NEWS

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RESPONSIBILITIES AND LIABILITIES FOR MUNICIPAL OFFERINGS

Remarks by

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When the Federal securities laws were enacted during the 1930's to protect the investing public by providing full and fair disclosure of the character of securities and by preventing inequitable and unfair trading practices, issuers of municipal securities and professionals dealing only in such securities were exempted from those statutes except for the general prohibitions against fraud. This pattern of non-regulation continued until the Securities Acts Amendments of 1975. In those Amendments a comprehensive pattern of regulation for brokers, dealers, and banks engaged in the underwriting and trading of municipal securities was enacted in response to changes in the municipal securities markets, a number of cases of outright fraud, and instances of unprofessional conduct by participants in municipal securities markets.

Specifically, under the '75 Amendments, broker dealers exclusively dealing in municipal securities, and bank dealers in municipal securities, are required to register for the first time with the Commission; a Municipal Securities Rulemaking Board was created to develop rules governing the operations and trading activities of municipal securities professionals; and the Commission's rulemaking authority was expanded to cover municipal securities activities. The

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legislation, however, left untouched the exemption for municipal securities issuers from the registration requirements of the Securities Act with an explicit provision restating the fact that neither the Commission nor the Municipal Securities Rulemaking Board had authority to require issuers of municipal securities to file documents as a prerequisite to the sale of such securities.

The regulatory provisions of the '75 Amendments with respect to municipal securities had not yet begun to take effect when the fiscal crisis in New York City surfaced. Attention was suddenly focused on the risks associated with New York's securities, on whether appropriate disclosure had been provided to investors, and on the question of who should be liable for the offer and sale of such securities if full and fair disclosure had not been provided. There were several responses. The SEC undertook a formal investigation to determine the facts surrounding the sale of New York City's securities. Leglislation was introduced to remove the exemption for municipal securities in the Securities Act of 1933, which would subject municipal issuers to the full registration and disclosure provisions of that Act. Another bill was introduced to amend the Securities Exchange Act of 1934 to require certain municipal issuers to prepare annual reports and to prepare and disseminate distribution statements in connection with new issues of securities.

The market itself responded dramatically as investors became aware that municipal securities are not without risk and as underwriters and other market professionals became concerned about their potential liability to investors. Typical of the impact was the experience in Suffolk County, New York, where an attempt to market $54 million of bonds was thwarted because potential bidders were not satisfied with the disclosure of the county's financing needs. Another example, outside of New York, was the determination of underwriters not to submit bids on a $25 million general obligation offering by the City of Richmond, Virginia, despite a 30-page offering circular which city officials called "the fullest disclosure ever offered on a municipal issue." Apparently, the marketplace was concerned with the city's lack of disclosure regarding its ability to pay principal and interest on all of its outstanding debt in the event the city should lose an annexation suit.

About a year has passed since the peak of the municipal securities market crisis. It is evident that there has been a significant increase in the degree of disclosure by some municipalities, but there is no uniform standard of required disclosure to which issuers and underwriters can refer. Hearings have been held on legislative proposals designed to bring about appropriate and uniform pre-sale disclosures, but no legislation has been enacted. Numerous

suits have been brought in which investors seek redress on the ground that there was not adequate disclosure, but for past purchases of municipal securities, definitive answers regarding the responsibilities and liabilities applicable to municipal securities issuers and underwriters shall await final judicial resolutions.

Perhaps the best starting point for a discussion of disclosure responsibility and liability is the question of whether the Federal law dealing with municipal securities is constitutional. It is well known that New York City and Philadelphia have each sued the Commission to test the constitutionality of our authority to conduct formal investigations and informal inquiries with respect to their securities. The assertion that securities issued by a state or municipality are immune from the Federal securities law is ostensibly based on the recent Supreme Court decision in the Usery case that the commerce clause of the Constitution does not authorize the imposition of Federal regulations that interfere with a state's freedom to structure "integral operations" of its "traditional governmental functions." The Commission does not desire to intrude into the judgmental and policymaking functions of State and local governments. We have sought in all of our comments on proposed legislation and our litigation activities to preserve the right for State and local governments to determine whether, when, and for

what purposes they will issue securities. However, when State and local governments voluntarily choose to raise funds for their operations by distributing securities to the investing public across State boundaries, such activities are no longer limited to the integral operations of traditional State or local government functions. Rather, they involve important national matters of investor protection which necessarily and appropriately require the application of the Federal securities laws.

