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A NEW LOOK AT MUNICIPAL BONDS — DISCLOSURE RESPONSIBILITIES IN THE MUNICIPAL BOND MARKET

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A variety of forces have recently emerged and combined to generate new responsibilities and as yet unanswered questions for issuers, underwriters, dealers, and attorneys involved in the municipal bond market.¹ These forces include a rate of increase in the cost of local and state governments exceeding the rate of increase of both the federal budget² and inflation,³ tax and rent control


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¹ Municipal securities are debt instruments issued by state and local governmental units to raise capital to fulfill their various obligations. Generally, they may be divided into four categories:

(1) General Obligation Bonds — Payment of these bonds is secured by the issuer's legal pledge to meet the obligation by means of its full faith and credit to the extent of its taxing power. In some jurisdictions general obligation bonds require voter approval.

(2) Revenue Bonds — Payment of these bonds is secured only by the revenues derived from the specific municipal project financed by the bond issue.

(3) Special Obligation Bonds — Principal and interest payments are met by means of special taxation or other specific types of income of the municipal issuer (e.g., highway bonds payable from gasoline tax).

(4) Industrial Development Bonds — An industrial facility is constructed with the capital provided by the bond issue and is subsequently leased to a private concern. The bond is then paid by means of the rent charged.


² During the period from 1950 to 1975 the federal budget increased at the rate of 8.5% per year while the combined state and local expenditures have increased at the rate of 8.8% per year. State expenditures were up 8.6% per year; local government expenditures were up 8.9% per year. See sources cited note 3 infra.

³ Inflation increased at the average annual rate of 4.4% during the period 1950 to 1975. In the same period state and local expenditures increased at a rate far outstripping the
policies that have eroded the tax base in many localities,\textsuperscript{4} borrowing to meet rising operating costs,\textsuperscript{5} and resort to questionable accounting practices and financial gimmickry.\textsuperscript{6} Even before the publicity surrounding the New York City fiscal crisis, these underlying forces had been eroding the fiscal stability of local governments while public confidence in municipal securities had been steadily deteriorating.

In the first weeks of 1972, the Securities and Exchange Commission received reports that the "boiler room" and "cold call" selling methods of the 1930's were being revived in the municipal bond market in Memphis, Tennessee. After an intensive 9-month staff investigation, the Commission, on October 26, 1972, instituted civil proceedings against certain dealers for fraudulent practices, including misrepresentations, interpositioning, and excessive mark-ups on sales and markdowns on purchases.\textsuperscript{7}

During the same year, officials of the City and State of New York complained that the reduction in the rating given New York
City and State bonds by Moody's Investors Service and Standard and Poor, the principal bond rating agencies, had increased the borrowing costs of those governmental units. A hearing on municipal bonds was called by Congressmen Murphy and Podell of the House Interstate and Foreign Commerce Committee to consider the extent to which the Federal Government should intervene to regulate rating agencies and other participants in the municipal securities market. Officials of Moody's and Standard and Poor patiently explained why they had taken this action with respect to the city and state bonds. In addition, the Chairman of the SEC commented upon broker-dealer abuses in the municipal bond market and stated: "[T]he time has come to require municipal bond dealers to register, to keep books and records and to meet the same kind of standards in selling practices and price mark-ups that registered dealers in other securities are required to meet." Thus, at this hearing, a week before the national elections of 1972, early signs of New York City's financial difficulties were visible, a call for federal intervention was sounded, and a first step in bringing municipal bond broker-dealers under SEC regulation was taken.

Today, the troubled financial condition of New York City particularly and urban areas generally, the regulation of municipal bond broker-dealers under the 1975 amendments to the Exchange Act, and the ever-increasing potential of liability under the antifraud provisions of the federal securities laws have caused underwriters to insist on expanded disclosure by local governments.

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8 See 168 N.Y.L.J. 81, Oct. 27, 1972, at 1, col. 3.
9 Id.
10 Id.
11 Id.
13 Securities Acts Amendments of 1975, Pub. L. No. 94-29, §§ 3(3), 3(6), 11, 13, 89 Stat. 97, 101-02, 121-27, 131-37, amending 15 U.S.C. §§ 78c, 78o (1970) (codified at 15 U.S.C.A. §§ 78c(a)(12), (29), (30), (31), (32), (33), 78o(b)(c), 78o-4 (Supp. 1975)). These amendments limit the municipal securities exemption of the Exchange Act and subject brokers and dealers, including banks, that deal in municipal securities to SEC registration and regulation. In addition, the Municipal Securities Rulemaking Board was created to act as a self-regulatory body overseeing the municipal securities industry. The Board has the authority to adopt rules designed to set standards of training and competence in the industry, 15 U.S.C.A. § 78o-4(b)(2)(A) (Supp. 1976), provide for periodic examination, id. §§ 78o-4(b)(2)(A)(I), (E), prevent and define manipulative acts and practices, id. § 78o-4(b)(2)(C), establish arbitration procedures, id. § 78o-4(b)(2)(D), regulate the form and content of price quotations, id. § 78o-4(b)(2)(F), and prescribe required records of municipal securities brokers and dealers, id. § 78o-4(b)(2)(G). All rules adopted by the Board are subject to review and amendment by the SEC. Id. § 78s(c); see S. Rep., supra note 1, at 48. Enforcement of the Board's rules is the responsibility of the SEC and other existing regulatory agencies. See id. at 47.
seeking to market their bonds. This Article will discuss these emerging disclosure requirements, focusing on the problems which have engendered them, the difficulty in resolving these problems through increased disclosure, and legislative attempts to define the disclosure obligations of the participants in a municipal securities offering.

**Disclosure**

Until recently there has been little or no disclosure by state and local governments in connection with the sale of their securities.\(^{14}\) Unlike the mandatory and highly detailed financial statements which accompany the issuance of securities by a private corporation,\(^{15}\) the typical state or local disclosure document consisted of a

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\(^{14}\) Due to the exemption of municipal securities from the disclosure provisions of the Securities Act of 1933, 15 U.S.C. § 77c(a)(2) (1970), state and local governments are not required by federal law to prepare or provide disclosure documents when they issue securities. Congress provided this exemption for several reasons:

(a) The significant abuses demonstrated in the sale of corporate securities were not duplicated in the sale of municipal securities. See H.R. Rep. No. 85, 73d Cong., 1st Sess. 7 (1933).

(b) The purchasers of municipal securities were highly sophisticated investors. See Hearings on S. 873 Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess. 292 (1933).

(c) Possible constitutional problems were anticipated. See H.R. Rep. No. 85, 73d Cong., 1st Sess. 14 (1933).


(e) Regulation would have impaired the marketability of municipal bonds and the ability of municipalities to borrow funds needed for municipal affairs. See generally Hearings on H.R. 7852 & H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 755 (1934).


As a result of these exemptions, publication of information with respect to a municipal issuer has been on a voluntary basis and determined by the issuer itself. This information, at least with respect to general obligation bonds, has been limited to a general description of the municipality. See Municipal Bonds, supra note 1, at 571. Nonetheless, the possibility that the antifraud provisions of the federal securities laws may now actually be enforced against municipal issuers, see note 76 infra, could stimulate disclosure of information which Congress and the courts have deemed material irrespective of the issuer's preferences.

\(^{15}\) Section 5 of the Securities Act of 1933, 15 U.S.C. § 77e (1970), provides that no security can be sold unless it is accompanied by a registration statement. The contents of the registration statement and the exhibits and other materials which must be filed have been
short description of the securities being sold, excerpts from the applicable statute, and a cover sheet. Some municipalities, certainly a minority, also issued abbreviated financial statements, most of which were unaudited and outdated. Due to a number of intertwined market, regulatory, and economic factors, municipalities are now being compelled to go beyond this limited disclosure and provide investors with detailed and expanding disclosure documents.

The still unresolved New York City fiscal crisis has not only illustrated the real possibility of a default on municipal bonds, but has also focused attention upon the possibly precarious financial situations of other cities. As a result, investors who would normally blindly rely on the security of a municipality are now questioning the ability of local governmental issuers to meet their obligations. Moreover, investors have become particularly concerned

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Few governmental entities are required to provide annual or other regular financial statements prepared by independent certified public accountants. In contradistinction, audited financial statements are necessary for all private corporations whose securities are offered to the public. This disparity in published financial information has been justified by the assertion that an audit of the records of an institution like the City of New York would prove to be an impossible task. Nevertheless, by virtue of the New York State Municipal Assistance Corporation Act, the legislation creating "Big Mac," the City of New York must institute audit procedures. See N.Y. PUB. AUTH. LAW § 3038 (McKinney Supp. Pamphlet 1970-1975).

Indicative of the troubled financial condition of cities other than New York are the widely publicized layoffs of municipal employees in several large urban areas. See, e.g., BUSINESS WEEK, July 21, 1975, at 51 (Detroit and Cleveland); id., Sept. 1, 1975, at 51 (Detroit and Philadelphia). Such problems have been discussed in a recent spate of commentaries dealing with the fiscal difficulties of American cities. See, e.g., R. PETTENGILL & J. UPPAL, CAN CITIES SURVIVE? (1974); BUSINESS WEEK, Aug. 11, 1975, at 46; N.Y. Times, Oct. 22, 1975, at 1, col. 8. Cities are now encountering greater investor hesitancy when they attempt to enter the municipal securities market. This problem is illustrated by the recent experience of Murfreesboro, Tennessee. In October 1975, a few months after the New York City crisis was first publicized, Murfreesboro borrowed $3.8 million for the construction of improved city facilities. The city found that because of the public's fear of purchasing municipal bonds, the city had lost an average of at least one-half of a percentage point in interest costs, an annual expense of approximately $20,000. Id., Oct. 19, 1975, § 1, at 1, col. 6.

