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SEC'S ROLE IN "MUNICIPAL FISCAL CRISES"

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I appreciate the opportunity to participate in this Institute and discuss the role of the Securities and Exchange Commission with respect to so-called "Municipal Fiscal Crises." The New York experience and that of other large cities have attracted widespread interest and may provide the primary focus for discussion about municipal finances. It is important to realize, however, than whenever investors in municipal securities are mislead or defrauded it represents a crisis for those investors, weakens municipal securities markets and has an adverse impact on municipalities. As the Federal agency charged with overseeing our securities markets and protecting investors and the public interest in securities transactions, the Commission has a limited but what we consider to be an important role.

In preparation for my remarks today, I reviewed many documents relating to the SEC's involvement with municipal securities. Of particular interest to me was a hearing held over 30 years ago on a bill apparently intended to remove the authority in the Securities Exchange Act for the Commission to promulgate regulations under Section 15(c) with respect to municipal securities. The Chairman of the Commission, in addition to testifying against the bill, submitted a letter to the Committee stating that:

> The constant aim of the Congress and the Commission has been primarily to prevent fraud and loss to investors rather than to punish violators after the injury has been done. . . . A fine or penitentiary sentence is just as cold comfort to an investor who has been defrauded by a broker or dealer in municipal securities as it is to an investor who has been taken in by a fraudulent broker or dealer in a private securities trade.1/

At those same hearings, a well-recognized bond counsel retorted that:

> Fraudulent transactions in [municipal] securities are not common. They are not sold to persons of small means or to gullible persons who want to get rich quick. You do not sell a person a New York City 2 at a price of 107 or more with the idea that he is going to get rich overnight by buying that security. Moreover, these securities are usually issued . . . in denominations of $1,000 and the purchasers of these securities are the most sophisticated investors in the world. He does not need regulation by any Federal bureau for his protection and he is not demanding it.2/

In 1945, when these comments were made, both issuers of municipal securities and professionals dealing only in such securities were exempted from all the provisions of the Federal securities laws except the general prohibitions against fraud.

During the intervening thirty years, there have been significant changes in both the size and the nature of the municipal securities marketplace. Municipal securities are no longer assumed to be totally riskless investments. Investors in such securities are not necessarily financial

institutions or wealthy or sophisticated individuals. And there have been egregious frauds and abuses in connection with primary distributions and secondary trading of municipal securities. Throughout this period of dramatic and sometimes traumatic change, the SEC's role has been expanded in scope but has remained constant in its purpose of protecting investors.

In recent years the Commission and its staff have become more knowledgeable with respect to the peculiarities of the municipal securities markets, and more active in carrying out our enforcement responsibilities under the Federal securities laws. Whatever else the future may hold, I think we can safely assume that both of these trends will continue. During the past four years the SEC has initiated eight lawsuits 3/ and three administrative proceedings against broker dealers 4/ involving fraudulent activity in connection with trading in municipal securities, and has filed three lawsuits directly related to primary distributions of municipal securities.5/ Private investigations, which may result in additional enforcement actions, are currently being conducted in other cases.

Some of our enforcement actions with respect to abuses in municipal securities trading markets have been directed against operations which, in the words of one district court, have:

> had all the elements of a classic "boiler room" operation; unqualified, improperly supervised salesmen; high pressure long distance telephone sales designed to induce hasty investment decisions by customers about whose financial conditions the salesmen knew very little; and heavy dealings in speculative bonds of issuers about whose adverse financial conditions there was very little disclosure.6/

Typical of this type of operation is the widespread utilization of fraudulent misrepresentations and omissions of material facts. A good example is the previously-quoted case in which the judge made the following findings:

