Securities and Exchange Commission Staff Report in Response
to Questions Relating to Municipal Securities Regulation

April 26, 1984

Question 1

With respect to corporate and municipal issuers, please state the differences in regulatory requirements relating to the obligations of issuers to disclose information in: a) offering statements covering the issuance of new securities; b) periodic reports; and c) other statements or publications.

Answer

The federal securities laws and the rules promulgated thereunder place significantly greater regulatory requirements on the offering of nonexempt securities than on offerings of exempt securities such as municipal securities. The Securities Act of 1933, which regulates transactions in newly issued securities, applies to nonconvertible debt, the corporate securities most similar to municipal securities, but exempts municipal securities from most requirements. Although the Securities Acts Amendments of 1975 established the Municipal Securities Rulemaking Board, the self-regulatory organization for the municipal securities markets, and provided for limited federal regulation of municipal securities brokers and dealers, the 1975 Amendments did not make municipal securities subject to the registration and prospectus delivery requirements of the Securities Act. On the contrary, as discussed below, the 1975 Amendments expressly preclude the Commission and the MSRB from establishing a registration system, comparable to that applicable to corporate securities, for municipal issuers.

Corporate issuers, unless specifically exempted, must file with the Commission disclosure documents known as registration statements prior to offering or selling new securities. Section 5(a), (c) of the Securities Act, 15 U.S.C. 77e(a), (c). In these statements, the issuer must accurately and adequately disclose material facts relating to, among other things, assets, business and competitive posture, investor risks, financial statements certified by public accountants, information about management and other data. Section 7 of the Securities Act, 15 U.S.C. 77g. Sales of nonexempt securities must be accompanied by a prospectus including similar information. Sections 5(b) and 10 of the Securities Act, 15 U.S.C. 77e(b), 77j.

Municipal issuers are not required to prepare or file with the Commission any disclosure documents prior to offering or selling new securities, or to provide purchasers with a prospectus. Section 3(a)(2) of the Securities Act, 15 U.S.C. 77c(a)(2). Indeed, Section 15B(d) of the Securities Exchange Act of 1934, 15 U.S.C. 78o-4(d), as amended by the 1975 Amendments, specifically prohibits the Commission and the MSRB from requiring a municipal securities issuer to file pre-offering disclosure documents and from using MSRB rules to require mandatory disclosure indirectly through the regulation of

municipal securities brokers and dealers. MSRB Rule G-32, however, requires that, if an offering statement is voluntarily prepared by an issuer, it must be provided to purchasers.[1]

Corporations with securities that are publicly traded in the secondary market are generally required to file with the Commission quarterly disclosure reports (Form 10-Q), and an annual report (Form 10-K), unless specifically exempted. Section 13(a) of the Exchange Act, 15 U.S.C. 78m(a), and Rules 13a-1 and 13a-13 thereunder, 17 CFR 240.13a-1 and 240.13a-13. See also Section 15(d), 15 U.S.C. 78o(d). Corporate issuers are also required to file additional reports with the Commission on Form 8-K upon the occurrence of certain significant events, such as the sale of major assets or a filing for bankruptcy. Rule 13a-11 under the Exchange Act, 17 CFR 240.13a-11. Municipal issuers with securities that are traded in the secondary market are not required either to file periodic or current reports with the Commission or to disseminate information periodically to investors. See Section 3(a)(12) of the Exchange Act, 15 U.S.C 78c(a)(12).

Notwithstanding these exemptions from certain regulatory requirements, municipal securities, like non-exempt securities, are subject to the antifraud provisions of the securities laws. Whenever either corporate or municipal issuers disseminate information to the public (whether or not dissemination of the information was required by law) these provisions preclude them from making material misstatements or material omissions which make other statements misleading. In particular, Section 17 of the Securities Act imposes liability on any person, including issuers, for fraudulent conduct in the offer or sale of both nonexempt and exempt securities. See Sections 17(a) and 17(c) of the Securities Act, 15 U.S.C. 77q(a) and 77q(c) and Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 CFR 240.10b-5, prohibit fraudulent conduct in connection with the purchase or sale of municipal securities as well as nonexempt securities. The Commission can, of course, enforce these antifraud prohibitions by bringing injunctive proceedings against violators.

With respect to private liability for fraud related to municipal securities transactions, the law is somewhat more complex. While Section 10(b), and Rule 10b-5 thereunder, does provide an implied private right of action, it is contingent upon proof of scienter. In contrast, although subparagraphs (2) and (3) of Section 17(a) do not require a showing of scienter to state a cause of action in a Commission proceeding, it is unclear whether that Section provides an implied private right of action.