In past years, investors did not question the security of municipal bonds, which were considered, along with obligations of the United States, as among the most secure investments available. Traditionally, trusts and various pension funds relied blindly on municipal
about the possibility of legislation that permits municipalities to defer payments and use tax revenues to meet other obligations.20

securities because of their apparent security. Indeed, a recent study by Professor Ronald Forbes at the State University of New York at Albany indicates that only 39% of the major institutional investors in municipal securities employed a full-time analyst to review municipal securities. See Hearings on S.2969 & S.2574 Before the Subcomm. on Securities of the Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. 253 (1976). Even in the event a security was questioned, that questioning was limited to an evaluation of the information obtained from the standard rating services. See Note, Federal Regulation of Municipal Securities, 60 MINN. L. REV. 567, 584-85 (1976).

The situation is entirely different today. Again using the plight of New York City as an example, a study of the results of the sale of Municipal Assistance Corporation bonds demonstrates that investors across the country are extremely hesitant to buy anything connected with New York City. BUSINESS WEEK, Aug. 4, 1975, at 57; id., Aug. 11, 1975, at 46; id., Sept. 8, 1975, at 58. As a direct result of New York's fiscal problems, other major cities throughout the United States have experienced similar problems in marketing their bonds. A recent report in the New York Times lists East Millsincket, Maryland, San Antonio, Texas, Salem, Oregon, and Murfreesboro, Tennessee among the cities which have experienced difficulties similar to those encountered by New York. It has been estimated that the reevaluation of municipal credit precipitated by New York's problems has added $3 billion a year to the interest costs of governmental units across the nation. N.Y. Times, Oct. 19, 1975, at 1, col. 6, at 48, col. 5.

20 See N.Y. Times, Sept. 28, 1976, at 1, col. 4. As a result of the severe crisis encountered by New York City, the state legislature enacted the New York State Emergency Moratorium Act for the City of New York, chs. 874-75 [1975] N.Y. Laws 1484-88 (McKinney Special Pamphlet) (EMA), to allow the city to regain its financial health and maintain its essential services. See id. § 1. The EMA prohibits the collection of sums due on outstanding city short term obligations until 3 years after the effective date if an offer has been made to exchange these obligations for long term notes. It also provides that upon refusal of the offer, interest is to be paid at the stated rate until maturity and thereafter at a minimum of 6% a year. The constitutionality of the EMA was recently upheld in Flushing Nat'l Bank v. Municipal Assistance Corp., 52 App. Div. 2d 84, 382 N.Y.S.2d 764 (1st Dep't 1976), appeal docketed, No. 39 (N.Y. Ct. App. May 13, 1976). The court, in reaching its conclusion that the Act "is not a . . . Law impairing the Obligation of Contracts," 52 App. Div. 2d at 87, 382 N.Y.S.2d at 766, quoting U.S. CONST. art. 1, § 10, emphasized the grave financial emergency facing New York City, the inherent power of the State to modify remedial processes and protect the public interest, and the legislative intent to simply delay payment of, rather than to dishonor, the short term obligations of the city. 52 App. Div. 2d at 87-89, 382 N.Y.S.2d at 766-67, citing, inter alia, Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502 (1942); Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934). In addition to rejecting the contract clause objection, the court also quickly disposed of challenges based on asserted violations of both the constitution and general laws of the State. The EMA has also been challenged and upheld in federal court. Ropico, Inc. v. City of New York, Civil No. 75-6168 (S.D.N.Y. Sept. 7, 1976) (rejecting arguments based on due process, equal protection, contract clause, access to the courts, full faith and credit, and the Bankruptcy Act).

The municipal bankruptcy reforms adopted by Congress in 1976 were also stimulated by the New York City situation, although they have wide applicability throughout the country. See 11 U.S.C.A. §§ 401 et seq. (Supp. 2, 1976); H.R. REP. No. 686, 94th Cong., 1st Sess. 4 (1975). These reforms are an attempt by the Government to provide some remedies upon municipal default or bankruptcy, and are thus of great interest to potential investors. Essentially, the new provisions establish a procedure under which a municipality in financial difficulty may file a petition in the federal district court without first obtaining the consent of its creditors. This eliminates the extensive prepetition negotiations previously required and operates as an automatic stay of all actions. See 11 U.S.C.A. § 405(c)(1) (Supp. 2, 1976). The amendments also provide for joinder of the state, the SEC, and all known or unknown creditors, so that cooperation of all parties may be achieved. See id. § 405(d); H.R. REP. No. 686, 94th Cong., 1st Sess. 3-6 (1975). In addition, the amendments accord the bankruptcy court certain new powers. Most important of these is the power to authorize the petitioner to issue certificates of indebtedness having such priority and security as is determined by the
This loss of investor confidence has undermined the ability of local governments to obtain bids, causing an increase in interest rates and, in extreme cases, a complete refusal to bid. Consequently, investors' demands for greater disclosure take on biting significance for any governmental unit which desires to issue *marketable* bonds.

Compounding the pressures exerted by the loss of investor confidence, the recent imposition of greater investigative and disclosure obligations upon underwriters has forced underwriters to protect themselves by demanding the required information from the issuer under pain of not handling the issuer's paper. Both the SEC and the courts have emphasized the special relationship and the concomitant greater obligations which an underwriter assumes when he underwrites a corporate issue. Since the underwriter

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court. *See* 11 U.S.C.A. § 402(b)(2) (Supp. 2, 1976). These certificates would allow the municipality to once again enter the credit market by assuring potential lenders both security and priority over existing obligations. The use of these certificates will usually be essential to the reconstitution of a bankrupt municipality into a financially viable entity. *See* H.R. Rep. No. 686, 94th Cong., 1st Sess. 9 (1975). At the conclusion of negotiations between the municipality and its creditors, the agreement reached is filed with the court for approval. The court then considers the plan, and if the "creditors holding at least two-thirds" of the claims notify the court that they find the plan agreeable, the court may approve it. 11 U.S.C.A. § 412(b) (Supp. 2, 1976). After confirmation, the court supervises the municipality's operations to ensure that the terms of the plan are complied with. *Id.* § 416(c).

21 *See* BUSINESS WEEK, Aug. 11, 1975, at 46. Most municipal securities are sold by public bid. Under this procedure, a municipality first announces that it is seeking to sell securities. Afterwards, an offering statement and details of the terms of sale are made available. Traditionally, underwriters flocked to such offerings. Due to the loss of investor confidence resulting from the New York City fiscal crisis, however, underwriters are no longer actively seeking these offerings. This has resulted in increased interest rates and debt service charges for many municipalities. *See* note 19 supra; *Note,* Federal Regulation of Municipal Securities, 60 MINN. L. REV. 567, 588 (1976); N.Y. Times, Oct. 19, 1975, § 1, at 1, col. 6.

22 The market is demanding information concerning the revenue sources from which the bonds will be repaid and the limitations, both legal and practical, on increasing these levies. It wants to know about population movement and growth or decline of the business base on which this income depends. It wants to know where and how costs are increasing and what capital and funding requirements lie ahead, with particular focus on pension obligations and, in suburban communities, the impact of sewer assessments. It wants an accurate gauge of the extent to which current operating costs are paid by short term borrowing, capital financing on long term bond issues, and/or federal, state, or county grants. Dependence on grants, in turn, requires an assessment of the ability of these higher governmental units to continue their largess. Additionally, with respect to the sale of revenue bonds, the market wants reliable information to establish the ability of the facility to generate sufficient income to meet its expenses and pay the obligations under the bond. Since it is possible that liability under the federal securities laws may be imposed on a municipality and its officers, *see* note 76 infra, and since the marketability of a municipality's bonds is largely dependent upon the extent of its disclosure, it has become advisable for a municipal issuer to provide this information together with any known or ascertainable data material to a calculation of its outstanding and anticipated debt.

23 *Section* 11(a)(5) of the Securities Act of 1933, 15 U.S.C. § 77k(a)(5) (1970), which does not apply to municipal bond transactions, subjects an underwriter to civil liability for damages resulting from depreciation in value of a security due to inclusion in the registration statement of an untrue material fact or the omission of a material fact necessary to make the statement not misleading. To escape liability under this section, the underwriter must
occupies the unique position of being able to obtain unpublished information from the issuer, it has been held, under section 11(e) of the Securities Act, that in order for an underwriter to establish a "due diligence" defense he must conduct a thorough investigation aimed at uncovering material misstatements and omissions in the issuer's registration statement. It is insufficient for the underwriter to simply accept the predictions and statements of officers and directors of the corporation. As further support for the imposition of these greater obligations, the courts have focused upon the prove that "he had, after reasonable investigation[,] reasonable ground to believe and did believe . . ." that the nonexpert sections of the registration statement were true and complete. Id. § 77k(b)(3)(A). Interpreting the extent of the investigatory efforts necessary to successfully assert this "due diligence" defense, courts have carefully scrutinized the efforts of underwriters since they should assume an adversarial relationship with corporate management and pursue an independent investigation of the issuer. See Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 580-82 (E.D.N.Y. 1971); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 696-97 (S.D.N.Y. 1968); Comment, BarChris: Due Diligence Refined, 68 COLUM. L. REV. 1411, 1420-23 (1968). Indeed, the SEC has made its position clear: underwriters' expertise, intermediary function, adversarial position, and public trust require, at the very least, an independent verification of the information submitted to it and, in some cases, a thorough and intensive investigation. See SEC Securities Act Release No. 33-5275 (July 26, 1972), reprinted in 1 CCH FED. SEC. L. REP. ¶ 4506 B. Similarly, in Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 910 (1973), the Court of Appeals for the Second Circuit, analogizing to both § 10(b) of the Exchange Act, rule 10b-5, and § 11 of the Securities Act, held that an underwriter must, under § 14(e) of the Exchange Act, 15 U.S.C. § 78n(e) (1970), independently evaluate the registration statement, and, where there is a strong suggestion of deception, it must conduct "a reasonable further investigation." 480 F.2d at 371. The court premised this duty upon the critical position occupied by the underwriter in the securities marketing scheme. As the court noted: "No greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter." Id. at 370. The status of this decision is in some doubt due to the grant of certiorari in Piper v. Chris-Craft Indus., Inc., 96 S. Ct. 1505 (1976).