> . . . salesmen, in connection with the sale of bonds, made numerous misrepresentations, including that certain bonds were being offered by persons needing to sell the bonds to establish a tax loss or raise money to pay taxes when, in fact, such was not the case; that there was available only a limited supply of bonds to be sold when, in fact, the supply was abundant; that certain bonds were general obligation bonds when, in fact, they were revenue bonds; that the payment of interest and principal of certain bonds was guaranteed by the state and federal governments when, in fact, payment was not so guaranteed; that certain securities were presently rated "BBB" by Standard and Poor's Corporation when, in fact, that rating had been withdrawn; that the financial condition of certain issuers was good when, in fact, the issuers were experiencing severe financial difficulties; and, that a purchase of bonds offered would be a safe investment when, in fact, the investment was highly speculative.7/

As might be expected, the boiler room operations purchased and sold municipal securities at unreasonable prices

involving excessive mark-ups and mark-downs and fraudulent interpositioning.

The Commission has also found that broker dealers have engaged in additional fraudulent acts, practices and courses of business such as:

"Churning" whereby a broker dealer induces a customer, or manages a customer's discretionary account, to effect municipal bond transactions which are excessive in size and frequency in view of the financial resources and character of the customer or his account;

"Switching" whereby a broker dealer convinces a customer to order a particular municipal bond, and then sends the customer a confirmation of purchase for, and delivers, a bond issue other than that ordered;

"Bucketing" whereby a broker dealer accepts a client's money without ever buying municipal bonds which the client ordered and pocketing the money paid by the customer for his purchase;

"Adjusted Trading" a practice in which some financial institutions are apparently willing participants in order to avoid showing a loss on their books, whereby a broker dealer purchases municipal bonds from a customer at a price which is above the current market price and simultaneously sells other bonds

to the same customer at a price which exceeds the then current market price for the bonds sold. The mark-up on the bonds sold is always more than sufficient to absorb the loss sustained by the broker dealer on the purchase side and still result in a profit, which is often excessive, to the broker dealer; and

"Reverse Trading" whereby a broker dealer purchases bonds from a customer at a price which is below the then current market price without disclosing that fact and simultaneously sells with full disclosure other bonds to the same customer at a price which is also below the then current market price. The mark-down on the bonds purchased by the broker dealer is always more than sufficient to absorb the loss sustained by the broker dealer on the sale side, and still provide a profit to the dealer.

I will not attempt to articulate an exhaustive litany of illegal and questionable practices which the Commission has found in the municipal securities marketplace.8/ Suffice it to say that we have uncovered the foregoing practices; other exotic-sounding practices such as "free riding," "parking," "buy backs," "warehousing," and "streetwalking;" and such mundane practices as improper hypothecation of securities, sending of false confirmations, failure to keep accurate books and records, and failure to supervise employees.

By dwelling on the fraudulent activities in these relatively few cases, I am not suggesting that these types of activities are prevalent throughout our municipal securities markets. To the contrary, the professional standards in the municipal securities marketplace are generally high and abuses are the exception. Abuses need not be very numerous, however, to destroy the trust and confidence that investors must have in order to invest their savings in securities. The Commission believed that the types of abuses which existed in the trading markets clearly justified the Securities Acts Amendments of 1975 which imposed a comprehensive pattern of regulation on brokers, dealers, and banks engaged in the underwriting and trading of municipal securities.

Under the '75 Amendments, broker dealers exclusively dealing in municipal securities, and bank dealers in municipal securities, were 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 legislation, however, left unchanged the exemption for municipal securities issuers from the registration requirements of the Securities Acts.

To me, one of the most satisfying aspects of implementing the '75 Amendments has been the manner in which

the Municipal Securities Rulemaking Board has recognized and responded to the significant responsibilities it has as the primary rulemaking body for municipal securities professionals in many areas under the Exchange Act. There have been, and probably will continue to be, a few disagreements between the Commission and the Board and I expect that these disagreements will, as in the past, be well publicized. I believe, however, that these differences represent a healthy tension that stems, in large part, from the fact that reasonable men and women have reasonable differences. Although not publicized, of course, areas of agreement between the Commission and the Board far exceed those in which there has been disagreement and, in my judgment, we have resolved our few differences in a responsible and amicable manner. I look forward to continued and even increased cooperation and coordination between the Commission and the Board, and our respective staffs, in carrying out our important municipal securities market regulatory functions.