Issuers of nonexempt securities are also subject to strict liability to purchasers for material misstatements and omissions in a registration statement under Section 11(a) of the Securities Act, 15 U.S.C. 77k(a). Under Section 12(1), 15 U.S.C. 77l(1), issuers of nonexempt securities can be liable for offering or selling unregistered securities in violation of Section 5, 15 U.S.C. 77e, or by means of a prospectus or oral communication which includes a material misstatement of fact or omission, unless the issuer can establish

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[1] Rules of the Municipal Securities Rulemaking Board, MSRB Rule G-32, Disclosures in Connection with New Issues, MSRB Manual (CCH) ¶3656 at 3577.

that it acted with due diligence, that is that it did not know, and in the exercise of reasonable care could not have known, of such untruth or omission. Section 12(2), 15 U.S.C. 77l(2). There are no comparable provisions with respect to issuers of exempt securities.

Question 2

Specifically, what would have been the differences in information made available to public investors if the disclosure requirements relating to nonexempt issuers had been applicable to WPPSS?

Answer

If the disclosure requirements relating to non-exempt issuers had been applicable to the Washington Public Power Supply System, WPPSS would have been required to file with the Commission (and investors in the new issues should have received) a disclosure document containing certain information prepared in conformity with the Securities Act. In addition, WPPSS would be filing periodic disclosure reports with the Commission pursuant to the Exchange Act.

Official statements prepared in accordance with these requirements would require disclosure of, among other facts, risks to the investors, a detailed explanation of the use of proceeds, WPPSS' ability to complete construction of the plants, and the background and experience in energy construction of the WPPSS management. However, the existence of these or any other legal requirements does not guarantee compliance by any individual issuer, municipal or corporate. Moreover, because the staff has not yet completed its review of the WPPSS disclosure, we are unable to express any opinion concerning the extent to which WPPSS voluntarily disclosed this information.

Question 3

Please state the differences in regulatory requirements relating to the obligations of underwriters of corporate and municipal securities and state what would have been the differences in the obligations of underwriters of WPPSS bonds if the bonds were not exempt securities.

Answer

Municipal securities underwriters are not subject to the disclosure scheme applicable to nonconvertible debt securities. Under Section 5 of the Securities Act, 15 U.S.C. 77e, an underwriter may sell nonexempt securities only if a registration statement, filed with the Commission, has become effective and purchasers have been provided with a statutory prospectus. An underwriter who sells securities in violation of these registration and prospectus delivery requirements can be held liable for damages under Section 12(1) of the Securities Act, 15 U.S.C. 77l(1). Moreover, the registration statement and prospectus required by Section 5 for a nonexempt offering must be accurate and complete. An

underwriter may be liable for material misstatements and omissions in a registration statement under Section 11(a) of the Securities Act, 15 U.S.C. 77k(a), and in a prospectus under Section 12(2) of the Securities Act, 15 U.S.C. 77l(2) (regardless of whether the underwriter acted with scienter), unless it can establish a due diligence defense pursuant to Section 11 or 12. The due diligence standard under Section 11 is that the underwriter conducted a reasonable investigation of the offering after which it believed and had reason to believe that there were no material misstatements or omissions in the registration statement. The due diligence standard under Section 12 is that the underwriter did not know and in the exercise of reasonable care could not have known of the material misstatements or omissions in the prospectus.

As discussed in the answer to Question1, the antifraud provisions of the federal securities laws apply equally to nonexempt and municipal securities.[2] In addition, Rule 15c1-6 under the Exchange Act, 17 CFR 240.15c1-6, requires an underwriter to disclose its interest in an offering when engaging in customer transactions for nonexempt debt or municipal securities subject to a distribution. Rule 15c1-8 under the Exchange Act, 17 CFR 240.15c1-8, prohibits an underwriter from representing that nonexempt securities or municipal securities subject to a distribution are offered "at the market" unless the underwriter knows or has reason to know that there exists an independent market for the security.

In contrast, the rules of self-regulatory organizations apply unevenly to underwriters of nonexempt and municipal securities. The National Association of Securities Dealers, Inc.'s rules generally do not apply to transactions in municipal securities. In particular, the NASD's Corporate Financing Interpretation,[3] which regulates the amount and type of underwriting compensation and imposes holding periods for stock given to underwriters, requires members to submit only nonexempt offerings for review of underwriting terms and arrangements. However, MSRB Rule G-32 requires disclosure of an underwriter's compensation in connection with a negotiated sale of new issue securities.[4]

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2 The Commission has said that dealers offering municipal bonds should "make certain that the offering circulars and other selling literature are based on an adequate investigation so that they accurately reflect all material facts which a prudent investor should know." In re Walston & Co., Inc. and Harrington 43 SEC 508, 512 (1967). Failure to do so in Walston resulted in liability under Section 17(a) of the Securities Act, 15 U.S.C. 77q(a), and Sections 10(b) and 15(c)(1) of the Exchange Act, 15 U.S.C. 78j(b) and 78o(c)(1), and Rules 10b-5 and 15c1-2, thereunder, 17 CFR 240.10b-5 and 17 CFR 240.15c1-2.