The imposition of greater investigative duties upon underwriters is in accordance with the congressional recognition that varying degrees of responsibility should attach to the different functions in the marketing scheme. See H.R. REP. No. 85, 73d Cong., 1st Sess. 9 (1933). For a discussion of the inequity of imposing greater investigative duties on municipal securities underwriters while exempting the issuer of these securities from disclosure obligations, see note 38 and text accompanying note 59 infra.

24 See, e.g., Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971) (Weinstein, J.); cases discussed in note 23 supra. In Feit, the court found that the issuer's registration statement was materially misleading. After discussing the degree of investigation required into the accuracy of the registration statement by an inside director, Judge Weinstein observed that "[s]ection 11 holds underwriters to the same burden of establishing reasonable investigation and reasonable ground to believe the accuracy of the registration statement." 332 F. Supp. at 581. The court did recognize, however, that underwriters do not possess the same intimate knowledge of corporate affairs as do officers and directors, and defined the investigative responsibilities of underwriters in light of these considerations. Nonetheless, Judge Weinstein held that underwriters "are expected to exercise a high degree of care in investigation and independent verification of the company's representations." Id. at 582, citing, inter alia, Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 696-97 (S.D.N.Y. 1968); Comment, BarChris: Due Diligence Refined, 68 COLUM. L. REV. 1411, 1417 (1968). The court therefore concluded that the underwriters in Feit had "just barely established" their due diligence defense since they had conducted a reasonable investigation and had reasonably verified representations made by the issuer. 332 F. Supp. at 583.
reliance by investors on an underwriter's association with a particular issue. 25 Of course, an underwriter of municipal bonds is not subject to section 11(e) of the Securities Act since a registration statement need not be filed by a local or state government. 26 Nevertheless, recognition of the underwriter's increased opportunity for verification and the investor's reliance upon an underwriter's association with an issue may lead other courts to conclude that an underwriter in a securities offering should be held to a higher standard of conduct than other participants under section 17(a) of the Securities Act, 27 section 10(b) of the Exchange Act, 28 and rule 10b-5, 29 all of which do apply to municipal securities. 30

Accordingly, the recent Supreme Court ruling in Ernst & Ernst v. Hochfelder 31 — that scienter is necessary to maintain a private

25 See cases cited in note 23 supra. Discussing the unique status of an underwriter with respect to the distribution of securities, the SEC has noted the underwriter's central role as an intermediary between the issuer and the investing public. The public looks to the underwriter for protection and expects the underwriter to verify the accuracy of the registration statement. See Richmond Corp., 41 S.E.C. 398, 406 (1963); SEC Securities Act Release No. 33-5275 (July 26, 1972), reprinted in 1 CCH FED. SEC. L. REP. ¶ 4506 B. See also H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933).


30 In Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955) (Kaufman, J.), an action was brought for rescission and damages by the purchasers of certain bonds of the Bellevue Bridge Commission ( Nebraska) against several defendants, including the underwriters. The plaintiffs alleged that they purchased the municipal bonds "in reliance upon false and misleading matter in an offering circular" and other documents that violated § 17(a) of the Securities Act of 1933, § 10(b) of the Securities Exchange Act of 1934, and rule 10b-5. On defendants' motion to dismiss for failure to state a claim, the court held, in substance, that despite the municipal bond exemption from liabilities for material misrepresentations in a prospectus or oral communication under § 12(2) of the Securities Act, 15 U.S.C. § 77q(j)(2) (1970), §§ 17(a) and 10(b) are still applicable since § 12(2) sets a negligence standard for liability and shifts the burden of proof to the defendant, whereas § 10(b) and § 17(a) apparently require the plaintiff to allege and prove knowing or intentional material misrepresentations. 131 F. Supp. at 419-20. In other cases involving claims similar to those presented in Thiele, the courts have reached a like result. See Greenwich Savings Bank v. Shields, 131 F. Supp. 368 (S.D.N.Y. 1955) ( § 17(a) and § 10(b) claims upheld); Connecticut Mutual Life Ins. Co. v. Shields, 131 F. Supp. 363 (S.D.N.Y. 1954) (§ 10(b) claim upheld, § 17(a) claim not ruled on); Baron v. Shields, 131 F. Supp. 370 (S.D.N.Y. 1954) (§ 10(b) claim upheld, § 17(a) claim not discussed). See also Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962) ( §§ 17(a), 10(b), and rule 10b-5 applied to municipal bond transaction); Shapiro v. Schwamm, 279 F. Supp. 798 (S.D.N.Y. 1968) (§ 10(b) claim substituted for claim under § 12(2) of the Securities Act to avoid statute of limitations in municipal securities suit). For a discussion of the law in this area, see Doty, Application of the Antifraud Provisions of the Federal Securities Laws to Exempt Offerings: Duties of Underwriters and Counsel, 16 B.C. IND. & COM. L. REV. 393, 400-16 (1975); Rosenzweig, Municipal Securities and the Antifraud Provisions of the Federal Securities Laws, 4 SEC. REG. L.J. 135, 142-50 (1976).

31 96 S. Ct. 1375 (1976). Ernst involved an action brought by customers of First Securities Co. The president of First Securities had induced these customers to invest funds in escrow accounts which were promised to yield a high rate of return. After investing continually in the escrow accounts from 1942 through 1966, the customers learned in 1968 that the accounts did not exist. The customers commenced an action against First Securities' account-
action for damages under rule 10b-5 — may not afford as much protection for underwriters as first appears. Significantly, the defendant in *Ernst* was an accounting firm whose identity was unknown to the plaintiff and whose audits of First Securities, a small brokerage firm, were not relied upon by the plaintiffs at the time they invested in a fraudulent securities scheme perpetrated by the president of First Securities. Moreover, although the Court defined scienter as including intent to deceive, manipulate, or defraud, it declined to rule on “the question whether, in some circumstances, reckless behaviour is sufficient for civil liability under § 10(b) and Rule 10b-5.” Given an underwriter’s special characteristics, im-

ing firm, Ernst & Ernst, alleging that Ernst & Ernst had failed to conduct a proper audit and that employment of proper auditing procedures would have resulted in discovery of the fraud. In effect, the plaintiff argued that Ernst & Ernst had “aided and abetted” a fraudulent scheme, thus violating § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970), and rule 10b-5, 17 C.F.R. § 240.10b-5 (1976).

The Court rejected plaintiff’s negligence theory of rule 10b-5 liability and reached the conclusion that scienter is a requisite element of a private civil action under § 10(b) and rule 10b-5. Construing the words of the statute and the legislative history underlying the Exchange Act, the Court found Congress’ use of the words “any manipulative or deceptive device or contrivance” in § 10(b) particularly significant in that the combination of the words “manipulative or deceptive” with “device or contrivance” “strongly suggest that... knowing or intentional misconduct” was intended to be proscribed. 96 S. Ct. at 1383. Moreover, the Court found that although the legislative history does not bear directly on the question of whether scienter is an element of a § 10(b) action, the legislative history which did exist tended to support the conclusion that scienter is required. Id. at 1385-89.

Prior to the decision in *Ernst*, it was established in the Second Circuit that scienter was required for civil liability under rule 10b-5. See, e.g., Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971); Lanza v. Drexel & Co., 479 F.2d 1277, 1301-02 (2d Cir. 1973) (en banc) (dicta). In SEC enforcement actions, however, that court requires only a finding of negligence. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), cert. denied, 99 U.S. 976 (1969); SEC v. Spectrum, Ltd., 489 F.2d 555 (2d Cir. 1973). Since the Supreme Court in *Ernst* specifically reserved the question whether scienter is required in an enforcement action, 96 S. Ct. at 1381 n.12, it is possible that the Supreme Court, like the Second Circuit, will distinguish between the culpability required in enforcement actions and private civil actions. Judge Friendly, in his concurring opinion in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 866-69 (2d Cir. 1968), cert. denied, 99 U.S. 976 (1969), justified just such a reading of different standards in the same statutory language. Significantly, Judge Friendly noted that the Supreme Court has recognized that the elements of fraud vary “with the nature of the relief sought” and that “[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for money damages.” 401 F.2d at 868, quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193 (1963). He further reasoned that a negligence standard in an enforcement action is proper since one of the purposes of the securities laws is to prevent the circulation of improper information. Judge Friendly also observed that the imposition of a negligence standard in civil suits would discourage optional disclosure of financial and business information, thus reversing the growing trend of corporations and the investment community to increase the amount of information available to investors. Recently, however, a district court has refused to recognize any distinction between the standards for the two actions, and stated that scienter is required in enforcement suits. SEC v. Bausch & Lomb, Inc., Civil No. 73-2458, slip op. at 30 (S.D.N.Y. Sept. 16, 1976). For a discussion of this decision, see Brodsky, *SEC Enforcement Weapon May Be Blunted*, 176 N.Y.L.J. 58, Sept. 22, 1976, at 1, col. 2.

32 96 S. Ct. at 1381 n.12. The question of the extent of the scienter requirement for underwriters in particular will be faced by the Court of Appeals for the Seventh Circuit in...
position of greater investigative and disclosure obligations to meet a "reckless behaviour standard" is quite possible. Indeed, applying the "shingle" theory, courts may find that an underwriter's association with an issue gives rise to an implied representation that the underwriter has reasonable grounds to believe that the issuer is fiscally sound. If, in fact, the issuer is financially unstable and the underwriter has not conducted a thorough investigation, it can be argued that the underwriter has vouched for the issuer's fiscal soundness knowing that he lacked sufficient information upon which to base this representation. In short, it is possible that a

Sanders v. John Nuveen & Co., 524 F.2d 1064 (7th Cir. 1975), vacated and remanded, 96 S. Ct. 1659 (1976), discussed in note 34 infra.

