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"The MFOA and Municipal Disclosure"

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I appreciate the opportunity to participate in this colloquium and to offer some personal observations on municipal securities disclosure, a topic in which I have been interested for some time.

At a forum sponsored by the Municipal Finance Officers Association in October of 1974, I commended the MFOA for its concern with municipal securities disclosure practices and encouraged it to pursue the consideration of developing appropriate disclosure guidelines for municipal issuers. Several months later, I had the opportunity to evaluate and to recommend an MFOA application for a research grant from the National Science Foundation, the funding of which assisted the Association in the preparation if its "Disclosure Guidelines for Offerings of Securities by State and Local Governments."

Thus, I have felt some satisfaction in the very real progress which the MFOA has made during the past three years in upgrading the quality of disclosure available in the municipal marketplace. In my judgment, the MFOA's Guidelines are the current benchmark for municipal securities disclosure and are a hallmark of the Association's good faith efforts to improve disclosure practices on a voluntary basis.

With some reluctance, however, I have concluded that this approach is not adequate to protect investors and to

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assure fair and efficient municipal markets, and that mandatory, minimum disclosure requirements for municipal issuers are appropriate, are necessary, and are virtually inevitable.

This viewpoint is certainly not an original one. Some interested parties apparently believed that there should have been explicit disclosure requirements for municipal securities, and that the responsibilities and liabilities of major participants in the municipal securities underwriting process, should have been established when Congress adopted the Securities Act of 1933. In a 1959 law review article, one of the principal draftsmen of the 1933 Act wrote that: "Municipal bonds, which we sought to include in our original draft, were made exempt for obvious political reasons."

Whatever the reasons, the exempting of municipal securities from the registration requirements of the Securities Act may have been justified in 1933. Although there were thousands of municipal bond defaults in the early Thirties, it could be argued that municipal bonds were generally sold to financial institutions and wealthy, sophisticated investors, who did not need the protection afforded by the full and fair disclosure requirements of the securities laws. During the past 44 years there has been a gradual, but significant, change in the nature of the municipal securities marketplace. The types, amounts, and purposes of municipal bonds have changed. And, perhaps most importantly, because of inflation and tax laws, the types of persons investing in municipal securities have also changed. Particularly during the past decade, municipal bonds in relatively small denominations have been directly marketed to unsophisticated investors, who often have not had access to meaningful information regarding the municipal issuer or its securities.

Changes in the municipal marketplace, however, do not necessarily justify federal legislation. In fact, many well respected individuals are convinced that market forces and the widespread acceptance of the MFOA's Guidelines, supplemented by the SEC's current anti-fraud powers, provide adequate protection for the investing public. This conviction is buttressed by views, such as those of the MFOA's present General Counsel, that most courts would find a violation of the anti-fraud provisions of the securities laws whenever relevant material information suggested in the Guidelines has not been provided. I can readily agree that these factors have a strong beneficial influence on municipal markets, but I cannot agree that they provide adequate protection.

The SEC does possess formidable enforcement tools with respect to municipal securities by virtue of the anti-fraud provisions of the federal securities laws. For example, Section 17(a) of the Securities Act states:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly--

> (1) to employ <u>any</u> device, scheme or artifice to defraud, or
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> (2) to obtain money or property by means of <u>any</u> untrue statement of a material fact or <u>any</u> omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (3) to engage in <u>any</u> transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser. (emphasis added)

This is an extremely broad provision which, in the Commission's view, is not subject to the Supreme Court's <u>Hochfelder</u> decision, irrespective of whether courts may rule that <u>Hochfelder</u> requires a showing of <u>scienter</u> in Commission injunctive actions or administrative proceedings brought under Rule 10b-5.

There are, however, several weaknesses in any program which relies exclusively on generic anti-fraud provisions for compliance. The major foible with such an approach is that its effectiveness depends on enforcement actions after violations have been committed and the investing public has already been harmed. Another undesirable aspect of a pure anti-fraud approach is that all persons violating these provisions, from the con artist deliberately issuing phony industrial revenue bonds to the possibly well intended, but neglectful public official who omits a material fact from an official statement, are categorized as having defrauded the investing public. Still another recurring objection raised by those to whom the generic anti-fraud provisions apply is that they are too vague and do not offer specific guidance.

By their very nature, voluntary disclosure guidelines also have serious defects. As stated in its Preface, the MFOA Guidelines:

> . . . are suggestions of information which may be discussed in offerings of municipal securities. These guidelines are not intended to be legally binding. Rather, they represent information that usually should be included in official statements because it would be relevant to investors on most occasions for most issues. (emphasis added)

On its face, this Preface makes it quite clear that in some instances the Guidelines may not be applicable. This problem is compounded by the fact that even in situations where the suggested disclosure Guidelines are applicable, there will not be universal compliance. Progressive and enlightened municipal issuers, which probably includes the vast majority of municipalities, will comply fully with the Guidelines because they are not burdensome or are a necessary burden far outweighed by the benefits of disclosure. Unfortunately, when it appears not to be in their best interest to disclose certain negative facts, some issuers will not comply with the Guidelines or will comply only superficially. Because there are no explicit legal responsibilities or liabilities imposed on the access points to municipal markets, such as underwriters, accountants, financial advisers, bond counsel and others, there will continue to be marginal institutions and individuals who together with municipal issuers will take unfair advantage of the investing public. Moreover, because of the lack of a legal point of reference, all municipal issuers will be subject to more volatile disclosure demands depending on the prevailing attitude in the marketplace and the desire of underwriters to protect themselves from poorly defined liability to investors. The impact of the New York City crisis on totally unrelated municipal issuers was ample evidence of this fact.

