of other taxing districts which look to this same wealth for their revenues are important for this consideration.

The capacity of the issuer to apply the tax revenues to repayment of the particular debt in question will be revealed by the level

¹²² *Id.* Item 16(a), (b), (d).

¹²³ *Id.* Item 5.

¹²⁴ *Id.* Item 9(a)(7)(a).

¹²⁵ *Id.* Item 8.

¹²⁶ *Id.* Item 1.

¹²⁷ *Id.* Item 20.

¹²⁸ 1975 House Hearings, *supra* note 24, at 110.

and repayment conditions of other debts, the amount of excess revenue above that required for the services provided to the citizens, and items which reveal the general quality and reputation of the government or other issuing authority.¹²⁹

When the issue in question is a special tax bond, the investor will focus his attention on the wealth of the particular group to be taxed or assessed and upon the factors affecting that base amount.¹³⁰ When the issue is a revenue bond, the investor will seek the information about the business whose success or failure will control the issuer's ability to repay the debt.¹³¹ In this situation the investor is really placing his money in a security which would otherwise be characterized as a corporate issue to which the municipal issuer is only lending his tax-free status.¹³²

In addition to the factors mentioned above there is one additional area of risk apparently not fully realized by all investors in municipal bonds.¹³³ While in the corporate bond market the investors, being creditors, have a superior claim to all others,¹³⁴ this priority does not carry over into the municipal arena. Courts have repeatedly held that the first priority for municipal revenues, prior to the repayment of any outstanding debt, is for use in providing governmental services.¹³⁵ While the bond classification systems given in this note are based upon the security pledged, there may not be any security at all.

VI. CONCLUSION

Investors in the municipal bond market are seeking a return on their investment just as other investors in other markets are doing. They have placed their money, totaling millions, in the

¹²⁹ For a complete discussion of these and other items of interest to the investor see MOAK, *supra* note 11, at 157; FUNDAMENTALS, *supra* note 13, at 35; A. RABINOWITZ, MUNICIPAL BOND FINANCE AND ADMINISTRATION 136 (1969).

¹³⁰ See note 15 *supra*.

¹³¹ FUNDAMENTALS, *supra* note 13, at 49; MOAK, *supra* note 11, at 175.

¹³² "When local or state government embark upon enterprises that are to be financed from user charges, essentially they are entering the field of business." MOAK, *supra* note 11, at 176.

¹³³ 1975 House Hearings, *supra* note 24, at 111.

¹³⁴ H. HENN, LAW OF CORPORATIONS § 155 at 277, § 383 at 822 & n.19 (2d ed. 1970).

¹³⁵ See, e.g., Borough of Fort Lee v. U.S. *ex rel* Baker, 104 F.2d 275 (3d Cir.), cert. denied, 308 U.S. 629 (1939); Town of Mt. Vernon v. General Electric Supply Corp., 289 Ky. 355, 158 S.W.2d 649 (1942).

hands of federal, state and local government officials and by doing so have given up the protections offered by Congress to the investors in other areas. If there was a sound basis for this exclusion in 1933, the change in values caused by the present volume of this market would now require at least a re-examination. If there was political motivation in 1933, whatever its reason, the events of the intervening forty-three years are also a sufficient basis for review.

While disclosure on the part of some municipal issuers is presently practiced, either due to direct pressures from the dealers or due to indirect pressures from supervising agencies of certain groups of investors, the results cannot be said to be uniform or to sufficiently reveal what is needed. The argument that the extra costs of forced disclosure under the 1933 and 1934 Acts makes the use of the bond revenues for public purposes too expensive is meaningless at best. The costs of assembling the data would be substantially the same for any official system as for present unofficial systems, and while the expense of bond counsel might be a major factor, demands placed upon bond counsel by dealers¹³⁶ and the courts¹³⁷ to investigate and disclose facts surrounding a bond issue for which they prepare a letter opinion will cause the costs to approach that for a corporate issue. The other item of expense, the SEC registration fee, can only be considered minor.¹³⁸

The other result of removing the municipal exemption would be to bring into play the liabilities sections of the securities legislation, giving investors additional protection against the use of false or misleading information given by the issuer.

To evaluate the merits of any argument raised against the imposition of registration and disclosure requirements for municipal issuers, one must remember that those who finance government are deserving of at least as much protection as those who finance industry.

Daniel R. Schuda

¹³⁶ FUNDAMENTALS, *supra* note 13, at 128.

¹³⁷ See, e.g., SEC v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973).

¹³⁸ The 1933 Act imposes a fee of one fiftieth of one per centum of the aggregate price at which the securities are to be offered with a minimum of \$100. For a \$1,000,000 issue this fee would be only \$200. Securities Act of 1933, § 6(b)2; 15 U.S.C. § 77f(b) (1970).