33 In certain instances those who sell securities publicly, who "hang out their shingles," are said to make implicit representations to their customers. See 5A A. Jacobs, The Impact of Rule 10b-5 § 210.03, at 9-14 to 9-15 (1974). In Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944), for example, the SEC revocation of a broker-dealer's registration was upheld since the broker-dealer's nondisclosure of his practice of selling securities at prices substantially above the market was deemed to be an omission of a material fact and a fraudulent device. Emphasizing the rapport which the broker-dealer had established with his customers, the Second Circuit reasoned that as a result of this confidential relationship, the broker had implicitly represented to its customers that the price it was charging was "close to the market [price]." 139 F.2d at 437. Thus, the broker's concealment of the price differential was held to be a fraud upon its customers.

Today, under the shingle theory, a failure to disclose facts which are contrary to one of the implied representations amounts to a violation of rule 10b-5. See 5A A. Jacobs, The Impact of Rule 10b-5 § 210.03, at 9-12 (1974). Some of the specific representations which have been held to be implicitly made under the theory include representations that statements of a stock's value are sound and that estimates of earning potential and similar statements have an adequate basis in fact. See Kahn v. SEC, 297 F.2d 112, 114-15 (2d Cir. 1961) (Clark, J., concurring); 5A A. Jacobs, The Impact of Rule 10b-5 § 210.03, at 9-14 to 9-15 (1974).

34 In Sanders v. John Nuveen & Co., 524 F.2d 1064 (7th Cir. 1975) (Stevens, J.), vacated and remanded, 96 S. Ct. 1659 (1976), the Seventh Circuit held that an underwriter's participation in an offering gives rise to "an implied representation that he has met the standards of his profession in his investigation of the issuer." 524 F.2d at 1070. The court proceeded to distinguish between the duties of investigation owed by an underwriter and a broker-dealer, stating that while a broker-dealer may rely on published information, an underwriter, by virtue of his special relationship with the issuer, is able to and must examine more than just this readily available information. The court found a violation of rule 10b-5 since the underwriter had given "his implied stamp of approval without having a reasonable basis for concluding that the issue . . . [was] sound." Id. at 1071. In its initial decision, the Seventh Circuit refused to discuss the appropriate general standard to be applied in civil actions under rule 10b-5, preferring to determine the appropriate standard in the context of the particular circumstances of each case. Id. at 1069. As a result of the Supreme Court's remand of the case for reconsideration in light of Ernst, the Seventh Circuit has been given an opportunity to decide whether, in the context of underwriter liability, scienter can be found in a failure to meet an implied obligation to investigate or in some other variation of the shingle theory. Of particular note in this area is Chris-Craft Indus. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 910 (1973), in which the court, due to the similarity in language between the two provisions, applied the requirements of rule 10b-5, including scienter, in imposing liability on an underwriter for violation of § 14(e) of the Exchange Act, 15 U.S.C. § 78n(e) (1970). It should be noted that the Supreme Court may now be considering the propriety of this Chris-Craft decision since it has granted certiorari to a later ruling of the Second Circuit on another issue in the same litigation. 96 S. Ct. 1505 (1976).
material misrepresentation with scienter can be established through the breach of what is essentially a duty of investigation.\textsuperscript{35} Admittedly, this discussion is speculative in nature, but it is this very uncertainty in the extent of and standards for liability which forces an underwriter to adopt a much more conservative attitude and demand greater information from the issuer.

Of particular note in this area is an administrative decision, \textit{Walston & Co.},\textsuperscript{36} in which the SEC premised the finding of a broker-dealer's violation of the antifraud provisions of the federal securities laws upon a failure to sufficiently investigate the municipal issuer and the resultant nondisclosure of material information. The Commission underscored the obligation to properly investigate:

\begin{quote}
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
\end{quote}

\textsuperscript{35} According to Dean Prosser, the requirement of scienter is satisfied when a person makes a representation knowing that he lacks sufficient information upon which it may be based. Establishing the existence of a lack of personal knowledge must depend on the circumstances of the particular case and the reasonableness of inferring from those circumstances that the person "must have known that he did not know." W. PROSSER, THE LAW OF TORTS § 107, at 701 (4th ed. 1971).

Additionally, some courts have recognized a breach of a duty to investigate as a form of scienter. For example, in Anderson v. Tway, 143 F.2d 95 (6th Cir. 1944), \textit{cert. denied}, 324 U.S. 861 (1945), a bank vice president induced a friend of his, one Tway, to purchase 2000 shares of the bank's stock. The vice president did not know and thus did not reveal that the bank's assets were impaired. When the bank's receiver sued to recover on the note that Tway had executed in return for the stock, Tway argued in defense that he had been defrauded. The receiver answered this argument by contending that since the bank vice president did not know that the bank's assets were impaired, the scienter requirement for a fraud action had not been satisfied. Disagreeing with the receiver's contention, the Sixth Circuit noted: "It is now . . . very generally held that knowledge may be attributed to persons making false representations in circumstances where it is their duty to know whether such representations are true or false, or where they have the means of knowing the truth." 143 F.2d at 99.

\textsuperscript{36} 43 S.E.C. 508 (1967). Walston & Co., which had recently entered the municipal bond business, sold some 250 bonds issued by the Rio Ramaza District in California. Harrington, the vice president who handled the transaction, furnished the company's salesmen with an offering circular which was adapted from the principal underwriter's circular. No other information was given to the salesmen. The salesmen represented the bonds as either "good," "high-grade," or "secure" municipal bonds. In fact, the bonds were highly speculative. The entire tract making up the district was owned by one individual, and the district had been formed by the vote of the six eligible voters on the tract. Furthermore, the owner of the land, his son, and one other person were the directors of the district. Finally, the value of the land was assessed at only $15,560, while the bond issue was for a $555,000 principal amount. Harrington knew that only one individual owned the tract included in the district and was aware of the facts concerning the election that formed the district, but he did not inspect the land or inquire into the financial condition of its owner.

Walston & Co. and Harrington consented to findings that they had willfully violated § 17(a) of the Securities Act, § 10(b) and § 15(c)(1) of the Exchange Act, and rules 10b-5 and 15c(1)-2. Both were censured; Walston & Co. was ordered to suspend its municipal securities trading and dealing for 30 days, and Harrington was "suspended from association with a broker or dealer for a period of 6 months . . . ." 43 S.E.C. at 513.
and disclosure as to material facts relating to the issuer of the securities and bearing upon the ability of the issuer to service such bonds. It is, moreover, essential that dealers offering such bonds to the public make certain that the offering circulars and other selling literature are based upon an adequate investigation so that they accurately reflect all material facts which a prudent investor should know in order to evaluate the offering before reaching an investment decision.37

This statement, which sets a standard strikingly similar to the "due diligence" obligation of section 11(e) of the Securities Act,38 illustrates the Commission's view of the duty owed to investors by underwriters and broker-dealers of municipal bonds. Moreover, the case itself demonstrates the extent to which the 1975 amendments, by subjecting municipal bond dealers and brokers to registration and regulation by the SEC, have strengthened the need for full disclosure by municipal issuers. Not only are municipal bond brokers and dealers liable for civil damages under the antifraud provisions, but they are now also subject to the full panoply of SEC administrative enforcement procedures.39

37 43 S.E.C. at 512 (emphasis added). It has been noted that the Commission's language in Walston appears to extend the standards of investigation applicable to registered offerings, i.e., due diligence, to exempt offerings of municipal securities. Doty, Application of the Antifraud Provisions of the Federal Securities Law to Exempt Offerings: Duties of Underwriters and Counsel, 16 B.C. IND. & COM. L. REV. 393, 412-13 (1975). Although such an extension may not be appropriate in civil actions for damages in view of Ernst, see notes 31-35 and accompanying text supra, such a standard may still be applicable to injunctive actions under § 10(b) or rule 10b-5. See note 39 infra.

38 15 U.S.C. § 77k(b) (1970). This section, which sets out the due diligence defense, relieves an underwriter of liability under § 11 for material misrepresentations in the nonexpert sections of the registration statement if "he had, after reasonable investigation, reasonable ground to believe and did believe . . . that the statements . . . were true and that there was no omission to state a material fact required to be stated . . . or necessary to make the statements . . . not misleading . . ." Id. § 77k(b)(3)(A) (1970).

While at first glance it may seem equitable to hold underwriters of municipal securities to this standard, it has been pointed out that underwriters face a severe time constraint in investigating the adequacy of the information furnished by the issuers. See text accompanying note 59 infra. Moreover, even if underwriters did not face such severe time problems, the lack of established criteria by which to judge the fiscal soundness of a governmental entity raises serious doubts as to their ability to successfully evaluate the adequacy of the information supplied. Id. Thus, it might well be unfair, as well as unrealistic, to hold underwriters of municipal securities to the same due diligence standard which is applied to underwriters of corporate securities.

39 The armament available to the SEC for enforcement purposes can be broken down into three classifications: administrative disciplinary actions; equitable remedies; and criminal proceedings. An administrative disciplinary action may be maintained by the Commission against a registered dealer, including a municipal securities dealer, for any violation of, inter alia, the Securities Act of 1933, the Securities Exchange Act of 1934, or the rules promulgated thereunder. See 15 U.S.C.A. § 78o (Supp. 1976). In an action of this kind, the finding of a wilful violation may result in the imposition of various administrative sanctions ranging from censure to revocation of the offending party's registration with the SEC. See id. § 78o(b)(4)(D). It is important to note that the willfulness requirement will be satisfied if the broker breaches his duty of investigation. Hanly v. SEC, 415 F.2d 589, 595-96 (2d Cir. 1969); Dlugash v. SEC, 375 F.2d 107, 109-10 (2d Cir. 1967); see Doty, Application of the
As a result of these and other potential liabilities\textsuperscript{40} and the loss


Equitable enforcement procedures available to the Commission include the power to bring an action for the purpose of enjoining "any acts or practices which constitute or will constitute a violation of the provisions of . . ." the Securities Act or the Exchange Act or rules and regulations promulgated thereunder. 15 U.S.C. § 77t(b) (1970); 15 U.S.C.A. § 78u(d) (Supp. 1976). It should again be noted that the Supreme Court has specifically reserved the question "whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10b-5." Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375, 1381 n.12 (1976). Thus, it is possible that a standard of negligence may ultimately be adopted in an action brought by the Commission for injunctive relief under § 10(b) and rule 10b-5. Indeed, the Second Circuit utilizes a negligence standard in such enforcement actions, while requiring scienter in private civil liability suits. Compare SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854-55 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969), with Lanza v. Drexel & Co., 479 F.2d 1277, 1304-05 (2d Cir. 1973) (en banc) and SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 866-69 (2d Cir. 1968) (en banc) (Friendly, Kaufman & Anderson, JJ., concurring), cert. denied, 394 U.S. 976 (1969). For a discussion of the Second Circuit's position, see note 31 supra.

