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MANDATING DISCLOSURE IN MUNICIPAL SECURITIES ISSUES: PROPOSED NEW YORK LEGISLATION

*Thomas S. Currier**

I. Introduction

When the federal securities laws were passed in the early 1930's, issuers and other participants in the distribution and trading of municipal securities[1] were exempted[2] from all but the general antifraud provisions.[3] While one of the principal draftsmen of the Securities Act explained this exemption as resulting from "obvious political reasons,"[4] testimony before Congress revealed economic[5] and other policy[6] justifications for the "hands-off"[7] approach adopted by

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1. "Municipal securities" are defined in section 3(a)(29) of the Securities Exchange Act of 1934 (hereinafter "the Securities Exchange Act"), 15 U.S.C. § 78c(a)(29) (Supp. 1978), as:

> [S]ecurities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of one or more States, or any security which is an industrial development bond . . . [which qualifies under certain provisions of the Internal Revenue Code].

2. Section 3(a)(2) of the Securities Act of 1933 (hereinafter "the Securities Act"), 15 U.S.C. § 77c(a)(2) (1970); section 3(a)(12) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(12) (1970).

3. Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a) (1970); sections 10(b) and 15(c) of the Securities Exchange Act, 15 U.S.C §§ 78j(b), 78o(c) (1970), and rules 10b-5 and 15c1-2 thereunder, 17 C.F.R. §§ 240.10b-5, 240.15c1-2 (1978).

4. Landis, *The Legislative History of the Securities Act of 1933,* 28 GEO. WASH. L. REV. 29, 39 (1959).

5. It was feared that the imposition of capital requirements on underwriters, the separation of broker and dealer functions, the costs of independent auditing of municipal finances, and dealer commitment requirements and underwriter and dealer investigatory duties that failed to consider the competitive bidding procedures mandated for most municipal issuers would burden the municipal finance industry generally, impair the marketability of municipal bonds and hinder efforts of municipalities to raise public capital. *See Stock Exchange Practices: Hearings on S.R. 84, S.R.56 & S.R. 97 Before the Senate Comm. on Banking and Currency,* 73d Cong., 2d Sess. (1934); *Hearings on H.R. 7852 & H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce,* 73d Cong., 2d Sess. (1934).

6. Proponents of exemption pointed to (a) the sophistication of most municipal securities investors, (b) the general confidence in the trustworthiness of municipal securities, (c) the absence of any evidence of abuse in the sale or trading of municipal securities comparable to that found in the corporate securities markets and (d) possible constitutional problems of

the Congress. Over the next forty years, however, the mushrooming volume of municipal securities issues[8] and increasing entry of non-institutional investors in that market,[9] coupled with growing evidence of sale and trading abuses by brokers and dealers,[10] led Congress to amend the Securities Exchange Act in 1975.[11] These amendments provide for registration of brokers and dealers, including banks, of municipal securities with the Securities and Exchange Commission (hereinafter "the Commission") and for self-regulation, through the mechanism of a Municipal Securities Rule-making Board empowered to promulgate rules of general applicability pertaining to municipal securities professionals' qualifications, internal practices and business conduct.[12] These rules are enforced by the Commission through administrative and judicial proceedings.

In the 1975 amendments Congress did not end the exemption from Securities Act registration or otherwise mandate disclosures of material investment information by issuers of municipal securities.[13] Nevertheless, the contemporaneous near-default of New York

federal regulation of state and municipal governmental entities. *See* note 5 *supra;* H. R. REP. No. 8, 73d Cong., 1st Sess. (1933); *Hearings on S. 873 Before the Senate Comm. on Banking and Currency,* 73d Cong., 1st Sess. (1933).

7. *See generally* Note, *Municipal Bonds and the Federal Securities Laws: The Results of Forty Years of Indirect Regulations,* 28 VAND. L. REV. 561, 582-86 (1975).

8. *Proposed Amendments to the Securities Exchange Act of 1934: Hearings on S. 2574 & S. 2969 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs,* 94th Cong., 2d Sess. 45 (1976) (statement of H. Kapnick).

9. *Id.* at 27 (statement of R. Hills). *See* Dikeman, *The Municipal Securities Rulemaking Board: A New Concept of Self-Regulation,* 29 VAND. L. REV. 903, 908 (1976).