As I previously indicated, the application of the Federal securities laws to municipal securities is limited by specific exemptions. Thus, underwriters of municipal securities are not subject to the broad liability provisions of Section 11 of the Securities Act which, in the words of one court, makes an underwriter "responsible for the truth of the prospectus." Nor is a municipal underwriter subject to the express liability provisions of Section 12 of the Securities Act, which makes any person who offers or sells a security liable for misstatements or omissions in a prospectus or oral communication. These exemptions, however, are not an unmixed blessing because the securities laws, along with the Commission rules, regulations and interpretations, and court decisions with respect thereto, provide a great deal of guidance for those to whom they apply.

For example, the Securities Act does not explicitly permit a municipal underwriter to rely on the statement of an expert, such as an accountant or bond counsel, or on the statement of an official person, such as a municipal officer, as a defense against liability. Moreover, the Securities Act does not explicitly afford a municipal underwriter the traditional "due diligence" defense that, "after reasonable investigation," he had "reasonable grounds to believe and did believe" that the issuer's disclosures were true and there were no omissions of material facts. And finally, the Securities Act does not provide an explicit statute of limitations for filing suits relating to municipal securities underwritings, nor does that Act even specifically limit the liability of a municipal underwriter to the dollar amount of the underwriter's offering.

These matters may eventually be resolved in a court of law or by Congress. But, until that occurs, municipal underwriters may have significant questions concerning their risk of legal exposure. There is no question, however, that underwriters of municipal securities are subject to the general antifraud provisions of the Federal securities laws and the requirement incumbent upon all brokers and dealers in securities to deal fairly with their customers.

Section 17(a) of the Securities Act makes it unlawful for any person in the offer or sale of any security to engage in fraud or to obtain money or property by means of any untrue statement of, or omission of, any material fact. As of yet, the case law concerning private actions under Section 17(a) is not well developed. The Commission has taken the position, however, that a private action should be recognized under Section 17(a) in the context of a case dealing with securities excempt from registration. Absent legislative amendment to the Securities Act with respect to municipal securities, and in light of recent judicial decisions regarding Rule 10b-5, I would speculate that plaintiffs may seek to utilize Section 17(a) in bringing actions against municipal underwriters.

Section 10(b) of the Exchange Act grants the SEC broad power to adopt rules, in the public interest or for the protection of investors, relating to manipulative or deceptive devices or contrivances in connection with the purchase or sale of any security. Our Rule 10b-5 thereunder makes it unlawful for any person, in connection with the purchase or sale of any security, to engage in any fraudulent, manipulative, or deceptive act or practice or to make any untrue statement of material fact or to omit 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.

Rule 10b-5 has been interpreted quite broadly by many courts and an implied right of private action is clearly established.

You have all probably been advised by counsel, however, of the Hochfelder decision, in which the Supreme Court held that private plaintiffs could not recover damages under Rule 10b-5 by establishing that the defendant's conduct was merely negligent, but rather, required such plaintiff to establish that the defendants had acted with scienter, which the court defined as "a mental state embracing an intent to deceive, manipulate or defraud." I will not attempt to discuss the legal ramifications of that decision, which was engendered by the peculiar facts involved, except to say that the Court expressly left open the question whether scienter is a necessary element in an SEC action under 10b-5. I believe that courts might be reluctant to apply the Hochfelder rationale broadly to private suits involving municipal underwritings. In any event, there are probably years of litigation ahead about the exact scope of the Hochfelder decision.

The last general antifraud provision which I want to mention is Section 15(c)(1) of the Exchange Act which, among other things, prohibits any broker dealer, including a municipal securities dealer, from effecting any transaction in, or inducing or attempting to induce the

purchase or sale of, any security by means of a manipulative, deceptive, or other fraudulent device or contrivance as defined by the Commission's rules. The SEC has adopted Rule 15c1-2 which defines the term "manipulative, deceptive, or other fraudulent device or contrivance" to include: any act, practice or course of business which operates as a fraud or a deceit upon any person and any untrue statement of a material fact and any omission to state a material fact, which statement or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading. To date, there has been no judicial or administrative development of the parameters of Rule 15c1-2 with respect to municipal securities dealers.