In addition to the statutory authority of the SEC to seek an injunction, other equitable remedies often sought by the Commission include consent decrees and disgorgement of profits obtained by unlawful insider trading. For an excellent discussion of the various equitable remedies available to the SEC, including an evaluation of some remedies of recent origin, see Comment, \textit{Equitable Remedies in SEC Enforcement Actions}, 123 U. PA. L. REV. 1188 (1975).


\textsuperscript{40} In addition to possible liability based on an implied representation of issuer soundness, underwriters and broker-dealers involved in municipal bond transactions may face liability due to breaches of their other duties. For example, they have an obligation to determine whether municipal bonds are a suitable investment for their customer. If it is determined that bonds are a worthwhile investment, the underwriter must then ascertain whether a particular bond issue properly fulfills the investment needs and goals of its customer. See SEC v. Charles A. Morris & Associates, 386 F. Supp. 1327 (W.D. Tenn. 1973). A securities professional's liability in this area is based on a refinement of the "shingle" and "fair dealing" concepts, and is generally known as the "suitability" requirement. For an extensive discussion of the suitability theory, see 6 L. Loss, \textit{SECURITIES REGULATION} 3708-27 (Supp. 1969).

Professor Loss ascribes the development of the suitability theory to the use of high-pressure sales tactics to force a customer to hastily purchase speculative securities. Id. These sales tactics have become known as "boiler room" operations. See United States v. Ross, 321 F.2d 61, 64 (2d Cir. 1963), cert. denied, 375 U.S. 894 (1964); United States v. Rollnick, 91 F.2d 911 (2d Cir. 1937). The SEC has stated that:

[The antifraud] provisions contemplate, at the least, that recommendations of a security made to proposed purchasers shall have a \textit{reasonable basis} and that they shall be accompanied by disclosure of known or easily ascertainable facts bearing upon the justification for the representations.

Best Securities, Inc., 39 S.E.C. 931, 934 (1960) (emphasis added) (footnote omitted). Further, the SEC has taken the position that a broker-dealer who sells a security exempted from the registration requirements of the Securities Act incurs a greater obligation to determine the suitability of the investment, since the customer is not afforded the added protection of the registration process. See SEC Securities Act Release No. 4445 (Feb. 2, 1962), \textit{reprinted in} 2 CCH FED. SEC. L. REP. ¶ 22,753.

Until recently, questions of suitability did not play an important role in a municipal securities professional's operations. Most purchasers of municipal securities were highly
of investor confidence, the marketplace has forced municipalities to supply the investing public with disclosure documents which in detail and length equal or exceed the required corporate documents. A review of official statements issued by municipalities seeking to market securities during the first 6 months of 1976 reveals a significant increase in the amount of information disclosed. New York City is a prime example. Pre-1976 New York City disclosure documents consisted of a notice of sale and a statement of the terms of the issue. In 1976, however, the offering statement issued in connection with the sale of $185 million in New York City general obligation serial bonds extended to 96 pages, of which 53 pages were devoted to the city's fiscal crisis. The reality of expanded disclosure is not limited to New York City with its fiscal problems. Despite an excellent credit reputation, the County of

sophisticated investors, interested in large denomination notes. Typically, the purchaser of municipal bonds was the local banker who bought securities for the bank's own account. It was not necessary to provide him with detailed information because he already possessed it. The local banker knew the tax collection experience of the municipality, the background of the municipal officers, the practices of the community, tax procedures, principal employers, median income, and a host of other information now included in offering statements. Individual investors did not become a significant factor in the municipal bond market until the 1950's when rising wages and increasing taxes made municipal bonds attractive to individuals in the middle income tax brackets. See S. Rep., supra note 1, at 41-42; Municipal Bonds, supra note 1, at 565. The following table is indicative of this trend:

Annual Net Changes in Holdings of Municipal Securities by Major Holder Groups (1970-1975) (Amounts are par values in billions of dollars)

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<tbody>
<tr>
<td>Commercial banks</td>
<td>10.7</td>
<td>12.6</td>
<td>7.2</td>
<td>5.7</td>
<td>5.5</td>
<td>-2.7</td>
<td>6.9</td>
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<tr>
<td>Households</td>
<td>-0.8</td>
<td>-0.2</td>
<td>1.0</td>
<td>4.3</td>
<td>10.0</td>
<td>13.9</td>
<td>9.3</td>
</tr>
<tr>
<td>All other**</td>
<td>1.3</td>
<td>5.2</td>
<td>6.2</td>
<td>3.7</td>
<td>1.9</td>
<td>2.9</td>
<td>4.5</td>
</tr>
<tr>
<td>Total</td>
<td>11.2</td>
<td>17.6</td>
<td>14.4</td>
<td>13.7</td>
<td>17.4</td>
<td>14.0</td>
<td>20.7</td>
</tr>
</tbody>
</table>

Source: Unpublished flow of funds data from the Board of Governors of the Federal Reserve System (Processed: August 19, 1975)

* Annual rate.

** This includes corporate business, state and local general funds, mutual savings banks, insurance companies, state and local government retirement funds, and brokers and dealers.


As a result of the proliferation of individuals in the municipal securities markets, the suitability doctrine has taken on added significance to municipal securities professionals and provides another area of possible liability. Both SEC v. R.J. Allen & Associates, 386 F. Supp. 866 (S.D. Fla. 1974), and SEC v. Charles A. Morris & Associates, 386 F. Supp. 1327 (W.D. Tenn. 1973), illustrate the use of this doctrine to support findings of antifraud violations in particularly reprehensible municipal securities sales operations.

Nassau of the State of New York has been forced by various market factors to prepare a comparable document consisting of 69 pages including 31 pages of financial statements. Similarly, the State of New York, in order to meet the information demands of the underwriters, prepared an 88-page document in connection with an offering of $59 million general obligation serial bonds. Further afield, the City of Baltimore issued a 108-page document in connection with a $34.35 million offering of general obligation serial bonds. Clearly, as a practical matter, disclosure requirements have been imposed on municipal issuers despite congressional refusal to take such action. The lack of definitive legislation, however, has generated both uncertainty and confusion in the law of disclosure relevant to municipal securities.

**CONTENTS OF DISCLOSURE DOCUMENTS**

In the private sector, the extent of disclosure required for the issuance of securities has been delineated by the SEC through the development of elaborate instructions, rules, and guidelines that have the status of law. A private corporation preparing an offering statement can find some comfort in the fact that the Commission requires the disclosure of certain enumerated information. If an issuer has disclosed all material information called for in the SEC’s forms and rules, it has some assurance that its disclosure obligations have been fulfilled.

In the municipal securities area, however, there is no compar-

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42 Official Statement of the County of Nassau, June 1, 1976.
44 Preliminary Official Statement of the City of Baltimore, April 15, 1976.
48 Compare 3 L. Loss, Securities Regulation 1938 (2d ed. 1961), with 1 K. Davis, Administrative Law Treatise § 5.03, at 298-300 (1958). It should be noted that materiality and accuracy are still the ultimate criteria applied to determine the extent of information necessary in corporate disclosure documents:
   In addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.
49 In addition to the availability of carefully drawn directives and SEC guidance during preparation of the disclosure documents, corporate issuers must, before the registration statement will be declared effective, submit it for Commission review. See 15 U.S.C. § 77h(a) (1970). Filing with and review by the Commission, however, does not imply SEC approval of either the securities or the adequacy and accuracy of the disclosure. See SEC Rule 425, 17 C.F.R. § 230.425 (1976) (disclaimer of Commission approval must be printed on all prospectuses).
A NEW LOOK AT MUNICIPAL BONDS

able set of rules upon which the draftsman of an offering statement may rely to ensure adequate disclosure and avoid liability for omissions. Similarly, resort to judicial doctrines is of little use since the question of liability for nondisclosure involves the issue of materiality,60 an issue that is a mixed question of law and fact requiring "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him . . . ." 51 In short, this determination, though based on a general legal standard, is fundamentally unique to each particular factual setting. Although the materiality problem is common to both corporate and municipal issuers, the draftsman of a municipal securities offering statement is forced to make potentially devastating disclosure decisions without the benefit of any guidance from the Congress, the courts, or the SEC.52

60 The proper definition of the term "materiality" has been the subject of much litigation, see Doty, Application of the Antifraud Provisions of the Federal Securities Laws to Exempt Offerings: Duties of Underwriters and Counsel, 16 B.C. IND. & COM. L. REV. 393, 403-04 (1975), which has divided the circuits. Compare Kohn v. American Metal Climax, Inc., 458 F.2d 255, 269 (3d Cir.), cert. denied, 409 U.S. 874 (1972), with Smallwood v. Pearl Brewing Co., 489 F.2d 579, 603-04 (5th Cir.), cert. denied, 419 U.S. 873 (1974). The difficulty stems, at least in part, from Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970), wherein the Court held that a misstatement need not have a decisive effect to be material. A misstatement is material if a reasonable investor might consider it important and a causal relationship exists between the misstatement and the injury. Id. at 384-85. Refining this definition in Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), the Court withdrew the requirement of reliance and stated that representations or omissions were material when a "reasonable investor might have considered them important in the making of [an investment] decision." Id. at 154 (emphasis added).