The cornerstone of investor protection is full and fair disclosure of material information with respect to the nature and character of securities and the issuer of the securities. Over the past 43 years a body of law and regulation has been developed to assure appropriate disclosure in our corporate securities markets. Although municipal securities have been subject to the antifraud provisions of

the securities laws, no specific disclosure standards for municipal issuers have been established by federal law, rule, or regulation.

States and municipalities have always had very strong feelings, with which I agree, about their ability to seek funds from the public without having to obtain the consent or approval of a Federal government agency. This became an important issue when the legislation to regulate brokers, dealers and banks trading in municipal securities was being considered by the Congress because municipal issuers rightly believed that standards could be established for those underwriting or trading their securities which could either directly or indirectly result in disclosure requirements for the issuing municipality. When hearings were held in May of 1974 on S. 2474, the first bill to provide regulation of municipal securities professionals, a witness testifying for the Municipal Finance Officers Association ("MFOA") discussed the possibility of requirements being placed on dealers that would effectively translate into pre-issuance restrictions on issuers.

On July 22, 1974, the MFOA issued a memorandum requesting that in order to alleviate their concern the bill be amended to provide that:

> Neither the Commission nor the Municipal Securities Rulemaking Board is authorized under this title to require an issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of such securities

> on original issuance, to furnish to the Commission or the Board or to a purchaser or prospective purchaser prior to the sale of such securities any application, report, document, or other information, in connection with their issuance, sale, or reoffering on original issue.

The Senate Committee staff was sympathetic to the municipalities' concern over possible pre-offering filing requirements and included in Committee Print No. 2 of S. 2474, dated August 7, 1974, a limited provision which stated that:

> Neither the Commission nor the Municipal Securities Rulemaking Board is authorized under this title, by rule, to require an issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to its sale of such securities any application, report, document or other information in connection with their issuance, sale or distribution.

It is important to notice that the approved provision did not contain a prohibition against either the Board or the Commission requiring that an "application, report, document or other information" be furnished to "a purchaser or prospective purchaser" in connection with the issuance, sale, or reoffering of a municipal security as was requested by the MFOA. This preserved the power which the Commission already had under the antifraud provisions of the securities laws, and arguably permitted the Board, to require the disclosure of material information to purchasers of municipal securities by underwriters and municipal securities dealers.

Inasmuch as this could impact municipalities, the MFOA was not completely satisfied with this result. Because there was little, if any, support to reduce powers which the Commission had held for 40 years, the MFOA proposed that Committee Print No. 2 be amended to state that the rules of the Board would not be designed to require issuers of municipal securities or professionals dealing in municipal securities to furnish to the Board or to purchasers or prospective purchasers any application, report, document or other information with respect to the issuing municipality. On September 11, 1974, the Committee reported S. 2474 9/ without further amendment in this regard and the bill was passed by the Senate five days later.10/ There was no action by the House, however, and the bill died at the end of the session.

On January 17, 1975, S. 249 which incorporated the provisions of S. 2474 of the previous session and three other securities bills was introduced in the Senate.11/ In subsequent discussions with the MFOA, the Commission made it very clear that we had no desire to restrict or condition access by municipalities to the capital markets, but that we were strongly opposed to any language that could be interpreted as limiting the Commission's authority to establish standards for underwriters and dealers to protect investors from misleading or deceptive information in connection with the sale of municipal securities. Moreover, we expressed our

belief that under the regulatory pattern established in the legislation, the Board was intended to be the primary rule-making body for municipal securities brokers and dealers and was granted authority to establish rules which, among other things, were to be designed to prevent fraudulent and manipulative acts and practices, and to promote just and equitable principles of trade.

We worked with the MFOA representatives in a good faith attempt to develop language that would satisfy their fears of possible improper intervention, but still preserve authority for the Board to impose reasonable informational requirements on brokers and dealers trading municipal securities. Although we made significant progress, we were unable to agree upon any language that the Commission was willing to recommend to the Senate Committee.