In my opinion, these deficiencies can be alleviated by federal disclosure legislation which can and should be drafted in a manner to avoid federal interference with the ability of municipal governments to determine how and when to issue securities. Such federal disclosure legislation need not change behavioral patterns for the vast majority of issuers, but should establish minimum required standards of acceptable disclosure to protect the public and the municipal markets themselves from abuses by a minority of municipal issuers.

The enactment of mandatory disclosure requirements would establish meaningful guidance for all municipal issuers and would provide for comparable information to all investors. The development of various guidelines and other activities by the MFOA certainly provide some guidance for issuers. But until there are mandatory disclosure requirements, including a requirement that financial statements be certified in accordance with applicable generally accepted accounting principles, there will not be truly comparable information on which investment decisions can be made.

One point of comparison, which apparently is relied on heavily by investors, is the rating received from rating agencies. The Twentieth Century Fund's 1974 report, entitled "The Rating Game," concludes that "[r]atings have become the great common denominator of the municipal bond market," but sets forth some of the problems which may be involved in such ratings. Regardless of whether the conclusions of that report are valid, a mechanism whereby a municipal issuer pays a rating agency and supplies it with information, and the rating agency disclaims legal responsibility for its rating, leaves something to be desired. While this system has served the marketplace relatively well in the past, there have been some notable exceptions and there clearly is room for improvement. In any event, a rating can never be an adequate substitute for full and fair disclosure. All persons, including financial institutions and fiduciaries who invest considerable funds in municipal securities, should have access to full and fair disclosure documents as well as ratings prepared on the basis of accurate and comparable financial and other data.

Such a result could be facilitated through the enactment of legislation patterned after recommendations discussed and tentatively approved by the Commission last February as a "high priority" item on our legislative agenda.

Our recommendations were transmitted to various Congressional leaders who requested our views, and our staff has had several discussions with Congressional committee staff members. Following the release in August of the SEC Staff Report on Transactions in Securities of the City of New York, there appeared to be renewed interest in municipal securities disclosure legislation. As of this date, however, legislation of the type the Commission recommended has not been introduced.

This fact is indicative of the importance and difficulty of the issues involved. In all candor, it may also reflect softness in the support for such legislation. It is my current understanding that proposed legislation will be introduced before the close of this Congressional session and that hearings will be held next year. The bill or bills to be introduced will, of course, reflect the best judgment of the Congressional leaders sponsoring such legislation, and will not necessarily embody the type of provisions I am advocating.

In my opinion, the current statutory pattern of the Securities Act of 1933, wherein municipal securities are exempted from the registration provisions of Section 5 but subject to the generic anti-fraud provisions of Section 17, should be kept intact with one notable exception. Because industrial revenue bonds are payable, in whole or in major part, from revenues received by a governmental entity under the terms of a contractual agreement with a private enterprise and generally do not have the backing of the credit and taxing power of the governmental issuer, I believe such bonds should be subjected to the full registration requirements of the Securities Act, including pre-offering review by the SEC, as well as the periodic reporting requirements of the Securities Exchange Act of 1934. Moreover, disclosure with respect to industrial enterprises is an area in which the SEC's staff has experience and expertise, and thus might make a significant contribution through comments on proposed disclosure documents. While I recognize the strong regional support for this type of financing, the growing numbers of industrial development bond frauds and defaults have had an adverse impact on other industrial development bonds, as well as the entire municipal marketplace, and demonstrate the critical need for more meaningful federal protection of investors in this area.

The major thrust of the SEC's recommended legislation could be accomplished by adding a new section to the Securities Exchange Act of 1934. Just as in the Municipal Securities Full Disclosure Bills introduced in 1976 by Senators Williams and Tower and by Congressman Murphy, there would be specific requirements for annual reports and reports of events of default by certain municipal issuers and for distribution documents in connection with offerings by certain municipal issuers. These requirements would not mandate any filing with the SEC and would not involve any preoffering review by the

Commission. However, the Commission would have the rulemaking power to adopt additional similar disclosure requirements or to exempt some or all municipal issuers from the specified statutory disclosure requirements. While this residual rulemaking authority may be perceived as a threat to municipal issuers, my experience as a staff member of the Senate committee with other legislation that did not include authority for administrative flexibility, is that the rigidities are detrimental either immediately or eventually to those who are subject to the legislation. Thus, it is essential for the Commission to have the flexibility to deal with novel disclosure issues and to relieve municipal issuers of disclosure burdens which prove to be unnecessary.