3 NASD Rules of Fair Practice, Art. III, §1, Review of Corporate Financing, NASD Manual (CCH) ¶2151 at 2019.

4 MSRB Rule G-32, Disclosures in Connection with New Issues, MSRB Manual (CCH) ¶3656 at 3577.

The NASD's Free-Riding and Withholding Interpretation[5] prohibits an underwriter from selling a "hot issue" to its own account or that of certain other enumerated persons. In addition, NASD Schedule E further regulates broker-dealer self-underwriting, the practice by which a broker-dealer underwrites an offering of its own securities or those of an affiliate. The legislative history of Section 15B of the Exchange Act, 15 U.S.C. 78o-4, explicitly rejected the concept of a "free-riding" rule for municipal securities because it could adversely affect the ability of municipalities to obtain the most favorable rate of interest on their bonds, if underwriters, particularly banks, were not permitted to purchase the securities for investment.[6] Instead, MSRB Rule G-11 requires that syndicate managers establish allocation procedures and furnish them in writing to other syndicate members who must furnish them to others upon request. Under the rule, managers may provide that allocations different from that set forth may be made on a case-by-case basis.

Section 24 of Article III of the NASD Rules of Fair Practice prohibits an underwriter from granting selling concessions to non-syndicate members except as consideration for services rendered in a distribution.[7] The MSRB has no comparable rule. MSRB Rule G-11, however, requires that, after the distribution, the lead underwriter of a municipal securities offering must disclose to syndicate members the allocation of securities among the syndicate and the expenses the syndicate incurred.[8]

Question 4

With respect to securities sales representatives, are there differences in regulatory requirements relating to the sale of municipal and corporate securities?

Answer

For the most part, sales representatives selling municipal securities are subject to similar regulatory requirements as representatives selling nonconvertible debt. Transactions in municipal securities, like transactions in nonexempt securities, are subject to the antifraud provisions of the securities laws. Municipal securities dealers and non-bank municipal securities brokers, like brokers and dealers in corporate debt, are required to register with the Commission. Furthermore, the rules of the MSRB governing the conduct of municipal securities brokers and dealers in most respects parallel the rules of the NASD applicable to the conduct of brokers and dealers with respect to corporate debt.

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5 NASD Rules of Fair Practice, Art. III, §1, Free-Riding and Withholding, NASD Manual (CCH) ¶2151 at 2039-3.

6 Senate Comm. on Bank, Housing & Urb. Affs., Report to Accompany S. 249: Securities Acts Amendments of 1975, S. Rep. No. 94-75, 95th Cong., 1st Sess. 49 (Comm. Print 1975) ["Senate Report"], reprinted in [1975] U.S. Code Cong. & Ad. News 179, 227.

7 NASD Manual (CCH) ¶2174 at 2097-2.

8 MSRB Rule G-11, Sales of New Issue Municipal Securities During the Underwriting Period. MSRB Manual (CCH), ¶3551 at 3541-3.

As a result, with respect to both municipal and corporate securities, activities such as the recommendation of unsuitable securities to a customer, excessive trading in a customer's account, and charging a price not reasonably related to the prevailing market price are prohibited by Rule 10b-5 under the Exchange Act, 17 CFR 240.10b-5, and by NASD or MSRB rules. In addition, broker-dealers selling municipal and nonexempt securities are required under Commission, NASD, or MSRB rules to provide similar customer confirmations. Similar professional qualification and supervision requirements also apply to municipal brokers and dealers and other brokers and dealers.

Although sales of municipal and nonexempt securities are subject to similar regulatory requirements in most respects, some differences exist, for the most part due to the special characteristics of municipal securities. For instance, municipal securities are not subject to the requirement of Rule 15c2-11 under the Exchange Act, 17 CFR 240.15c2-11, that broker-dealers have on hand current information concerning a security before quoting the security in an interdealer system; the legislative history of Section 15B of the Exchange Act, 15 U.S.C. 78o-4, explicitly states that Rule 15c2-11 should not apply to municipal securities because of the absence of disclosure requirements for municipal issuers.[9]

Furthermore, MSRB and NASD rules regarding fair mark-ups differ in that the MSRB rules do not include any numerical guidelines comparable to the NASD's 5% mark-up policy.[10] Nevertheless, in light of the fact that the mark-ups on municipal bonds are significantly less than those for equity securities "[t]he Commission has consistently held that the appropriate level of mark-ups on municipal securities is lower than those for equity securities."[11]

The MSRB and NASD suitability standards also differ in that the MSRB explicitly requires a reasonable inquiry into a customer's financial situation in reaching a conclusion concerning the suitability of a transaction in a municipal security; the NASD does not, as a general matter, specifically require this investigation.[12] Finally, municipal

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9 Senate Report, supra note 6, at 48, [1975] U.S. Code Cong. & Ad. News at 226.

10 Compare NASD Rules of Fair Practice, Article III, §1, Execution of Retail Transactions in the Over-the-Counter Market, NASD Manual (CCH) ¶2151 at 2035 with MSRB Rule G-30(a), Prices and Commissions--Principal Transactions, MSRB Manual (CCH) ¶3641 at 3575-5.