When we were asked by the Committee to comment on language offered by the MFOA, we responded that the "Commission finds it difficult to support actively any legislative proposal which might impede the flow of material information from issuers of securities to investors." We added, however, that "If the Committee should conclude that additional provision should be made in S. 249 to insulate issuers of municipal securities from demands for information based upon the Board's rules, the Commission believes that the language suggested by the MFOA, with certain modifications, could achieve this objective in an appropriate manner." Our

proposed modification was to clarify "that issuers of municipal securities themselves are not to be required by the Board, directly or indirectly to supply information to the Board or to a purchaser." In addition, we asked for language to clarify the fact that the Commission's authority to require such information would not be impaired.12/

When the bill was considered in the Committee, Senator Tower offered language to insulate municipal issuers from Board disclosure requirements either directly or indirectly and preserve the Commission's authority to promulgate such rules. There were many other amendments offered in the Committee "mark up" and it was decided that the amendments would be offered in block on the Senate floor. This was done by Senator Williams on April 17, 1975. After brief remarks by Senators Williams and Tower to the effect that the amendments, among other things, were "designed to make it clear that the bill will not be a means of subjecting States, cities, counties, or villages to any unnecessary disclosure requirements which could be promulgated by the new Board," the amendments were approved and the bill was passed by voice vote.13/

The following day, April 18, hearings were held on H.R. 4570, a House bill dealing with the regulation of municipal securities markets. Testifying for the Commission on that bill, I told the Committee, with respect to what was termed the "Tower Amendment," that "as a disclosure agency, we cannot come in and say we think you should limit the type

of information that can be made available to customers. However, we can support the legislation even with that type of a provision in it."14/ The Tower Amendment was opposed by all of the other witnesses at the hearing except those representing the MFOA.

In opposing the Tower Amendment, the Chairman of the Public Finance Council of the Securities Industry Association inserted a letter to Senator Williams in the record of Committee hearings stating that the MFOA proposal with Commission amendments should not be approved because its lack of clarity "makes it difficult to understand the parameters of the Board's authority should the Board deem it appropriate to adopt rules requiring disclosure of information regarding issuers by brokers and dealers in municipal securities." He continued that the Rulemaking Board should be "in a position to formulate rules for the regulation of the municipal securities industry. A part of those rules may be a requirement that dealers furnish, or make available, certain information to customers. The bill should not suggest any possible limitations on the Board's ability to act in this area." He added that, ". . . the Commission's formulation of the amendment would appear to place primary responsibility in this area upon the Commission. This is counter to our understanding of the direction of the bill, that regulation of the municipal securities industry is initially to be formulated by the Board."15/

The MFOA witness supported the Tower Amendment stating that, because the Board "is elected and representative

of the dealers--there was a possibility--perhaps a probability --that the Board would promulgate information requirements that directly or indirectly would be burdensome and costly to issuers." The witness stated further that the Board would be dominated by members of the securities industry and the MFOA did "not believe it appropriate for this body [the Board] to regulate State and local governmental bodies, directly or indirectly, in any respect." The witness also stated that the SEC already had the power to require information under its various antifraud provisions and "there seems no good reason to allow an open extension of additional powers with respect to such requirements to the Rulemaking Board. . . ." The MFOA witness also warned that with the Tower Amendment the bill was acceptable; without it, they would oppose the legislation.16/

When the Conference Committee concluded its work and the differences between the Senate and House bills were resolved, municipalities were protected in Section 15B(d)(1) from being required by the SEC or the Rulemaking Board to file documents with the Board or the Commission prior to the sale of their securities. They were also protected in the Tower Amendment, that is Section 15B(d)(2), from being required by the Board, either directly or indirectly, to furnish information to the Board or to a purchaser or prospective purchaser. However, the Tower Amendment specifically stated that nothing therein "shall be construed to impair or limit the power of the Commission" under the Exchange Act.

