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THE CHANGING SCENE FOR MUNICIPAL SECURITIES

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THE CHANGING SCENE FOR MUNICIPAL SECURITIES

by A. A. Sommer, Jr.*

It may seem ironic that at a time when there is so much talk about deregulation, the desirability of lessening the government's interference in economic processes and the substitution of market forces for government forces, we seem to be witnessing a major advance of the federal government into one of the largest securities markets in the country, namely, that for municipal securities. Numbered among those who are strongly advocating federal legislation to govern more closely what governmental units disclose and how they disclose it, are many who have been the most ardent and articulate opponents of regulation and proponents of reduced emphasis by the federal government upon economic regulation. It may well be that this phenomenon, posing as it appears to, an ideology in conflict with a pragmatic problem, can give us some clues about what is useful regulation, what deregulation means and to what extent lessened government interference in the economy is necessary and consistent with the preservation of public good.

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Most reform in society seems to come about as the consequence of a crisis or a catastrophe or a dramatic event which points up the existence of a problem. This is not to deny that sometimes pressures for reform come about as a consequence of a gradually growing felt need by people, or because of a book, or because of a more enlightened awareness of what will serve the society's needs. But generally it takes a dramatic event to focus the public's thoughts on a problem. And that is precisely what happened with regard to municipal securities.

A little history might be helpful in putting current events in perspective. When Congress determined in 1933 to exempt municipal securities from the registration requirements of the Securities Act of 1933, one of the reasons for granting the exemption was the belief that the principal purchasers of such securities were institutions which could well protect themselves against the dangers of fraud without having the protections of the registration provisions applicable to municipal securities. The other prime reason the Congress determined close regulation of municipal securities was unwarranted was the belief, based upon the experience until then, that municipal securities were relatively safe, that defaults were infrequent, and that fraud was a rarely, if ever, present circumstance in the market for municipal securities. I would also suspect that there was in 1933 and 1934, some notion on the part of Congress that since these securities were issued by states or subdivisions of states, it was inappropriate for the federal government to regulate them or their method of distribution. In those days unquestionably we were likelier to be concerned about states' rights than we are today.

In recent years the first basis for the exemption has steadily eroded as more and more municipal securities were sold to individual investors. This may have been a consequence of the fact that inflationary forces pushed more people into higher brackets where securing the benefits of tax-free income became desirable. For a number of reasons such investments may have seemed less attractive to traditional purchasers. The other belief, that municipal securities markets were rarely, if ever, tainted with fraud, continued to be widely held.

However, during the late sixties and the early years of this decade, abuses began to appear in the municipal securities markets. They were seen in the activities of some of the dealers who were engaged in the business. The Commission found evidences of innumerable kinds of illegal activity: big mark-ups over cost, misrepresentations with regard to the characteristics of the securities, churning of accounts in municipal securities -

activities which, with respect to corporate securities, in large measure brought about the federal securities legislation in the thirties. The Commission responded to this situation by bringing a few cases directed against these erring dealers under the antifraud provisions of the federal securities laws. The Commission's cases and the public awareness, growing steadily, that abuses existed in the marketing of municipal securities led to alarm on the part of legitimate dealers at the fouling of their nest by questionable operators. Thus several years ago, the Securities Industry Association began addressing itself to this problem and what should be done about it.

Recognizing the difficulties of self-regulation, Senator Harrison J. Williams became interested in the subject and, beginning in 1972, began to press for a legislative solution to the problems which had been uncovered. Inasmuch as it appeared that the principal abuses with respect to municipal securities occurred at the broker and dealer level, the focus of attention as the legislation developed was on the most appropriate means of regulating those participants in the market. The municipal finance officers very successfully kept out of the legislation anything which might give the Commission power to require the filing of any documents with it or otherwise regulate the activities of municipalities.

Thus the Securities Act Amendments of 1975 provided for the registration of municipal securities dealers, regardless of whether they were banks or securities dealers, and created a Municipal Securities Rulemaking Board which would, subject to oversight by the Commission, have the power to make rules which would govern the market for municipal securities. This Board was specifically told that it was not to adopt any rules concerning the disclosures to be made by municipalities, either to underwriters, dealers or the public.