11 Commission Memorandum in Support of Application for an Order to Show Cause, Temporary Restraining Order, and Motion for a Preliminary Injunction, Expedited Discovery and other Equitable Relief, at 24, SEC v. MV Securities, 84 Civ. 1164 (S.D.N.Y. 1984). See e.g., In re Staten Securities Corporation, Securities Exchange Act Release No. 18628 (Apr. 12, 1982), SEC Docket 2006, 2008. See e.g., In re Edward J. Blumenfeld, Securities Exchange Act Release No. 16437 (Dec. 19, 1979), 18 SEC Docket 1379, 1382; In re DMR Securities, Inc., Securities Exchange Act Release No. 16990 (July 21, 1980), 20 SEC Docket 762, 764.

12 NASD Rules of Fair Practice, Article III, §2, Recommendations to Customers, NASD Manual (CCH) ¶2152 at 2051.

securities are not subject to Rule 15c2-5 under the Exchange Act, 17 CFR 240.15c2-5, regarding extensions of non-margin credit in connection with securities transactions. However, municipal securities, like nonexempt securities, are subject to disclosure of credit terms pursuant to Rule 10b-16 under the Exchange Act, 17 CFR 240.10b-16.

Question 5

While the rating services, as such, have no specific obligations under the federal securities laws, please state the nature of the liability of rating services registered as investment advisers with the Commission in: a) actions brought by the Commission; and b) actions brought by private parties.

Answer

Rating agencies registered with the Commission as investment advisers are subject to the provisions of the Investment Advisers Act of 1940, including the antifraud provisions in Section 206 of the Advisers Act, 15 U.S.C. 80b-6. In general, Section 206 makes it unlawful for an investment adviser to defraud or deceive a client.

The Commission can institute proceedings against an investment adviser for violating Section 206 by seeking injunctive relief in United States district court pursuant to Section 209 of the Advisers Act, 15 U.S.C. 80b-9, or by commencing administrative proceedings to censure, limit the activities of, suspend or bar investment advisers pursuant to Section 203(e) of that Act, 15 U.S.C. 80b-3(e).

The Supreme Court has held that there is no private cause of action for damages against an investment adviser for a violation of Section 206 of the Advisers Act. Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979). However, the Court implied a limited private right of action under Section 215 of the Advisers Act, 15 U.S.C. 80b-15, to "void an investment advisory contract." 444 U.S. at 24. In addition, an investment adviser may, under appropriate circumstances, be subject to the same liability under the general antifraud provisions of the securities laws as any other participant in the securities markets in actions brought by either the Commission or private parties.

Question 6

With respect to financial advisers to municipal securities issuers, how do their requirements differ from the requirements under the Investment Advisers Act?

Answer

Financial advisers to municipalities who are not broker-dealers or investment advisers are not subject to the registration requirements under the federal securities laws or the regulatory structure promulgated under these laws.

Brokers, dealers, and municipal securities dealers who act as financial advisers to municipal issuers are subject to the rules of the MSRB. In particular, they must comply with the ethical standards and disclosure requirements set forth in MSRB Rule G-23.[13] That Rule requires a writing to evidence the financial advisory relationship, sets strict conditions for the sale by a financial adviser of securities for which he had acted as financial adviser, and details the disclosure required to be made to the issuer and customers regarding possible conflicts of interest. These rules apply to financial advisory services rendered to state or local governments and their agencies and municipal corporations, but not to corporate obligors in connection with industrial development bond ("IDB") financings.

Investment advisers registered with the Commission pursuant to the Advisers Act are subject to its provisions, regardless of whether they advise a municipal or corporate issuer. But, in general the Commission has not interpreted the definition of "investment adviser" in that Act, Section 202(a)(11), 15 U.S.C. 80b-2(a)(11), to apply to persons who advise issuers regarding how to structure their financing. See, e.g., Joseph M. Dyson (avail. Apr. 9, 1975) (no-action letter); Gunnor/Burkhardt/Armstrong & Associates (avail. Jan. 26, 1975) (no-action letter).

Question 7

With respect to securities firms serving as underwriters of the bonds, advisers for investment companies holding the bonds, and brokers with public customers investing in the bonds, are there differing requirements relating to conflicts of interest depending on whether bonds are corporate or municipal bonds?

Answer

A) Underwriters

In most respects the regulatory requirements addressing conflicts of interest for underwriters are similar for municipal and corporate bonds. For instance, under Commission rules, underwriters of both municipal and corporate bonds must disclose to customers their interest in distributions and their control relationships with an issuer prior to trading in that issuer's security with their customers. Rules 15c1-5 and 15c1-6 under the Exchange Act, 17 CFR 240.15c1-5 and 240.15c1-6.

There are three principal differences, however, in conflict of interest standards for municipal and corporate bonds. First, unlike underwriters of municipal securities, underwriters of corporate debt are subject to the NASD's Free-Riding and Withholding Interpretation,[14] which, among other matters, prevents underwriters from holding back part of a hot issue and selling it for the underwriter's own account after the price rises.

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[13] MSRB Rule G-23, Activities of Financial Advisors, MSRB Manual (CCH), ¶3611 at 3571-5.

[14] NASD Rules of Fair Practice, Art. III, §1, NASD Manual (CCH) ¶2151.06 at 2039-3.