In fact, the '75 Amendments applied Section 15(c)(2) of the Exchange Act to municipal securities dealers. This action could have triggered Rule 15c2-11, which prohibits brokers and dealers from initiating market making activities when certain financial and other information about a security and its issuer are not available. The Senate Report stated, however, that the type of information required by Rule 15c2-11 is not generally available for municipal securities and their issuers and thus the rule would preclude brokers and dealers from submitting quotations on most issues of municipal securities. Therefore, the Committee stated in its report that it expected the Commission to use its power to exempt municipal securities from Rule 15c2-11 immediately upon enactment of the legislation.17/ The Commission did exempt municipal securities from the requirements of Rule 15c2-11 in order to avoid the immediate adverse consequences anticipated by the Committee.

However, there is no question that the Commission has power under Sections 15(c)(1) and 15(c)(2) to apply present rules or promulgate other rules and regulations reasonably designed to assure that brokers and dealers in municipal securities are prevented from inducing or attempting to induce the purchase or sale of any municipal security through engaging in any fraudulent, deceptive, or manipulative act or practice or making any fictitious quotation. In addition, in my view, the Commission could assert general

antifraud authority to proscribe issuers from selling securities without disclosing information before, concurrently with, or after the offering, if the Commission finds that the failure to provide that information would or could operate as a fraud or deceit upon investors. Similarly, the Commission could assert the authority to require such information to be furnished to the Board or the Commission concurrently with or after the sale of such securities. To date, the Commission has not asserted such powers.

It is well known, of course, that New York City has sued the Commission to test the constitutionality of our authority to conduct even a formal investigation with respect to its securities, and that the City of Philadelphia has challenged our staff's right to seek, on a voluntary basis, information that would enable the staff to decide whether or not to seek a formal investigation of the circumstances surrounding trading in Philadelphia's securities.18/ The assertion that securities issued by a state or municipality are totally immune from the Federal securities laws is ostensibly based on the recent Supreme Court decision in the Usery case 19/ 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 has never desired to intrude into the judgmental and policymaking functions of State and local

governments. For example, in 1945 a former SEC Chairman testified:

> We have been deeply concerned over the circulation of the statement that the Commission is trying to gain control over the issuance of municipal securities. We in the Commission have worked closely with State authorities over a period of some years in connection with our mutual problems. As we have sought carefully to maintain our good relations with the States--and I think with a considerable measure of success--we are particularly sensitive about any charge that we are attempting to infringe on the rights of the States in managing their own finances. 20/

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, in my view, 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.

During the more than three and one half years that I have been on the Commission, we have brought three enforcement actions relating to the issuance of municipal securities.

In SEC v. The Senex Corporation, 21/ the Commission sought to enjoin seven corporate and individual defendants (not including the issuer) from further violations of the antifraud provisions of the Federal securities laws in connection with the offer and sale of revenue bonds issued to finance the construction of a health care facility in Covington, Kentucky. Certain of the defendants consented to the entry of permanent injunctions; other defendants decided to litigate. While the district court rejected one of the SEC's contentions, it did grant preliminary relief based upon findings that the defendants violated the antifraud provisions by, among other things, failing to disclose: (1) that the defendant, which had issued a consultant's report demonstrating the desirability of the proposed project, would share in 50 percent of the developer's profit; (2) that other feasibility reports bearing adversely on the proposed project existed; and (3) that the project's financial adviser and underwriter were owned and controlled by the developer. The district court's decision was affirmed, per curiam, by the U. S. Court of Appeals for the Sixth Circuit. 22/ A related disciplinary proceeding by the Commission ended with a censure, by consent, of the bond counsel, who had assumed principal legal responsibility for reviewing the Offering Prospectus utilized by the City of Covington Health Care Corporation. 23/