Since the proper standard of materiality was not the central issue presented in either Mills or Affiliated Ute, lower courts disagreed on whether the appropriate standard was that the reasonable investor would be affected or whether it was sufficient that he might be affected by the representation. In Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1302 (2d Cir. 1973), the Second Circuit adopted the tort definition, asking "whether a reasonable man would attach importance to the fact misrepresented in determining his choice of action . . . ." Id. at 1302, quoting List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965); accord, Smallwood v. Pearl Brewing Co., 489 F.2d 579, 603-04 (5th Cir.), cert. denied, 419 U.S. 873 (1974). Meanwhile, the Third Circuit, in Ronson Corp. v. Liquifin Aktiengesellschaft, 483 F.2d 846, 851 (3d Cir. 1973), cert. denied, 419 U.S. 870 (1974), and the Seventh Circuit chose "a test that includes all facts which a reasonable stockholder might consider important." Northway, Inc. v. TSC Indus., Inc., 512 F.2d 324, 330 (7th Cir. 1975) (emphasis added), rev'd, 96 S. Ct. 2126 (1976).

In TSC Indus., Inc. v. Northway, Inc., 96 S. Ct. 2126 (1976), the Supreme Court, in the context of § 14(a) of the Exchange Act, 15 U.S.C. § 78n(a) (1970), dismissed the language in Affiliated Ute as obiter dictum, 96 S. Ct. at 2132 n.9, and set the following standard of materiality:

[An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.

Id. at 2133 (emphasis added). The Court concluded its discussion by stating that with this standard in mind, the final determination of whether the misstatement is material should normally be left to the trier of facts. Id.; see text accompanying note 51 infra.

52 Disclosure by municipal issuers is problematical not only because of lack of official
The Municipal Finance Officers Association (MFOA) has attempted to fill this vacuum by issuing a draft of disclosure guidelines.\textsuperscript{53} The guidelines are intended to provide the same type of guidance to the draftsmen of municipal offering statements as is afforded corporate issuers by the SEC. These directives, however, even when fully adopted by the MFOA, will not be legally binding, and can, therefore, unlike the SEC rules, be no more than unofficial instructions.\textsuperscript{54} In addition, the guidelines as released apply to all tax-exempt offerings by state or municipal entities\textsuperscript{55} and, consequently, represent broad generalities. Similarly, they apply to all offerings, even smaller offerings that are placed privately, often through negotiations with institutional or other highly sophisticated investors.\textsuperscript{56} Clearly, the test, in all cases, for inclusion of information in a municipal securities offering statement will continue to be materiality.\textsuperscript{57} And, the answer to that test, in municipal issues, must be arrived at without the benefit of authoritative guidance.

Recognizing the difficulty and cost of the present pattern of detailed disclosure, the Municipal Securities Rulemaking Board (MSRB) has stated that it supports limiting both disclosure re-

\textsuperscript{53} MFOA, Disclosure Guidelines for Offerings of Securities by State and Local Governments (1975).

\textsuperscript{54} See id. at 1.

\textsuperscript{55} The drafting committee has received recommendations that separate guidelines be developed for local revenue bonds, general obligation bonds, short-term bonds, and other major bond categories.

\textsuperscript{56} An exemption similar to the private placement exemption contained in rule 146, 17 C.F.R. § 230.146 (1976), has been proposed.

quirements and liabilities in the issuance of municipal securities.\textsuperscript{58}

The MSRB explained its position as follows:

Information on which to base an investment decision often is unavailable with respect to municipal securities. Indeed, substantial uncertainty exists concerning the nature and scope of such information and the appropriate form of its presentation. In order to bring their securities to market in recent months, many issuers of municipal securities have undergone protracted and costly negotiations with underwriters for increasingly comprehensive and possibly non-material items of disclosure. Underwriters, for their part, are asked to assess their potential liabilities without guidance as to what information may or may not be material.

(3) The vast majority of general obligation securities are sold through competitive bid. Often, the competitive bid procedure is mandated by state law on the theory that it results in lower costs to borrowers and is therefore in the public interest. At the same time, the competitive bid process imposes severe time constraints on underwriters in their ability to ascertain the adequacy of information supplied to them by issuers. The time elapsing between publication of a notice of sale and the date bids are required to be submitted often does not exceed seven days and almost never exceeds two weeks.

While the time constraints imposed by the bidding process make it impossible for underwriters to undertake an investigation in depth of a municipal issuer's affairs, it is questionable whether such an investigation would be feasible under any circumstances with respect to issuers of general obligation securities. In comparison to the well-recognized indicia of the viability of business corporations, the factors that contribute to the health of a governmental entity are at once complex and not readily determinable.

In view of these factors, we believe it appropriate to limit the liabilities of underwriters in the municipal area by affording them a defense based on the absence of reasonable grounds to believe or belief that the information furnished by the issuer contains a material misstatement or omission. This approach would eliminate the imposition of a due diligence obligation on underwriters of municipal securities which, for the reasons previously stated, cannot be fulfilled.

(4) Issuers should be responsible for the accuracy and completeness of information contained in an official statement which they prepare or which is derived from their own records. We do not believe, however, that an issuer should be held responsible for information derived from public sources not under the con-

\textsuperscript{58} Hearings on S. 2969 & S. 2574 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. 388-94 (1976).
trol or jurisdiction of the issuer in the absence of actual knowledge or reckless disregard for the accuracy or completeness of such information.\textsuperscript{59}

\section*{Legislative Proposals}

In late 1975, considerable pressure began to build for major legislation dealing with disclosure in the sale of municipal securities. Interest in such legislation arose during the debates on the 1975 amendments to the federal securities laws. At that time, Senator Eagleton attempted to amend the 1975 legislation to repeal the exemption in the Securities Act for obligations of state and local governments.\textsuperscript{60} This amendment was subsequently withdrawn, but Senator Williams, Chairman of the Subcommittee on Securities of the Banking, Housing and Urban Affairs Committee, agreed to hold hearings and attempt to report out a bill on municipal disclosure in 1976.\textsuperscript{61}

As a result of the continued exemption of municipal securities from federal regulation,\textsuperscript{62} congressional authority to enact such regulations has not been seriously challenged and has, therefore, never been clearly defined. Nonetheless, increasingly expansive interpretations of federal commerce clause power,\textsuperscript{63} even when it was exercised to control the activities of a state,\textsuperscript{64} appeared to have

\textsuperscript{59} Id. at 389-93.
\textsuperscript{60} 121 Cong. Rec. 21,192-93 (daily ed. Dec. 5, 1975) (remarks of Senator Eagleton).
\textsuperscript{61} Id. at 21,197 (remarks of Senator Proxmire).
\textsuperscript{62} See note 14 supra.
\textsuperscript{63} See, e.g., NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1 (1937) (Congress can regulate intrastate activities having a "close and substantial" relation to interstate commerce); Wickard v. Filburn, 317 U.S. 111 (1942) (production of wheat for home consumption exerts a "substantial economic effect" upon interstate commerce and thus may be regulated); Katzenbach v. McClung, 379 U.S. 294 (1964) (Congress may prohibit conduct when a rational basis exists for finding it "generally" burdensome to interstate commerce).
\textsuperscript{64} Use of the commerce power to control state activity seems to have reached a high water mark in Maryland v. Wirtz, 392 U.S. 183 (1968), overruled, National League of Cities v. Usery, 96 S. Ct. 2465, 2476 (1976). The Wirtz Court held that Congress could exercise its commerce clause authority to regulate state activities regardless of whether these were characterized as "governmental" or "proprietary." The Court relied upon its statement in United States v. California, 297 U.S. 175 (1936) that "we look to the activities in which the states have traditionally engaged as marking the boundary of the restriction upon the federal taxing power. But there is no such limitation upon the plenary power to regulate commerce." Id. at 185, quoted in Maryland v. Wirtz, 392 U.S. 183, 198 (1968). Federal control of state functions which affect interstate commerce was apparently reaffirmed in Fry v. United States, 421 U.S. 542 (1975). There, the Court noted that a federal freeze on public employee wages as part of the Economic Stabilization Act of 1970 was an even less intrusive regulation than the statute at issue in Wirtz. Id. at 548.

Federalism problems also confronted the Court in delineating the scope of the taxing power of the national and state governments over each other's instrumentalities. Initially, a broad doctrine of reciprocal immunity, based on Chief Justice Marshall's comment that "the power to tax involves the power to destroy," McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 431 (1819), was utilized. See New York v. United States, 325 U.S. 572, 575 (1946).
left little doubt that the federal government could regulate the entire securities industry regardless of the involvement of state and local governments. In *National League of Cities v. Usery,* however, the Supreme Court abruptly narrowed its broad interpretation of congressional authority and held that state sovereignty limitations on the commerce power prohibited federal legislation which would "operate to directly displace the States’ freedom to structure integral operations in areas of traditional governmental functions . . . ."66 Explaining that there exist certain attributes of state sovereignty which are protected from congressional interference by a constitutional limitation,67 Justice Rehnquist stated that the criti-

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66 96 S. Ct. at 2474. It should be noted that the "traditional governmental functions" distinction had been rejected in Maryland v. Wirtz, 392 U.S. 183, 195 (1968) and United States v. California, 297 U.S. 175, 183 (1936), and has been criticized in the tax immunity area, see note 64 supra, as "too shifting a basis for determining constitutional power and too entangled in expediency to serve as a dependable legal criterion." New York v. United States, 326 U.S. 572, 580 (1945) (Frankfurter, J.).