Existing statutory provisions and rules are not the only bases upon which liability could be asserted in connection with municipal underwritings. As I previously noted, the Securities Acts Amendments of 1975 vested pervasive authority in the Commission to regulate the conduct of municipal securities brokers and dealers and established a Municipal Securities Rulemaking Board which is charged with the responsibility of prescribing rules for the municipal securities industry with respect to transactions in municipal securities. Included within the Municipal Securities Rulemaking Board's authority is the

responsibility to "prevent fraudulent and manipulative acts and practices, [and] to promote just and equitable principles of trade, ..." This grant of authority is similar to that granted to the NASD for brokers and dealers in securities generally, and the courts have held that rules adopted by the NASD pursuant to this authority may give rise to a private cause of action by an aggrieved investor. There is, of course, much to be done in the way of adopting rules by the Municipal Securities Rulemaking Board. In my view, a private suit based on a Board rule would not be subject to the Hochfelder restrictions.

It should be obvious from this discussion that statutory provisions and rules thereunder offer little specific guidance at the present time regarding the responsibilities of municipal underwriters and little comfort regarding the limits of municipal underwriters' liability. Some additional assistance may be obtained, however, from a review of the Commission's actions in this area.

The Commission's authority with respect to brokers and dealers in securities, including brokers and dealers in municipal securities, is rather broad and expansive. Almost forty years ago, the Commission held that a broker dealer implies to the public--merely by engaging in the business of being a broker or dealer in securities--that his advice and

statements concerning any security are sound.1/ Courts have seized upon this implied representation and have noted that a securities dealer "occupies a special relationship to a buyer of securities in that by his position he implicitly represents that he has an adequate basis for the opinions he renders."2/

Almost ten years ago, the Commission considered the precise subject of what constitutes fairness to customers and reasonable care in the sale of municipal securities. In a disciplinary proceeding, the Commission held that, before promoting certain municipal bonds, Walston & Co. should have at least inspected the tract of land involved and inquired as to the financial condition of the developer of that land. The Commission's language in that case is quite instructive. It stated:

> 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 securites 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.3/

1/Duker & Duker, 6 SEC 386 (1939).

2/Hanly v. Securities and Exchange Commission, 415 F. 2d 589, 496 (C.A. 2, 1969).

3/Walston & Co., Inc. 43 SEC 508, 512 (1967).

During the past four years, the Commission has brought nine municipal securities enforcement proceedings. Six were secondary trading cases, five of which involved all types of municipal securities, and one of which involved industrial revenue bonds. Three were primary distribution cases, two of which involved industrial revenue bonds and one of which involved general obligation bond anticipation notes of a California water reclamation district.

In these cases, the Commission has taken action against promoters, a municipal issuer, bond counsel, underwriters and broker dealers. The broker dealers were charged with such things as boiler-room selling tactics, churning, excessive mark-ups and other fraudulent activities. In a recent administrative proceeding against a major broker dealer for certain secondary market activities in an industrial revenue bond which it had underwritten, a settlement was reached in which the sanctions included a partial reimbursement to customers for their losses and the imposition of internal operating procedures in its municipal bond department with respect to the underwriting and trading of industrial revenue bonds.

Underwriters have been named in our lawsuits for failing to disclose material facts with respect to the nature and viability of the project for which the bond proceeds were to be used, relying on unverified information and selling

municipal securities through misrepresentations and without exercising due diligence. The Commission has held that bond counsel who prepared a prospectus used in the sale of mjnicipal bonds has a responsibility to make a reasonable inquiry as to the accuracy of the information contained in the prospectus. And the Commission has argued, in a pending case, that bond counsel aided and abetted violations of the registration provisions of that Securities Act and the anti-fraud provisions of that Act and of the Securities Exchange Act where he was responsible for altering the terms of a certificate required under the bond lease agreement so as to permit the proceeds of the offering to be paid in contravention of the terms of the lease, and issued an opinion that the interest on the bonds was tax exempt without disclosing that the availability of the tax exemption was jeopardized by such payment.