In SEC v. Reclamation District No. 2090,24/ the Commission alleged violations of the antifraud provisions of the Federal securities laws by 21 corporate and individual defendants in connection with the offer and sale of approximately $202 million of general obligation negotiable promissory notes of the District, located in the County of Contra Costa, California, to 161 investors residing in 12 states. This action may be noteworthy because the SEC sued the District, which is a quasi-governmental agency of the State of California, created, and having taxing authority, under California's Water Code. Other defendants in the case included the promoters and trustees of the District, its general manager, its bond counsel, and certain broker dealers, their principals and salesmen. Among other things, the Commission alleged material omissions concerning such things as: (1) the revenues available for repayment of the securities; (2) the availability of sources of funds other than revenues to repay the securities; (3) the insufficiency of the District's tax base to generate enough funds to repay the securities; and (4) the absence of any liability of the State of California and the County of Contra Costa to repay the securities. Virtually all of the defendants have consented to permanent injunctions.

In SEC v. Astro Products of Kansas, Inc.,25/ the Commission charged 19 corporate and individual defendants with violating the Federal securities laws, including the

Trust Indenture Act, in connection with the offer and sale of industrial revenue bonds issued by Astro Products and the City of Haysville, Kansas. The named defendants in the case include: the corporate issuer, but not the city itself; certain promoters; a national bank which served as fiscal agent; bond counsel; several broker dealers; and certain of the project's equipment suppliers. Among other things, the Commission alleged in the complaint that certain individuals engaged in a scheme to promote an industrial development revenue project in Haysville, Kansas, involving the issuance by the City of Haysville of $2,200,000 industrial development revenue bonds of which the proceeds were to be used to acquire equipment for a plant to assemble vehicular wheels. As part of the scheme, one individual allegedly misrepresented his background and the economic potential to Haysville of the proposed assembling plant; and bond counsel, by furnishing an opinion that the bonds were duly authorized and that the interest on the bonds was tax exempt, allegedly made it possible for the bonds to be issued and marketed as tax exempt. Inasmuch as this matter is currently being litigated, I will not comment further on this case.

These types of cases raise the question of whether the Commission should use its antifraud powers to effect explicit disclosure standards with respect to municipal securities. In my view, it would be preferable for the Congress, thorugh legislation, to establish the

parameters of specific federal disclosure requirements for municipal issuers. Following the emergency of the crisis in New York, legislative proposals were introduced to establish federal requirements for disclosure by municipal issuers. One such proposal was S. 2574, a bill to remove the exemption for municipal securities which is contained in the Securities Act, and to amend Section 15B(d)(1) of the Exchange Act, as enacted in the '75 Amendments, so that the Commission could require municipal issuers to file with the Board or the Commission prior to the sale of securities, applications, reports or documents in connection with the issuance, sale or distribution of such securities.26/ This bill would have subjected municipal securities to the same registration, accounting, and disclosure requirements that apply to corporate securities.

The Commission opposed that proposal as being unnecessary and inappropriate to accomplish the objective of full disclosure of material facts to investors because we believed it would impose burdens and costs outweighing its benefits, and it would have involved the Commission in the processing of documents filed with us by municipalities before they could issue securities.27/

The Commission, however, did provide drafting assistance and supported a legislative proposal that would have established significantly more limited Federal municipal securities disclosure requirements than those for corporate

securities. The proposal supported by the Commission would have required 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 report of events of default available to the public upon request.

The legislation would also have required 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 have been 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 underwriters' liability and a provision exempting an issuer from the distribution statement requirements if an independent State government authority certified that

the disclosure provided by the municipal issuer was adequate to protect investors.

In hearings held by both House and Senate Committees, such legislation was generally supported by Federal governmental agencies, the Municipal Securities Rulemaking Board, and various industry witnesses representing accountants, underwriters, and institutional investors. But it was opposed by witnesses representing issuing municipalities. No legislation was reported last session.

Assurances have been given that municipal securities disclosure legislation will be introduced again next year. It is likely that such proposals will be similar to those considered last year, but I believe they should and will contain provisions establishing specific remedies and conditions under which participants in municipal securities offerings may claim defenses against liability for the use of false or misleading information in connection with the offering or sale of such securities.