One significant difference between the 1976 bills and our recommendations is with respect to the scope of the exemptions. The previous bills contained exemptions from the distribution statement requirements for all issues under five million dollars and for those issues approved by state governmental authorities, such as the North Carolina Local Government Commission. Inasmuch as four-fifths of the GO issues and two-thirds of the IDB issues are less than five million dollars, that threshold exemption should be deleted. Assuming the SEC would have appropriate classification powers with respect to the municipal disclosure requirements, I am confident that the Commission would tailor appropriate requirements for small issuers. The state approval exemption, in my opinion, should be refined to exempt only those issues that are subject to state laws providing substantially the same type of investor protection as would be provided by the new federal statute.

The most significant, and probably most controversial, change from the 1976 bills would be the addition of explicit liability provisions which effectively articulate the responsibilities of participants in the municipal securities underwriting process. Our recommendations would establish clear limits of liability for municipal underwriters and others, as well as a statute of limitations for the filing of lawsuits. The primary model for the Commission's liability provisions is, of course, Section 11 of the Securities Act. One significant revision, however, would be not to subject issuers to absolute liability, but permit them to assert the traditional underwriters' defense that the municipal issuer "had, after reasonable investigation, reasonable ground to believe and did believe" that the official statement was true and there were no material omissions of fact. Another significant change, which was not addressed in the Commission's recommended approach, might be the inclusion of some special provisions with respect to the imposition of due diligence responsibilities on underwriters in competitively bid offerings. While it may be impracticable for an underwriter in such offerings to fulfill the same due diligence responsibilities as in a negotiated transaction, I believe that some person independent of the municipal issuer should have the same due diligence responsibilities. Public investors should not have less protection just because a municipal issuer is required to, or voluntarily decides to, sell its securities through competitive bidding.

I hope that meaningful legislation, containing at least the essential elements of specific disclosure requirements with respect to municipal securities and explicit liability provisions with respect to municipal securities underwriting, will be introduced and seriously considered. At the public hearings on such proposed legislation, I anticipate that the Commission and other interested persons will strongly support the right of public investors to full and fair disclosure about the financial condition and the operations of municipal issuers. No doubt other witnesses will argue that Congress has not only the right--but in fact the obligation--to impose minimum disclosure standards, including certified financial statements, on all municipalities which are receiving funding under the federal government's revenue sharing plans.

Nevertheless, I am not particularly sanguine that federal legislation will be enacted during 1978, an election year. In 1933, municipal securities may have been exempted from the Securities Act for "obvious political reasons." In 1946, an SEC rule proposal, which would have affected the trading of municipal securities, was withdrawn after Congressional hearings in 1945 and 1946 on legislation designed to curtail the SEC's rulemaking authority under certain anti-fraud provisions. Just this year, the Massachusetts legislature passed a meaningful municipal disclosure bill which was subsequently recalled and emasculated as the result of pressure from local governmental organizations and others. These experiences are evidence that the MFOA and the other sponsoring organizations of these colloquia have tremendous political influence and may well have the capability to block temporarily any federal disclosure legislation with respect to municipal securities.

Although the immediate prospects for municipal securities full disclosure legislation may not be very bright, I am convinced that it is an idea whose time has come. While there is no truth in allegations that the Commission is orchestrating its activities in order to demonstrate the need for federal legislation, we have actively carried out, and will continue to carry out, our enforcement responsibilities under the federal securities laws. The handful of enforcement cases which the SEC has brought to date may not present a compelling basis for additional legislation. However, to the extent these few cases and future cases are symptomatic of problems in a relevant segment of municipal issues, federal disclosure legislation for municipal issuers may be long overdue.

Of course, the SEC is not the only impetus for municipal disclosure legislation. The average citizen may not be interested in such arcane and esoteric topics as municipal accounting, but municipal employees and their unions should be extremely interested in specific aspects of municipal accounting such as the treatment of unfunded municipal pensions. Certainly, the press, academia, the accounting profession and other interested persons and groups are able to recognize the gimmicks and other accounting abuses which have been employed by some municipalities. And you know far better than I, that all citizens are vitally concerned with escalating taxes and deteriorating services.

As surely as the night follows day, there will be local, regional and national officials, as well as those seeking political office, who will assert that municipal officers are accountable not only to their electorate, but also to all citizens in our country from whom municipalities borrow funds and on whom municipalities rely for revenues. In the event municipal disclosure legislation becomes a political issue, I anticipate that the average citizen will question what actual burdens are imposed by federal legislation if the MFOA Guidelines are already being followed. The average citizen may also suspect that real problems are being covered up if mandatory guidelines are vehemently opposed by municipal finance officers.

Because of its prestige and power, the MFOA is now in a position to help fashion appropriate legislation containing mandatory minimum municipal disclosure requirements. Such legislation may impose new costs on some municipal issuers, but it will foster increased investor confidence and better municipal markets which should result in all municipal issuers receiving interest rates more commensurate with their creditworthiness.

I challenge the MFOA to continue its recent efforts to upgrade the quality of municipal disclosure by supporting appropriate federal legislation. I thank you.