67 96 S. Ct. at 2471. The affirmative constitutional limitation upon which Justice Rehnquist relies is attested to, if not necessarily embodied in, the tenth amendment: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. CONST. amend. X. Analysis of Justice Rehnquist's dissent in *Fry v. United States,* 421 U.S. 542, 549 (1976), suggests that the actual basis of this limitation on congressional authority is not the language of the tenth amendment itself, but is rather an affirmative immunity to congressional power inherent in the federal system. *Id.* at 553 (Rehnquist, J., dissenting). Discussing the Court's opinion in United States v. California, 297 U.S. 175 (1936), which he regarded as "critical to the development of the doctrine which the [*Fry*] Court today applies," 421 U.S. at 549, Justice Rehnquist concluded that the *California* Court's refusal to apply the federalism concepts which justified limited state immunity from federal taxation to the commerce clause power was without justification. Noting that the taxation immunity is based *solely* on federalism, he indicated that a restriction on the commerce clause is also supported by the tenth amendment. Although it does not expressly prohibit congressional action, the tenth amendment is
cal question is whether the particular state attribute is "'essential to separate and independent existence.'" If this question is answered in the affirmative, Congress may not abolish the states' authority to fulfill those functions. Thus, in National League, the Court found that the minimum wage and maximum hour provisions of the Fair Labor Standards Act, if applied to the states, would significantly supplant important policy decisions upon which the performance of integral governmental functions depend. This interference was deemed impermissible since the states' power to determine the method and manner of fulfilling traditional governmental functions was considered essential to independent existence.

Careful analysis of National League indicates that the determination of the proper relationship between the federal and state governments will apparently embody a balancing of interests.

an expression of the understanding inherent in the federalist system that each state is a sovereign. Consequently, Congress may not treat a state "as if it were just another individual or business enterprise . . . ." Id. at 557. Justice Douglas espoused similar views in his dissent to Maryland v. Wirtz, 302 U.S. 183, 201-05 (1968) (Douglas, J., dissenting).


69 29 U.S.C. §§ 201 et seq. (1970), as amended, (Supp. IV, 1974). The Act provides that covered employers must pay a minimum wage, 29 U.S.C. § 206(a) (1970), and keep employment records, id. § 211(c). They are prohibited from employing individuals for more than a specified number of hours per week, unless the employees receive time and a half for overtime. Id. § 207(a)(3).

70 96 S.Ct. at 2474. The Court mentioned several areas of activity within which state governments traditionally discharge the functions of public law administration and public service furnishment: fire and police protection, sanitation, public health, and parks and recreation. Id. The Court observed that "[t]hese examples are obviously not an exhaustive catalogue of the numerous . . . activities which are well within the area of traditional operations of state and local governments." Id. n.16.

71 96 S.Ct. at 2473-74. The Court overruled Maryland v. Wirtz, 392 U.S. 183 (1968), which had upheld an earlier extension of the Fair Labor Standards Act to employees of state hospitals, institutions, and schools. Justice Rehnquist observed that obvious differences exist between the schools and hospitals involved in Wirtz and the police and fire departments involved here, but "each provides an integral portion of those governmental services which the States . . . have traditionally afforded their citizens." 96 S.Ct. at 2476.

72 The Court's suggestion that temporary legislation enacted in the context of a national emergency, see note 75 and accompanying text infra, can be read in connection with Justice Blackmun's concurrence, 96 S.Ct. at 2476 (Blackmun, J., concurring), to indicate that such a balance was struck here. Consideration of the opinions of all the Justices lends further support to the proposition that the guiding principle in this area embodies a balancing of federal and state interests. The dissent of Justice Brennan, with whom Justices White and Marshall joined, adhered to the position that the commerce clause power should be regarded as paramount to any state interest. Id. at 2477 (Brennan, J., dissenting). Justice Stevens, in a separate dissent, was unable to find any distinction between the activity regulated in this case and other state activity which is clearly subject to federal regulation, and therefore concluded that the wage and hour provisions were valid. Id. at 2488 (Stevens, J., dissenting). Thus, four members of the Court have apparently espoused a balancing approach, at least in national emergency situations; at least three Justices found the federal interest controlling in all cases; and Justice Blackmun cast the deciding vote on the understanding that, in fact, a balancing approach had been adopted.
Clearly, a showing of a rational relationship between the legislation and interstate commerce will be insufficient to justify federal regulation of an essential state activity. A showing of an important federal interest in a particular objective, coupled with a necessity for state compliance to achieve that goal, however, should provide the counterweight necessary to overcome the protection of state functions essential to independent existence. Indeed, it was the understanding of Justice Blackmun, whose concurrence in *National League* was decisive, that the majority opinion embodied just such a balancing approach. Significantly, Justice Rehnquist also noted that the state sovereignty limitation is not absolute, but will certainly succumb to federal authority in cases presenting carefully drafted legislation designed to combat a national emergency. Consequently, resolution of the question of federal commerce clause authority over issuers of municipal securities seems to call for a two-tier approach. First, is the issuance of securities an attribute of state sovereignty essential to separate and independent existence? If so, is the federal interest in regulating municipal issuers "demonstrably greater" than that involved in public sector hours and wages, and is state compliance with federal regulation in the municipal securities area essential? In view of the importance to the nation of broad public participation in financial markets, the

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73 See 96 S. Ct. at 2473.
74 Id. at 2476 (Blackmun, J., concurring).
75 Id. at 2474-75. Although Justice Blackmun chose to view the Court's decision as applying a balancing approach, Justice Rehnquist very narrowly circumscribed the extent to which emergency situations would justify federal intrusion upon the sovereignty of the states. In reconciling *Fry v. United States*, 421 U.S. 542 (1975) (wage freeze upheld), with *National League*, Justice Rehnquist stated that *Fry* presented a "temporary enactment tailored to combat a national emergency," and thus was distinguishable from the instant case which did not involve such narrowly drawn legislation. 96 S. Ct. at 2475. The question remains whether this reconciliation is to be viewed as a special exception to the state sovereignty limitation or an implicit adoption of a balancing approach. In either case, the term "national emergency" needs to be defined so as to clarify how immediate and extensive the problem must be. Justice Blackmun's concurrence indicates that environmental protection is an appropriate area for federal regulation, thus implying that the national emergency need not be as immediate as the one presented in *Fry* and that the legislation may extend beyond temporary enactments to long-range solutions for foreseeable national problems. 96 S. Ct. at 2476 (Blackmun, J., concurring).

76 In a suit brought to enjoin both SEC investigation of New York City securities and enforcement of the federal antifraud provisions against the city, New York argued that the issuance of securities is a fulfillment of the financing function of local governments and thus "is essential to their existence and operation as separate and independent political and governmental entities." Complaint at 3, City of New York v. SEC, Civil No. 76-3307 (S.D.N.Y., filed July 27, 1976). In contrast, SEC Commissioner Philip A. Loomis, testifying before the House Consumer Protection Subcommittee, argued that federal regulation of the municipal securities market would not displace state policies regarding the delivery of essential governmental services. Rather, such regulation "facilitates the creation of a viable municipal securities market in which States can raise funds with which to carry out their traditional functions." BNA Sec. Reg. & L. Rep. No. 368, at A-3 (Sept. 1, 1976).
increased role played in these national markets by municipal financing, and the lack of sufficient state authority to ensure, throughout the country, the open and honest financial disclosure upon which public participation rests, federal regulation of municipal issuers through carefully drafted legislation should be constitutionally permissible.

The principal legislative proposals presently before the Congress are the Eagleton bill and the Williams bill. The major difference between these legislative proposals is the extent of SEC jurisdiction. The Eagleton bill would repeal the general municipal securities exemption contained in the Securities Act and confer authority to the Commission to exempt any class of these securities. The ultimate effect of such selective exemptions would be the imposition of the full rigors of registration, including SEC review of disclosure documents, upon the issuers of nonexempt securities. Aside from the grave constitutional problems inherent in such pervasive regulation of the financing function of state and local governments, this proposal fails to recognize the essential differences between the marketing of corporate and municipal securities. This oversight would result in either a superimposing upon the municipal securities market of regulations and statutes tailored for the corporate field, or a grant of authority to the SEC without any clear congressional guidance. Moreover, the SEC has expressed opposition to this plan, stating that it would be unable to absorb the additional regulatory burden required by the Eagleton

77 The fragmentation of regulation inherent in state control of securities presents the largest obstacle to uniform and effective securities regulation. See generally Goodkind, Blue Sky Law: Is There Merit in the Merit Requirements?, 1976 Wis. L. Rev. 79. In addition, state regulation is further thwarted by the municipal securities exemption contained in nearly all Blue Sky Laws. See note 14 supra.


81 See notes 65-77 and accompanying text supra.

82 For a discussion of the differences between the underwriting processes for municipal and corporate bonds, see Municipal Bonds, supra note 1, at 567-74. The Eagleton bill fails to differentiate between the liability of municipal and corporate officials, and thus might allow unwarranted attachments against municipal officials. More importantly, the Eagleton bill would subject municipal issuers to SEC review of disclosure documents and the accompanying Securities Act restrictions on selling activities in the prefiling, waiting, and posteffective periods. See Hearings on S. 2969 & S. 2574 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. 14 (1976). SEC Chairman Roderick Hills testified that neither the industry nor the Commission could absorb the increased burdens of cost, time, and manpower which the Eagleton bill would impose. Id. at 21. The deficiencies in this proposal were discussed briefly in Note, Federal Regulation of Municipal Securities, 60 Minn. L. Rev. 567, 591 n.158 (1976).

83 See note 82 supra.
The Williams bill, in contradistinction, was drafted in conjunction with the SEC. It does not embody any amendments to the Securities Act, but rather provides for the addition of a new section 13A to the Exchange Act. Proposed section 13A requires the preparation and limited dissemination of annual reports by issuers having more than $50 million in municipal securities outstanding during any portion of a fiscal year and distribution statements by

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84 SEC Chairman Hills, in opposing the Eagleton bill's requirement of SEC clearance for disclosure documents, expressed concern that the burden imposed by the bill is one that the Commission could not bear, and further, that even if they could do so, the threatened harm to investors does not justify so drastic a proposal. See Hearings on S. 2969 & S. 2574 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. 21, 23 (1976). Chairman Hills' prediction of a massive regulatory burden is supported by statistics indicating that the number of municipal issues runs from 2500 to 8000 per year, in comparison to fewer than 1000 corporate issues.