Second, under MSRB rules, underwriters of municipal securities that act as financial advisers to issuers must obtain the approval of the issuer before acting as an underwriter in the securities, and must adequately disclose this financial adviser relationship to customers.[15] Finally, the MSRB has no rule analogous to the NASD's rule limiting self-underwriting.[16]

B) Advisers to Investment Companies

There are no significant differences in conflict of interest standards for advisers to investment companies with respect to municipal and corporate bonds. While Rule 10f-3 under the Investment Company Act of 1940, 17 CFR 270.10f-3, distinguishes between municipal and other securities with respect to the standards for exempting investment company purchases of securities where the company's investment adviser is involved in the securities distribution, these differences are minor.

C) Broker-Dealers

In most respects, similar conflict of interest standards apply to brokers, dealers, or municipal securities dealers selling municipal securities as apply to broker-dealers selling corporate bonds to customers. These standards include prohibitions on churning,[17] misuse of customer funds,[18] and hypothecation of customer securities.[19] Brokers dealers, and municipal securities dealers also are required under Commission, NASD, or MSRB rules to disclose to customers their participation in the distribution of a new issue.[20] In addition, gifts between securities professionals relating to their securities activities[21] are

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15 MSRB Rule G-23, Activities of Financial Advisers, MSRB Manual (CCH) ¶3611 at 3571-5.

16 NASD Rules of Fair Practice, Art. III, §1, Review of Corporate Financing, NASD Manual (CCH) ¶2151.02 at 2019.

17 Rule 15c-7 under the Exchange Act, 17 CFR 270.15c1-7; NASD Rules of Fair Practice, Art. III, §2, Recommendations to Customers, NASD Manual (CCH) ¶2152 at 2105; MSRB Rule G-19, Suitability of Recommendations and Transactions, MSRB Manual (CCH) ¶3591 at 3569-3.

18 NASD Rules of Fair Practice, Art. III, §19, Customers' Securities Funds, NASD Manual (CCH) ¶2169 at 2091; MSRB Rule G-25, Improper Use of Assets, MSRB Manual (CCH) ¶3621 at 3574.

19 Rule 15c2-1 under the Exchange Act, 17 CFR 240.15c2-1.

20 Rule 15c1-6 under the Exchange Act, 17 CFR 240.15c1-6; NASD Rules of Fair Practice, Article III, §14, Disclosure of Participation or Interest in Primary or Secondary Distribution, NASD Manual (CCH) ¶2164 at 2078; MSRB Rule G-32, Disclosures in Connection with New Issues, MSRB Manual (CCH) ¶3656 at 3577.

21 NASD Rules of Fair Practice, Art. III, §10, Influencing or Rewarding Employees of Others. NASD Manual (CCH) ¶2160 at 2075-6. MSRB Rule G-20, Gifts and Gratuities, MSRB Manual (CCH) ¶3596 at 3570.

similarly limited by NASD or MSRB rules. As discussed in response to question four above, there are differences between the NASD and MSRB standards regarding suitable recommendations to customers and fair mark-ups. These differences generally consist of more stringent obligations on municipal securities professionals.

Question 8

Are there any differences in the rules relating to insider trading involving municipal securities compared with non-exempt securities?

Answer

Like non-exempt securities, transactions involving municipal securities are subject to the antifraud proscriptions of Section 17(a) of the Securities Act, 15 U.S.C. 77q(a), and Section 10(b) of the Exchange Act, 15 U.S.C. 78k(b), and Rule 10b-5 thereunder, 17 CFR 240.10b-5. Thus, any person who buys or sells municipal securities while in possession of inside information in violation of these provisions has potential liability, both in Commission and private actions.

The type of information which would be material may be different in the municipal context, and could, for example, include nonpublic information concerning a change in the amount or prospects for revenues. In addition, insider trading in municipal securities (like other debt securities) is more difficult to detect than insider trading in exchange listed and NASDAQ national market system securities[22] in part because there is no last sale reporting or other consolidated reporting which would facilitate continuous monitoring of the market. Section 16 of the Exchange Act, 15 U.S.C. 78p, restricts insider trading for certain equity securities. Section 16(a), in part, requires insiders to report their transactions, Section 16(b) imposes liability for shortswing profits on sales by corporate insiders, and Section 16(c) prohibits short selling. This section does not apply to transactions in debt securities or exempted securities.

Question 9

Following the New York City crisis, voluntary guidelines for the disclosure of information in offering statements were adopted by the Municipal Finance Officers Association. Does the Commission know whether, in the case of WPPSS, these guidelines were complied with? Does the Commission believe they were sufficient?

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[22] NASDAQ is the National Association of Securities Dealers Automated Quotation system, which carries real time bids and asked quotations for certain over-the-counter stocks. The most active NASDAQ securities have been designated as National Market System securities, pursuant to Rule 11Aa2-1 under the Exchange Act, 17 CFR 240.11Aa2-1. NASDAQ reports continuous last sale price and volume information on these securities.