Another characteristic of this legislation should be noted. The municipal securities industry has been characterized by the presence of members of two larger industries in it, namely, the banking industry and the securities industry. Not surprisingly each of these groups was reluctant to be placed under the regulatory supervision of the authorities in the other area; thus the non-bank dealers did not want to be regulated by banking authorities, and the banks did not want to be regulated by securities authorities, notably the SEC. Thus a large part of the argument that preceded enactment of this legislation was over the question of how the balance of regulation should be accomplished. In what may seem to some as an awkward compromise, but nonetheless has some dimension of ingenuity, it was determined that the prime regulator with regard to the members of the municipal securities industry which were not banks would be the SEC, with the provision, however, that the Commission could, upon notification to and consultation with the appropriate bank regulatory authority, undertake investigations of bank members of the industry. Furthermore, while the Municipal Securities Rulemaking Board is made up of equal numbers of members from the banking industry, the non-bank part of the industry and the public, nonetheless, the sole governmental authority which passes upon its rules is the SEC. Thus, in some measure each of the groups is regulated by the regulators with respect to whom it is comfortable and with whom it has had historic relations. At the same time, a uniformity of regulation is assured by providing that the Commission have ultimate examination and enforcement powers with regard to all participants in the industry and that a single government entity make appropriate determinations with regard to the work product of the Municipal Securities Rulemaking Board.

This legislation had not even been enacted before its inadequacies began to appear. As the legislative process ground on, the financial plight of New York City began to claim headlines. Not only did it appear that New York had been living beyond its means and that drastic measures were going to be required to restore financial soundness to the City, but there emerged disquieting indications that perhaps inadequate information had been supplied to citizens and investors alike. This led to two predictable consequences. First, the Commission, whose mandate to protect investors since 1933 has, at least as far as fraud is concerned, not been limited to conventional stocks and bonds, began to examine whether, in pursuit of that mandate, it should commence an investigation of recent offerings of the City of New York. After extremely careful consideration of all the factors which go into our determinations with regard to the commencement of formal investigations, and after giving particularly careful attention to the impact such a suit might have upon the efforts of the City to straigten out its affairs, the Commission concluded there was no way to escape its responsibility to investigate the situation. Thus on January 5, 1976, the Commission voted a formal order of investigation. Recognizing the sensitivity of the New York problem, the Commission departed from its usual practice and made a public statement announcing the investigation. In part this was done to forestall the development of rumors, gossip and unfounded speculation. In that release, the Commission indicated that, having departed from past practice by making an announcement, it did not expect to make further announcements with regard to the progress of the investigation until it was complete - and that still is the intention of the Commission.

The second consequence of the worsening New York plight was, as one surely would expect, a high level of interest in Congress about the impact of New York City's problem, not only upon the residents of that city, but upon states and communities throughout the country. Congress therefore first addressed the question of how to deal with possible defaults and bankruptcy by municipalities. When the Administration relented with respect to its refusal to commit federal funds to ease the City's crisis, Congress quickly adopted legislation necessary to carry out the federal program.

In a third area of endeavor, some of those in Congress began to question the desirability of the continued exemption of municipalities and municipal securities from the registration and reporting requirements of the 1933 and the 1934 Acts. Late last year Senator Thomas Eagleton introduced in the Senate a bill which was remarkable principally for its simplicity: it would simply have removed the exemption for municipal securities from the 1933 and 1934 Acts. This simple expedient would have had vast and troublesome consequences. Depending upon how the Commission exercised its exemptive powers under the bill, it would have resulted in the filing of over 8,000 additional registration statements a year and might result, again depending upon how the exemptive power was used, in over 40,000 governmental units filing annual and periodic reports with the Commission. Needless to say, this blizzard of paper would have inundated the Commission and, unless substantial additional people were hired, placed the entire disclosure system administered by the Commission under tremendous and perhaps disastrous pressure.

Beyond the burdens which such a piece of legislation would impose upon the Commission, I would suggest that the costs of such a program would far exceed the benefits that would be derived from it. Without minimizing in any way the seriousness of the New York City problem, or the hardships which have been imposed upon some holders of New York City securities by the moratorium that was decreed by the New York legislature, it is very difficult to find in the history of municipal financing evidences of widescale fraud and deceit such as existed in the corporate world prior to 1933 and at which the Securities Act of 1933 and the Securities Exchange Act of 1934 were aimed. There have been defaults by municipalities, particularly during the depression, and yet, in virtually every instance, the investors ultimately were made whole. Beyond that, it is difficult to find evidences that investors in municipal securities have in any measureable numbers lost money because of fraud committed by municipalities in marketing securities. Thus, indeed, to use a well-worn simile, the Eagleton legislation would have used a cannon to kill a fly. Unless sufficient additional money was appropriated by the Congress to permit the orderly processing of the filings with respect to municipal securities, the Commission would be under an obligation to allocate some of its present resources to that review process, with the result that the attention given to corporate filings, where the potentials of fraud are significantly higher than in the case of municipal securities, would be correspondingly reduced.