85 S. 2969, 94th Cong., 2d Sess. § 5(e) (1976). The annual report required by proposed § 13A(a)(2) of the Exchange Act would include the following information:

(A) An identification and description of the issuer of the securities outstanding;
(B) A description of any legal limitation on the incurrence of indebtedness by the issuer or the taxing authority of the issuer;
(C) A description of the issuer's debt structure, including information with respect to amounts of authorized and outstanding funded debt; estimated amount of short term debt, character of amortization provisions of funded debt, sinking fund requirements, security for debt, nature and extent of guaranteed debt, and debt service requirements;
(D) A description of the nature and extent of other material contingent liabilities or commitments of the issuer;
(E) If any payment of principal or interest on any security of the issuer or any predecessor thereof has been defaulted on, or has been postponed or delayed, within the past twenty years, a description of the date, amounts and circumstances of such event and of the terms of any succeeding arrangements thereof;
(F) A description of the issuer's tax authority and structure over the past five years including the nature of taxes levied, tax rates, property (real and personal) valuation and assessment procedures, amounts of property valuations and assessments, amounts of tax levies, amounts of tax collections and delinquent tax procedures and experience;
(G) A description of the issuer's major taxpayers;
(H) A description of the principal governmental and other services provided or performed by the issuer, the extent to which similar or differing services are performed by other governmental entities which serve the same geographic area and any major changes in such services in the last ten years;
(I) A description of the nature and extent of Federal or other assistance programs available to the issuer; and
(J) Financial statements of the issuer in such detail and form and for such periods beginning not earlier than the fifth previous fiscal year as the Commission may prescribe, which statements for any fiscal year commencing on or after December 31, 1978, shall be audited and reported on by an independent public or certified accountant in such manner as the Commission may prescribe.

Id. § 13A(a)(2). The reports containing this information must be made available, at the issuer's expense, to all security holders. Any other person may also obtain a report after payment of a reasonable fee. Id. § 13A(f)(1). In addition, the issuer must file the report for public examination at a location designated by the Commission and, if the Commission chooses, at a central repository. Id. § 13A(f)(3).
those issuers offering more than $5 million in any one issue of municipal securities. Furthermore, in an apparent attempt to relieve the underwriter's concern over possible liability for non-disclosure, the bill also limits such liability to the underwriter's participation in the issue, unless, as in the case of a lead underwriter, it received a benefit from the issuer not shared in by other similarly situated underwriters. Unlike the Eagleton bill, Senator Williams' proposal both specifies guidelines to be followed by the SEC in prescribing disclosure requirements and avoids the imposition of corporate disclosure obligations upon the municipal security market. Moreover, the Williams bill exempts an issuer from the distribution statement provisions if the disclosure in connection with the issue has been approved, after a hearing, by an independent state authority. Despite these various legislative qualifications upon issuer disclosure, the Williams bill would grant the SEC broad authority to modify the minimum amounts necessary to invoke the disclosure obligation, to add and delete informational items from the disclosure documents, to prescribe the forms, finan-

86 Id. § 13A(b)(1). Under this section, the distribution statement must contain all items required by the annual report, see note 85 supra, in addition to the following:

(A) A description of the offering, including amount to be offered, price, plan of distribution, and underwriting arrangements and compensation;
(B) A description of the security to be offered, including provisions as to security, events of default, payment of principal and interest, sinking fund, redemption, debt reserve funds, priority, legality and authorization for issue and rights of security holders to bring suit against issuers;
(C) A description of any project or enterprise of the issuer to be financed from the proceeds of revenue or special assessment securities, and any engineering or financial feasibility reports or studies on the construction and operations of the project or enterprise;
(D) A description of the intended use of the proceeds of the offering;
(E) A statement of counsel's opinion as to the legality of the issuance of the securities to be offered;
(F) A statement of the availability of the reports required by this section; and
(G) Such other similar and specific information as the Commission may by rules or regulations require as necessary or appropriate in the public interest or for the protection of investors.

S. 2969, 94th Cong., 2d Sess. § 13A(b)(2) (1976). Certain securities, however, would be exempted from these requirements. See note 90 and accompanying text infra.

The distribution statements would have to be made available to all brokers, dealers, and banks "acting as agent for delivery to prospective purchasers." S. 2969, 94th Cong., 2d Sess. § 13A(f)(2). The Commission could also require the issuer to file the statement at a designated location and at a central repository. Id. § 13A(f)(3).

87 S. 2969, 94th Cong., 2d Sess. § 13A(g). This subsection was derived from § 11(e) of the Securities Act, 15 U.S.C. § 77k(e) (1970).

88 See notes 85 & 86 and accompanying text supra.

89 Since the municipal securities exemption of the Securities Act is retained, any question of the direct applicability of corporate requirements to municipal issuers is removed.

90 S. 2969, 94th Cong., 2d Sess. § 13A(c)(1) (1976). It is believed that federal regulation in this instance is unnecessary, since active state supervision of the offering would provide adequate protection to investors. Proposed § 13A(c)(2) also provides several exemptions based on those found in the Securities Act. The most important of these exemptions is the small offering exemption. See 15 U.S.C. § 77d(2) (1970).
cial statements, and accounting method to be used in preparing the reports, and to designate a location at which the reports must be filed and available for public inspection. Thus, the Williams bill segregates municipal securities disclosure regulations from corporate disclosure policies, initially delimits SEC jurisdiction to those municipalities that exceed the minimum dollar amounts, presents a framework within which the contents of disclosure documents may be formulated, and preserves flexibility by granting broad authority to the SEC in which to operate, and, in some instances, modify the proposed legislative scheme.

**Conclusion**

In 1933, the expenditures for state and local government approximated $7 billion. In 1976, such expenditures will exceed $200 billion, exclusive of Federal grants-in-aid. The long-term municipal securities presently being sold each year are in the general magnitude of $25 billion to $30 billion. These securities are now much more important in relation to total securities being issued and outstanding.

In recent years, the interest rates of municipal securities have tended to increase faster than interest rates on long-term corporate bonds. A knowledgeable estimate is that higher legal and accounting fees required by new disclosure requirements and potential liabilities will not only make municipal financing more time consuming, resulting in uncertainty as to proceeds and interest costs, but will also and more concretely triple or quadruple costs in a typical bond financing. However, this is only one side of the question. Any additional costs incurred as a result of greater disclosure requirements may be more than offset in the long run by an increase in investor confidence, which should result in lower interest costs than would otherwise be available.

Finally, it is to be hoped that stiffer disclosure and accounting requirements will discipline the management and financing practices and spending proclivities of local officials and lead to a public scrutiny of financial commitments. This scrutiny, in turn, can save local tax monies, avoid the cost in inflation of monetizing deficits of state and local governments, and prevent increased federal taxation due to revenue sharing, bailouts, and the inevitably more costly absorption of new functions by the Federal Government.

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Authors' Note: As this Article went to print, the New York Court of Appeals held that the Emergency Moratorium Act for the City of New York, discussed in note 20 supra, "violates the State Constitution in denying faith and credit to the short-term anticipation notes of the city." Flushing Nat'l Bank v. Municipal Assistance Corp., No. 391, slip op. at 1 (N.Y. Ct. App. Nov. 19, 1976). The court observed that "[t]he constitutional prescription of a pledge of faith and credit is designed, among other things, to protect rights vulnerable in the event of difficult economic circumstances." Id. at 6. This decision will, no doubt, profoundly affect the marketplace and should restore, to some extent, investor confidence in municipal securities.

The New York Regional Office of the SEC recently sent a questionnaire to members of the underwriting syndicates which have distributed New York City notes and bonds. The questionnaire is an important indication of SEC concern about the requirements of due diligence. It asks the extent to which the broker used or relied on its own independent research; on studies distributed by the managing underwriters; on information made available by the city in its statements, reports, and budgets; and on reports about the city by state officials, rating services, and the press. It then asks the extent to which the broker relied on the legally binding character of the city's obligations, its access to real property to pay the notes, relevant provisions of the state constitution, and the status of debt service as a lien on the city's revenues. The brokers are asked whether they understood that the managing underwriter, prior to forming the selling syndicate, had analyzed the city's creditworthiness and fiscal soundness, the sufficiency of its revenues to meet its maturing obligations, and its deficits and budget gaps. The questions continue: What did you know about the investigations the managing underwriter actually made prior to deciding to underwrite the bonds? Were there any consultations with outside technical experts such as accountants or municipal securities analysts? Who in the broker's organization verified the figures made available by the city? What was your understanding as to the managing underwriter's obligations, e.g., to verify the city's figures and bring to the buyer's attention any negative aspects about the bonds? Was the managing underwriter's decision to underwrite the bonds accepted as an express or implied approval of the creditworthiness of the city's fiscal position and its bonds? The questionnaire then asks for the broker's understanding of the role or duties of bond counsel and whether, prior to rendering its approving opinion, counsel verified or investigated the accuracy and completeness of the figures and textual information presented by the city. Examining the effect of the city's Notices of Sale and Reports, the SEC inquires whether the brokers expected that any material changes in the city's accounting practices and policies; any developments materially affecting the city's financial condition; any overestimates of revenues from prior years from the federal or state governments or from real estate taxes; any renewals or rollovers of notes and the reasons therefor; or any budget gaps, budget deficits, cash deficits, or deficit financing would have been disclosed in these publications. It then asks for instructions given to salesmen regarding the types of statements or representations permissible or impermissible in selling the bonds, the degree of risk believed to be involved in the bonds, the risks salesmen were instructed to relate to their customers, and what steps were taken to determine that the bonds were suitable to the needs of particular customers. The brokers are then asked to indicate whether, at the time they sold the bonds, they perceived the city's financial condition and accounting practices as excellent, good, fair, or poor. The questionnaire then inquires whether they were aware of several adverse observations which the state comptroller, in his audits, made about the city's financial condition and practices.

In this questionnaire, the SEC appears to be applying corporate securities' standards to a financial activity which has, for generations, relied solely on the full faith and credit of governmental units, constitutional commitments that municipal bondholders get first call on the city's revenues, and the exemption of bond income from taxation.