In the one case against a municipal issuer, the Commission named a quasi-governmental agency, its general manager, its bond counsel and others for offering and selling general obligation bond anticipation notes without disclosing material facts concerning, among other things, the issuer's tax base, revenues and sources of funds other than revenues available to repay the notes, the absence of any liability for the State or the county to repay the notes and the preparation and use of offering circulars and television

statements which contained false and misleading statements and omitted to state material facts.

These cases indicate that the Commission is not hesitant to use its authority over brokers, dealers, underwriters and other securities participants to assure that investors have access to material information and that they are protected from fraudulent and unfair selling practices. However, because the cases are limited to specific facts and virtually all of them involve rather egregious situations, they do not, in and of themselves, establish all-purpose guidelines or standards concerning the disclosure and due diligence responsibilities and the liabilities and defenses with respect thereto for issuers, underwriters, and others involved in the distribution of municipal securities.

I believe that the uncertainty that may now exist as to the full scope and effect of present law can best be resolved through new federal legislation, preserving the rights of municipalities to determine when, whether and for what purposes to issue securities, but explicitly insuring the right of the investing public to receive full and fair disclosure. The legislation should also clarify the specific obligations of issuers, underwriters and other participants in municipal securities markets and provide an express cause of action for damages against such participants who have not met their responsibilities. It would also be appropriate to provide express due diligence defenses.

As you know, a number of bills dealing with disclosure procedures in the municipal securities markets were considered during the last session of Congress, however, none of them was enacted. The Commission supported legislation that would require certain municipal issuers to prepare annual reports and reports of any events of default. The annual report would contain a description of the issuer and material financial and other information regarding the issuer, including financial statements audited and reported on by an independent public or certified accountant. The reports of events of default would contain similar information, as prescribed by the Commission through rule or regulation. The issuer would be required to make the annual report and reports of events of default available to the public upon request.

The legislation would also require an issuer that offers or sells an issue of municipal securities exceeding a certain size to prepare a distribution statement prior to such offer or sale. The distribution statement would contain the type of information required in the annual report to the extent prescribed by the Commission and other material information concerning the offering. The issuer would be required to make the distribution statement available to the underwriters of the security offering for delivery to prospective purchasers. It is also pertinent to note that

the proposed legislation contained a narrow provision limiting underwriter's liability.

I expect municipal securities disclosure legislation to be considered again next year. At that time we should all help Congress establish explicit reasonable standards and protections, which I believe should be patterned after Section 11 of the Securities Act. The legislation should not only set forth, clearly, the precise disclosure obligations of municipal issuers, but also make explicit the full extent of their liability and concomitantly, the legislation should establish an express means whereby investors may recover damages on the basis of issuers' material misstatements or omissions of material facts in connection with the offer and sale of their securities. Issuers should, however, be able to rely on facts and figures obtained from other official sources such as census reports.

Professionals such as accountants, bond counsel, engineers, appraisers, and other experts should be liable, with respect to the portions of the distribution statements which they prepare, just as experts are liable under Section 11 with respect to corporate offerings.

The questions become more difficult when we consider legislation to define precisely the scope of municipal underwriter's liability because a majority of the issues are underwritten by competitive bid. I see no reason why an

underwriter of revenue bonds or other municipal securities in a negotiated transaction should not be subject to the same Section 11 liabilities and have the same defenses as an underwriter of corporate securities. But it has been suggested that this approach is not appropriate for competitively bid underwritings.

The Commission's experience with competitive bidding is primarily limited to public utility underwritings which are held to the same standards that apply to negotiated offerings. Utility companies generally designate independent counsel to perform a due diligence investigation prior to the bidding on behalf of the successful underwriter. This may not be a perfect solution but it is an attempt to protect investors and yet permit securities to be sold as soon as practicable by the successful bidder. I'm not sure what the best solution is with respect to municipal underwritings but investors in all types of offerings deserve to be protected from false and misleading information. In my opinion, a due diligence investigation must be performed either by the underwriter or some other party which is independent of the issuer.

The need for legislation is clear. This does not mean, however, that the Commission should, or will, cease its pending enforcement activities or refrain from future enforcement actions. Present law imposes responsibilities

on all participants in the offering of municipal securities but the most equitable and efficient marketplace is one in which the rules governing major facets of its operations are articulated, known, and understood. Legislation to help bring about that result for the municipal marketplace would be in the interest of issuers, market professionals, investors, and the general public.