Happily, a more conservative, and in my estimation, more constructive approach has been emerging in the Congress. At the behest of Senators Williams and Tower, the Commission's staff has drafted legislation that would go far to thwart inadequate disclosure by municipalities to potential investors without burdening the Commission unduly. Under this legislation, any issuer of municipal securities proposing to make an offer of $5 million or more through a municipalities broker or dealer or bank acting as agent would be required to prepare and make available to dealers and others a "distribution statement" setting forth the information specified in the statute. This statement would not have to be processed or reviewed by or even filed with, the Commission, as is done with registration statements under the Securities Act of 1933, but would simply be made available to designated persons. Obviously, there are difficult problems here, particularly since a large amount of municipal financing is done by competitive bidding. However, the registration provisions of the 1933 Act have not proven a significant barrier to competitive bidding in the utility field and it is doubtful whether they would be such in this case.

In addition to these provisions pertaining to the distribution of municipal securities, the legislation would also require any issuer of municipal securities with more than $50,000,000 of such securities outstanding to file an annual report containing information specified in the bill as well as such "similar and specified" information as the Commission may require. Also an issuer would have to prepare a report of an event of default in accordance with such rules and regulations as the Commission may prescribe. These annual and default reports would have to be furnished free to any holder of the unit's securities who requested them and to others at their expense and would have to be maintained at a location in accordance with rules and regulations of the Commission. The Commission is given the power to contract for a central repository where all such reports would have to be filed.

This legislation seeks to deal with the liability of underwriters of municipal securities through a provision like that in the Securities Act of 1933 which limits the liability of an underwriter to the total price at which it offered the securities to the public.

A major characteristic of this proposal is that just as filings by corporate issuers must contain certified financial statements, so for fiscal years commencing on or after December 31, 1978, financial statements required to be included in distribution statements or reports would have to be audited by an independent public or certified accounting.

Under the proposed legislation the Commission is given the power to adjust the thresholds of disclosure - i.e., the five million and the fifty million dollar figures which determine the offering sizes and the amounts of outstanding securities which trigger the disclosure requirements. In submitting the proposed legislation to Senators Williams and Tower the Commission remarked that these limits were arbitrary, that the Commission had no basis upon which to recommend them, and that it hoped that during the course of the legislative process information would be forthcoming to indicate what should be the proper limits.

The proposed legislation would relieve issuers of the obligation to prepare and provide a disclosure document in connection with an offering if the disclosure had been approved, after hearing, as adequate for the protection of investors by a State governmental authority (other than the issuer itself) expressly authorized by law to grant such approval. It is uncertain how many states, if any, presently have laws which would provide the basis for this exemption; in fact, the law of North Carolina, which is generally acknowledged to be the most advanced from the standpoint of efforts by a state to police the quality of municipal disclosure, is thought by some to fall short of the requirements of this provision. It may well be that, if this provision is in the law as finally enacted, states will seek to bring their law into conformity, as was done with respect to insurance companies after the 1964 amendments to the Securities Exchange Act.

There are many issues to be confronted before this legislation is finally enacted. For one thing, the proposal contains no specific provisions for remedies; apparently the thought is that the remedies already provided for in the 1934 Act will suffice. I think there is considerable doubt whether that is enough. It may well be that provisions akin to Section 11 of the 1933 Act which spell out standards of care, the liabilities of the various parties to the distribution process, the statute of limitations and other particulars of private proceedings for redress of violations of the registration provisions of the statute should be added.

As frequently happens, there would be significant side-effects associated with such legislation as this. The Commission has as its thrust, as does this legislation, the protection of investors. However, unquestionably one of the collateral consequences of the enactment of this legislation, if that comes to pass, would be that voters and citizens of the states and communities which become subject to the legislation will be far better protected than they have been in the past. They would have assurances much stronger than those that existed before that the full facts with regard to the financial status of their communities had been disclosed. These assurances would flow from the requirements of federal law, the dangers of federal liability for violating its provisions on the part of those with responsibility for the finances of communities, and the increased watchfulness of the authorities responsible for administering the law. Hopefully, with this new opportunity for vigilance on the part of voters, other communities would be able to avoid the slide that we have witnessed in New York. As the financial information available became more credible, more widely disseminated, more thoroughly scrutinized, communities would be better able to sense the development of financial problems earlier and take measures to avoid their ever reaching a crisis level.