Answer

In 1976, the Municipal Finance Officers Association, a professional group of municipal officers, approved a set of voluntary guidelines designed to provide greater protection to investors through increased factual disclosure and through the standardization of disclosure practice. This publication, Disclosure Guidelines for State and Local Governments, was revised in 1979. In 1981, the MFOA also published Official Statements for Offerings of Securities by Local Governments - Examples and Guidelines, which illustrates the format for an official statement and a yearly report.

The Commission is currently investigating the disclosure made by WPPSS to determine whether this disclosure comports with the antifraud provisions of the securities laws.[23] The Commission has not determined whether WPPSS' disclosure comported with the MFOA's voluntary guidelines, nor whether compliance with these voluntary guidelines would constitute compliance with the federal securities laws in all circumstances.

Question 10

The American Institute for Certified Public Accountants undertook an effort to improve standards of accounting for municipal securities issues. Has the Commission assessed the adequacy of the voluntary program?

Answer

The American Institute of Certified Public Accountants conducted a study in which it asked state and local government units to prepare financial statements for a recent accounting period in conformity with certain AICPA principles and to assess the usefulness and practicality of these principles. The results were published in Accounting and Financial Reporting by State and Local Governments: An Experiment (1981). The Commission did not participate in the implementation of this study and has not formally assessed the effects of the voluntary AICPA standards on municipal issuer disclosure. The AICPA also published guidelines entitled Audits of State and Local Governmental Units in 1981.

Another body, the Financial Accounting Foundation, is in the process of establishing the Government Accounting Standards Board in cooperation with the Municipal Finance Officers Association, National Association of State Auditors, Comptrollers and Treasurers, and other organizations representing elected state, local, and county officials. The GASB would develop guidelines for financial accounting and reporting by state and local governmental units. The Commission has monitored the developments in the creation of the GASB. However, since the GASB members have not been named and the GASB has not begun operations, the Commission has not reviewed any work product. It

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[23] See In re Transactions in Washington Public Power Supply System Securities, Securities Exchange Act Release No. 6503 (Jan. 11, 1984), 29 SEC Docket 890.

is anticipated that the GASB will formally be established and a board named by mid-May, 1984.

On February 23, 1984, Chairman John S.R. Shad, in testimony before the House Subcommittee on Telecommunications, Consumer Protection, and Finance expressed his opinion that the municipal securities markets would benefit from more uniform accounting standards.

Question 11

When Congress determined in 1933 to exempt municipal securities from the registration requirements of the federal securities laws, one of the reasons for granting the exemption was the belief that the principal purchasers of such securities were institutions, which were able to protect themselves. However, the character of the municipals market has changed dramatically, with substantial changes in recent years. A September, 1983 report of the General Accounting Office noted that, while in 1972, households purchased 16% of all new municipal bond sales, just a decade later, in 1982, household purchases accounted for 87% of all new municipal bond sales. Does this information indicate a need to reassess the policy underlying exemptions for municipal securities?

Answer

The municipal securities market has changed dramatically since 1933. The market has grown to approximately 52,000 issuers and 1.5 million issues outstanding. In addition, only about one quarter of the market currently is composed of general obligation securities which are often deemed the safest because they are backed by the issuer's general revenues and taxing power. The vast majority of new issues are relatively riskier revenue bonds (which are backed only by the funds generated by the specific project being financed) and IDBs (which are used to finance private projects and whose investment quality is dependent upon the financial condition of the private enterprise operating the project). It is noteworthy, however, that some of this dramatic change, particularly the increased public interest in the municipal markets, was apparent to Congress in 1975, when Congress determined to continue the exempt status of municipal securities.[24]

The GAO Report indicates that households recently have become the predominant purchasers of municipal securities, as inflation has pushed more households into higher tax brackets, making tax-free municipal securities more attractive. Nevertheless, the increase in the household sector's participation in this market does not necessarily reflect a decline in the level of purchaser sophistication and bargaining power. The definition of household used by the GAO Report includes personal trust accounts that are managed by bank trustees, and the 87% figure for municipal bond purchases by households includes purchases of municipal bond mutual funds.

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[24] Senate Report, supra note 6, at 44, [1975] U.S. Code Cong. & Ad. News at 222.

Moreover, the level of expertise available to households is dependent on the extent and the quality of professional intermediaries who advise and manage households' municipal securities purchases. Many individuals invest in municipal securities through participation in municipal bond funds or unit trusts, which are arranged by professionals. In addition, the increasing use of insurance helps to protect investors from the impact of defaults on the repayment of interest and principal.

Furthermore, the quality of voluntary disclosure has improved in recent years. As a result of the New York City financial crisis, municipalities have responded to increased pressure for disclosure by improving the quality and volume of their disclosures. In this regard, the MFOA has published a series of voluntary guidelines that have been widely accepted and followed by issuers and underwriters.[25] To a large extent, voluntary disclosures by issuers have become a necessary precondition to attracting investor dollars.