There are indications that some industry participants are no longer anxious to push for municipal securities disclosure legislation which they previously considered a desirable means to clarify the limits of their liability and provide explicit statutory defenses against private damage suits. The basis for this perceived change in attitude is the Hochfelder decision 28/ in which the Supreme Court held that private plaintiffs could not recover

damages under Rule 10b-5 on the basis of establishing mere negligence by a defendant, but required a plaintiff to establish scienter or "intent to deceive, manipulate or defraud." Although the Supreme Court expressly did not deal with the question of whether scienter is a necessary element in an SEC action under Rule 10b-5, a judge in the Southern District Court of New York has attempted to extend the scienter requirement to SEC actions in his decision in the Bausch & Lomb case.29/ The Commission believes that its enforcement actions were not intended to, and should not, be subject to a scienter standard. Accordingly, the Commission has announced that it has appealed the Bausch & Lomb case to the Second Circuit Court of Appeals,30/ which in the past has held that negligence could serve as a basis for the entry of an injunction in Commission actions for violations of Rule 10b-5.31/ I might also add that a recent decision in another court of appeals appears to be consistent with the Commission's understanding of the law.32/

Regardless of the ultimate development of law under Rule 10b-5, there are other antifraud provisions--such as Section 17(a) of the Securities Act and Sections 15(c) and 15B of the Exchange Act--which are not subject to the Hochfelder rationale and on the basis of which private actions may be sustained and damages recovered.

The New York municipal crisis of a year ago made investors aware that municipal securities are not without

risk, and investors and underwriters demanded greater disclosure which issuers had to provide in order to market their obligations. Some issuers were delayed in going to market with their securities until they provided additional information which they believed was not always material to investors, but which they thought was sought out of an abundance of caution because there were no explicit disclosure standards on which underwriters or institutional investors could rely in order to limit their liability to clients. There is no question that these market forces have resulted in greater disclosure and that the Municipal Finance Officers Association's voluntary guidelines approach has also been helpful in this respect. But, they have not resolved the basic problems.

In my opinion the most reasonable and prudent course to pursue is new legislation which is carefully developed, after weighing the needs of investors, securities professionals associated with municipal offerings, and issuers. Such legislation should help stabilize our municipal securities markets because it would minimize demands for unnecessary disclosure by establishing explicit standards of full and fair disclosure by municipal issuers to the investing public, while avoiding the threat of unnecessary federal intervention in State and local affairs and preserving the rights of municipalities to determine whether, when and for what purposes to seek funds through issuing securities.

I believe such legislation can and will be approved by Congress and that all who seek funds in our municipal securities markets, all who are associated in some way with the offering and sale of municipal securities, investors, and the citizens of municipalities have an interest in the enactment of such legislation.

FOOTNOTES

1/Hearings on H.R. 693 Before the House Comm. on Interstate and Foreign Commerce, 79th Cong., 1st Sess. 59 (1945)

2/Id. 7.

3/The SEC's complaints, and judicial resolutions thereof, usually are briefly summarized in litigation releases. SEC v. Investors Associates of America, Lit. Rel. Nos. 5583, 5763 and 6164 (Oct. 26, 1972, Feb. 28 and Dec. 4, 1973); SEC v. Chas. A. Morris & Associates, Inc., Lit. Rel. Nos. 5584 and 6264 (Oct. 26, 1972 and Feb. 28, 1974); SEC v. Paragon Securities Co., Lit. Rel. Nos. 6005 and 6539 (Aug. 2, 1973 and Oct. 9, 1974); SEC v. First U.S. Corp., Lit. Rel. No. 6032 (Aug. 22, 1973); SEC v. R. J. Allen & Associates, Inc., Lit. Rel. No. 6574 (Nov. 6, 1974); SEC v. Union Planters Corp., Lit. Rel. No. 6733 (Feb. 13, 1975); SEC v. Scott, Gorman Municipals, Inc., Lit. Rel. No. 7095 (Sept. 23, 1975); and SEC v. Bertsil L. Smith and Jon R. Walls, Lit. Rel. No. 7652 (Nov. 16, 1976).