As the result of the events which I have been discussing, there are major changes already happening in the world of municipal securities. Unquestionably, underwriters of such securities and dealers in them are exercising a higher degree of vigilance; they are demanding more information and they are developing procedures to test the credibility of such information. In response to this, municipalities realize that to get to market with their securities they must provide more information and must take measures to assure that it will be believable. As a result, we have seen clear evidence of a substantial upgrading of the quality of information emanating from governmental sources. In some cases, municipalities which had been able to get to market without trouble in the past, found themselves without bidders or with too small a group of bidders to permit the financing to go forward. In those cases, they have quickly developed the data necessary to permit a re-entry into the market.

This renewed attention by securities dealers and others in the municipal securities market to the necessities of full disclosure is of course extremely healthy and it is well that it is happening. Particularly is this so since it is by no means assured that any legislation in this area will be forthcoming during the present session of Congress. As everyone knows, there is a tremendous legislative load on Congress and as we grow closer to the election, Senators and Representatives will be more and more distracted by the necessities of election. Whether a sufficient crisis atmosphere will continue to attend this proposal, and thus make likely its enactment, it is difficult to say. I have spoken with some who rate the chances of enactment this term as very remote. However, the Commission feels that legislation of this sort is extremely important and should receive careful and prompt attention in both Houses of Congress.

However, the Commission, as has become evident in recent weeks, believes it is not without resources under existing law. While some doubts have been expressed concerning the power of the Commission to bring actions against municipalities, it appears to me that that power is surely with us. Thus we have the power to investigate situations in which it appears there may have been violations of the antifraud provisions of the laws we administer, and if we believe such are found, to bring appropriate actions. The Commission has used this power sparingly; in fact, no municipality or other state authority has ever been sued by the Commission under these provisions. But, no matter how dormant that power may have been, the Commission has it and would in appropriate circumstances not hesitate to use it.

In saying these things it is not my purpose to spread doom and gloom. Rather, I think a frank recognition by everyone of the deficiencies of municipal disclosure in the past and the necessity of remedying those deficiencies in the future, and the prudent use of governmental power where appropriate, is healthy and good for the American society.

Now how does all this jibe with deregulation? It seems to me that it demonstrates one facet of deregulation - maybe two. First, I do not think that deregulation entails or demands a turning away from governmental action when a clear danger to the well being of our society appears - and I think there was a clear danger to a major financial market, a danger which may have abated somewhat, but which still exists in many quarters. Deregulation does not demand that protection of the public be exclusively vested in the competitive forces of the marketplace. When those forces have not provided a sufficient protection then I think it is thoroughly proper for the government to intervene to remedy the deficiencies of those forces.

However, I think the proposed legislation is in another way consistent with notions of deregulation. Instead of requiring the expenditure of substantial public funds to review and comment upon filings, the proposed legislation is leaving the determination of the integrity, credibility and accuracy of the information provided by municipalities to a combination of market forces, private litigation, where appropriate, and occasional government intervention if it appears that fraud has been committed or is about to be committed.

One final aspect of this problem, I think, deserves comment. As you probably know, the Commission recently authorized an intensive and extensive study of corporate disclosure with an eye to looking at the profoundest and most troublesome questions in that area. There have been those who have contended that the disclosure mandates administered by the Commission are superfluous, that the forces of free competition will cause corporations to make adequate disclosure, that the cumbersome mechanisms of the SEC and state authorities are unnecessary in order to provide investors with adequate information. I would suggest that the clearest evidence that such is not the case has been what we now know about the municipal securities market. We realize now that much vital information has been lacking there and that some of the information available has been of questionable credibility. More profoundly we know that market forces have not been sufficient to assure that the information becomes available. Thus I would suggest that this experience may be of great significance in putting to rest some of the more extreme suggestions that have been made with regard to the role of government in the disclosure process.

Out of every crisis, I think there emerges change and in most, perhaps not all cases, a change that serves the public good. I am hopeful that our experience with reform in the area of municipal disclosure will be another instance of crisis fostering constructive change.