Since 1977, the Commission has not had occasion to revisit the legislative framework regarding municipal securities disclosure policy. In the past, the Commission traditionally has supported narrowly-drafted legislative proposals that would provide a high degree of investor protection without unduly burdening municipalities. For instance, the Commission testified favorably concerning the Municipal Securities Full Disclosure Act of 1976[26] that would have required issuers that had over $50 million in outstanding municipal securities to prepare uniform annual reports and reports concerning defaults. In addition, this proposed legislation would have required all issuers to prepare a standardized distribution statement prior to the sale of any new issue.

The Commission also has supported legislative efforts to standardize accounting methods used in the preparation of voluntary municipal securities disclosure documents.[27] In addition, the Commission has supported voluntary efforts to develop uniform accounting standards for government units, such as the effort by the Financial Accounting Foundation and MFOA to create a government accounting standards board.

Finally, in view of the increase in IDB financing, the Commission has supported legislation to repeal the Securities Act exemption for IDBs.[28] The Commission premised its recommendation on the fact that the risks associated with these types of bonds are similar to those associated with traditional corporate debt securities.

Question 12

That same GAO report also contained facts which may indicate the difficulty in removing the current exemption from registration. It noted that an estimated 52,000 political

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25 See answer to question 9.

26 S. 2969, 94th Cong., 2d Sess. (1976).

27 S. 1236, 96th Cong., 1st Sess. (1979); S. 610, 97th Cong., 1st Sess. (1981)

28 S. 3323, 95th Cong., 2d Sess. (1978).

entities have debt outstanding, with a total of about 1.5 million separate issues. In contrast, the corporate market has only about 10,000 issuers, with under 100,000 separate issues of stocks and bonds outstanding. Does this indicate a need to address the concerns about municipal securities disclosure by a means other than requiring the filing of registration statements by all municipal issuers?

Answer

The municipal securities market differs somewhat from the corporate debt market. The major differences include the much greater number of municipal issuers and issues outstanding, the relatively small size of most issues, the localized markets for many issues, the greater number of municipal investors, and the facts about the issue which are material to an investor. Any disclosure scheme for municipal securities should account for these differences.

In 1975, Senator Eagleton introduced S. 2574, a bill which would simply have removed the exemption for municipal securities from the Securities Act and the Exchange Act. The Commission testified that a municipal registration requirement might not be workable because of the burden such a requirement would impose on the issuers and the Commission.[29] However, the Commission has not recently considered any proposals to require filing with the Commission.

In testimony before the Senate Subcommittee on Securities on S. 2574 and S. 2969, which would have required disclosure, but not filing, then Chairman of the Commission, Roderick M. Hills, suggested that requiring registration would create a number of disadvantages not needed to provide adequate consumer protection. Chairman Hills stated that, in addition to the enormous burdens it would impose on the Commission, the costs would far exceed any benefits to the public. Rather than requiring registration, he pointed to the advantages of requiring disclosure by municipalities without requiring filing with or review by Commission. He also noted that since a municipality differs in nature from a corporation, different information should be disclosed, such as revenues, expenses and cash flow, rather than data on operations.[30]

Another possible alternative to requiring municipal issuers to file registration statements would be to impose (either through Commission or MSRB rulemaking) additional regulatory requirements on municipal underwriters, attorneys, and other non-municipality participants in the offering process. However, the Commission has not had occasion to consider such an approach and has no position concerning it.

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29 Municipal Securities Full Disclosure Act of 1976: Hearings Before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, 94th Cong., 2d Sess., 18 (Feb. 24, 1976) (testimony of Roderick M. Hills, Chairman, SEC).

30 Id.

Question 13

In 1976, the Commission developed legislation to enhance disclosure and accounting with respect to municipal securities issuers. What is the Commission's current position on the legislation?

Answer

On February 17, 1976, the "Municipal Securities Full Disclosure Act of 1976" was introduced by Senator Harrison A. Williams to require the preparation of annual reports and distribution documents by issuers of municipal securities. The Commission, represented by Chairman Roderick M. Hills, testified favorably about the bill at hearings held on February 24, 1976, before the Senate Subcommittee on Securities. On August 23, 1976, Congressman John M. Murphy introduced an identical bill as H.R. 15205, "Municipal Securities Full Disclosure Act of 1976." Neither bill was ever voted on. In 1978, the Commission recommended eliminating the exempt status under the Securities Act of IDBs.[31]

More recently, in 1981, the Senate Committee on Banking, Housing and Urban Affairs asked the Commission to comment on S. 610, the "State and Local Government Accounting and Reporting Standards Act of 1981." S. 610 would have have created the Institute for State and Local Accounting and Financial Reporting Standards, to promulgate accounting and financial reporting standards for state and local governments, and the State and Local Government Accounting and Financial Reporting Standards Council, to review the by-laws and other procedural matters pertaining to the Institute. In that regard, the Commission favored efforts to develop standards for municipal standards and accounting, and supported S. 610. However, the Commission saw potential problems in allowing voluntary compliance by municipalities and noted with concern several omissions. These included the bill's failure to provide for an explicit private remedy, Institute authority to set auditing standards, requirements for the preparation or dissemination of municipal issuer financial statements, or Council oversight with respect to the accounting and financial reporting standards promulgated by the Institute.