4/In re SMW Securities, Inc., Exchange Act Rel. Nos. 12275, 12375 and 12375A (Mar. 29, Apr. 26 and May 6, 1976); In re Hibbard & O'Connor Securities, Inc., et al., Exchange Act Rel. Nos. 12343 and 12344 (Apr. 14, 1976); and In re Bache Halsey Stuart, Inc., et al., Exchange Act Rel. No. 12847 (Oct. 1, 1976). See also In re Walston & Co., Inc. and Gregory I. Harrington, 43 S.E.C. 508 (1967).

5/SEC v. The Senex Corp., Lit. Rel. Nos. 6451 and 6769 (Jul. 24, 1974 and Mar. 5, 1975); SEC v. Reclamation District No. 2090, Lit. Rel. Nos. 7460 and 7590 (Jun. 22 and Sept. 28, 1976); and SEC v. Astro Products of Kansas, Inc., Lit. Rel. No. 7557 (Sept. 13, 1976).

6/SEC v. Chas. A. Morris & Associates, Inc., 386 F. Supp. 1327, 1336 (W.D. Tenn. 1973).

7/Id. 1333.

8/The type of fraudulent behavior in certain of these cases is aptly described by one judge as:

> a horrible fraud, one that has been vicious and brutal. It is difficult to imagine how anyone could contrive and execute a more diabolical scheme. It has effectively defrauded and cheated the customers . . . many of whom have been left destitute.

SEC v. R. J. Allen & Associates, Inc., 386 F. Supp. 866, 874 (S.D. Fla. 1974).

9/S. Rep. No. 93-1145, 93d Cong., 2d Sess. (1974).

10/120 Cong. Rec. 31170 (1974).

11/S. 249, 94th Cong., 1st Sess. (1975). See also Cong. Rec. S432 (daily ed. Jan. 17, 1975) (remarks of Senator Williams).

12/Letter from SEC Chairman Ray Garrett to Senator Williams, April 10, 1975.

13/Cong. Rec. S6163, at S6189 (daily ed. Apr. 17, 1975) (remarks of Senator Tower).

14/Hearings on H.R. 4570 Before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce, 94th Cong., 1st Sess. 65 (1975).

15/Id. 72.

16/Id. 103-104.

17/Senate Comm. on Banking, Housing and Urban Affairs, Securities Acts Amendments of 1975, S. Rep. No. 94-75, 94th Cong., 1st Sess. 48 (1975).

18/City of New York v. SEC, No. 76 Civ. 3307 (S.D.N.Y., filed July 27, 1976); City of Philadelphia v. SEC, No. 76-2396 (E.D. Pa., filed July 29, 1976).

19/National League of Cities v. Usery, 96 S. Ct., 2465 (1976).

20/Hearings on H.R. 693 Before the House Comm. on Interstate and Foreign Commerce, 79th Cong., 1st Sess. 100 (1945).

21/399 F. Supp. 497 (E.D. Ky. 1975).

22/No. 75-1656 (6th Cir. May 7, 1976).

23/In re Jo M. Ferguson, Securities Act Rel. No. 5523 (Aug. 21, 1974).

24/C-76-1231-RHS, (N.D. Cal., filed June 17, 1976).

25/ (D. Kan., filed Aug. 31, 1976).

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

27/Hearings on S. 2969 and S. 2574 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. 18 (1976).

28/Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375 (1976).

29/SEC v. Bausch & Lomb, Inc., 73 Civ. 2458 (S.D.N.Y., Sept. 16, 1976).

30/Lit. Rel. No. 7663 (November 23,1976).

31/E.g., SEC v. Spectrum, Ltd.- 489 F. 2d 535 (2d Cir. 1973) and SEC v. Management Dynamics, 515 F. 2d 801 (2d Cir. 1975).

32/SEC v. World Radio Mission, Inc., No. 76-1285 (1st Cir., Nov. 4, 1976).