Neither these nor other recent bills involving municipal issuer disclosure has been enacted into law. Since no similar bill is pending before Congress, the current Commission has not considered such proposals.

Question 14

In a March 11, 1976 speech, former Commissioner A.A. Sommer, Jr. suggested that provisions similar to Section 11 of the Securities Act of 1933 might be useful in connection with offerings of municipal securities. What is the Commission's view on this suggestion?

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[31] S. 3323, 95th Cong., 2d Sess. (1978).

Answer

Section 11 of the Securities Act, 15 U.S.C. 77k, applies to public offerings of nonexempt securities but not municipal securities. Under Section 11, certain designated persons such as issuers, underwriters, and attorneys are potentially liable for material misstatements or omissions in a nonexempt security registration statement. For issuers, Section 11 liability is akin to strict liability. Designated persons other than issuers, even those who in good faith make an untrue statement, are liable unless they can establish the defense of due diligence. The due diligence defense requires a showing that the person conducted a reasonable investigation after which it believed and had reason to believe that there were no material misstatements or omissions in the registration statement.

Following the New York City fiscal crisis of the mid-1970's, there was extensive discussion in the Congress, the Commission, the municipal securities industry, and academia about whether the securities laws should be amended to correct abuses in the municipal securities markets. In this connection, Commissioner Sommer suggested that a provision comparable to Section 11 of the Securities Act, which would specify the standards of care and the liabilities of various parties to a municipal securities distribution, might be useful. Indeed, a variety of draft bills were proposed in both the House and Senate during 1975 and 1976 that would impose liability on issuers of municipal securities, their underwriters and attorneys, and other designated persons for any material misstatements or omissions in municipal securities offering circulars.[32] None of these bills, however, was enacted into law. As a result, participants in an offering of municipal securities are liable for improper disclosure only in situations in which the conduct violates the current antifraud provisions of the securities laws, i.e., Section 17(a) of the Securities Act, 15 U.S.C. 77q(a), or Sections 10(b) and 15(c)(1) of the Exchange Act, 15 U.S.C. 78j(b) and 78o(c)(1).[33] The Commission has not formally considered this proposal and thus has not taken a position on it, or on the substantial policy issues it raises.

Question 15

Does the Commission believe the present authority of the MSRB is adequate? Has the Commission assessed the adequacy of the MSRB's activities?

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32 S. 2574, 94th Cong., 1st Sess (1975); H.R. 11044, 94th Cong., 1st Sess. (1975); H.R. 11536, 94th Cong., 2d Sess. (1976); S. 2969, 94th Cong., 2d Sess (1976); H.R. 15205, 94th Cong., 2d Sess. (1976).

33 It should be noted, however, that those courts which have considered the issue consistently have held that reckless conduct may violate the antifraud provisions. It may be necessary, therefore, for an underwriter to undertake some investigation of a new issue in order to demonstrate that underwriting the issue was not itself a reckless act. See enerally Shores v. M. E. Ratliff Investment Co., [1981-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶98,425 at 92,540 (N.D. Ala. 1982); In re Walston & Co., Inc. and Harrington, 43 SEC 508 (1967).

Answer

Congress established the MSRB to address, among other things, trading abuses in connection with the purchase and sale of municipal securities. For the first time, a self-regulatory organization directly regulates the trading practices of brokers, dealers, and banks that trade municipal securities. The MSRB is responsible for setting standards for professional conduct, including qualifications of municipal securities brokers and dealers, rules of fair practice, and recordkeeping. The Board discharges its responsibilities through its general rulemaking authority, subject to Commission review, and by providing interpretive letters regarding its rules. It does not have enforcement authority.

Instead, the Commission, the NASD, and the bank regulators enforce the MSRB rules. This is an efficient scheme because these regulators currently have effective enforcement programs, and generally have overlapping regulatory oversight responsibilities for municipal securities professionals. Although multiple regulators can result in unequal enforcement of MSRB rules, the Board has worked closely with the regulators to ensure uniform application of its rules.

In 1977, the House Committee on Interstate and Foreign Commerce reviewed and reported on the functioning of the MSRB.[34] The Oversight Report commended the Board's practice of issuing interpretive letters and its efforts to coordinate the enforcement of MSRB rules with other regulatory bodies. The Oversight Report also recommended that the Board ensure that its membership adequately represents small dealers and the public, and observed that the quality of the Board's rulemaking process would improve substantially if proposed rules were discussed and adopted at open meetings.

The Commission conducted an oversight inspection of the MSRB in June 1980, which in general concluded that the MSRB was functioning satisfactorily. Although it uncovered a few minor operational difficulties, these have since been corrected.

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[34] Oversight of the Functioning and Administration of the Securities Acts Amendments of 1975, Report of the Subcomm. on Oversight and Investigations and the Subcomm. on Consumer Protection and Finance of the Comm. on Interstate and Foreign Commerce. House of Representatives Comm. Print No. 95-27, 95th Cong., 1st Sess., 13 (1977).