10. *See* text accompanying notes 36-45 *infra.*

11. Pub. L. No. 94-29, 89 Stat. 97 (codified in scattered subsections of 15 U.S.C. § 78 (Supp. 1978)).

12. *See* text accompanying notes 46-57 *infra.*

13. The "Tower Amendments," section 15B(d) of the Securities Exchange Act, 15 U.S.C. § 78o-4(d) (Supp. 1978), provide as follows:

> (1) Neither the Commission nor the Board is authorized under this chapter, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities.
>
> (2)The Board is not authorized under this chapter to require any issuer of municipal securities, directly or indirectly through a municipal securities broker or municipal securities dealer or otherwise, to furnish to the Board or to a prospective purchaser of

City[14] and the ensuing investigation by the Commission,[15] as well as severe financial difficulties experienced by other municipal issuers[16] have spawned renewed controversy. The Municipal Finance Officers Association proposed disclosure guidelines for offerings of municipal securities in 1976.[17] Additionally, bills were introduced in the

such securities any application, report, document, or information with respect to such issuer: *Provided, however,* That the Board may require municipal securities brokers and municipal securities dealers to furnish to the Board or purchasers or prospective purchasers of municipal securities applications, reports, documents, and information with respect to the issuer thereof which is generally available from a source other than such issuer. Nothing in this paragraph shall be construed to impair or limit the power of the Commission under any provision of this chapter.

14. In the early 1960's, the City of New York ("the city") began to have annual budget deficits. These deficits were financed by deficit borrowing. The city first drained its "rainy day fund" and periodically relieved itself of the obligation to replenish it. Shortly thereafter short-term budget notes and, beginning in 1965, revenue anticipation notes were issued. State legislation was passed broadening the categories of expected revenues against which these anticipation notes could be issued. N.Y. LOCAL FIN. LAW §§ 25.00(c)(2), 25.00(d)(3) (McKinney Supp. 1978). The city also issued tax anticipation notes which, when anticipated real estate taxes were not collected, were rolled over. Nor was the city's deficit financing restricted to short-term borrowing. By 1970 the city had begun to include current expenses in its capital budget financed by longer term bonds. In 1975 asmuch as one-half of the capital budget was used to finance operations. During this time overall debt limits were evaded by arrangements with Mitchell-Lama housing projects and public benefit corporations whose debt issues were not counted against city limits.

By late 1975 the City was on the brink of default. In June of 1975 the State Legislature created the Municipal Assistance Corporation, a state instrumentality, to assist the City by exchanging its securities for those of the city. N.Y. PUB. AUTH. LAW §§ 3030-3040 (McKinney Supp. 1978). Exchange offers were made in November 1975 and again in May 1976. However, the city's slide to default continued. In November 1975 the State passed moratorium legislation permitting the city to suspend payments for three years on its short-term notes. New York State Emergency Moratorium Act for the City of New York, 1975 N.Y. Laws, ch. 874, *as amended by* 1976 N.Y. Laws, ch. 875 at 22-26. However, this legislation was subsequently found unconstitutional in Flushing Nat'l Bank v. Municipal Assisttance Corp., 40 N.Y.2d 731, 358 N.E.2d 848, 390 N.Y.S.2d 22 (1976). Debt service payments were resumed in 1977. *See* Committee on Municipal Affairs of the Association of the Bar of the City of New York, *Proposals to Strengthen Local Finance Laws in New York State,* 34 THE RECORD 58, 105-24 (Jan./Feb. 1979, No. 1/2) [hereinafter cited as PROPOSALS]; Comment, *Municipal Bonds: If Default Is Here, Can Disclosure Be Far Behind?*, 41 ALB. L. REV. 545, 546-48 (1977).

15. *SEC Final Report in the Matter of Transactions in the Securities of the City of New York,* [Current] FED. SEC. L. REP. (CCH) ¶ 81,936 (Feb. 5, 1979).

16. *See generally* J. Peterson, *Changing Conditions in the Market for State and Local Government Debt* (prepared for the Joint Economic Committee of Congress) (1976); R. PETTENGIL & J. UPPAL, CAN CITIES SURVIVE? (1974).

17. Municipal Finance Officers Association, *Disclosure Guidelines for Offerings of Securities by State and Local Governments* (1976) [hereinafter "the MFOA Guidelines"].

Senate and House during 1975 and 1976[18] that would subject municipal issuers to the registration and periodic reporting requirements of the federal securities laws by deleting the exemption of municipal securities provided in section 3(a)(2) of the Securities Act.[19] A more carefully drawn legislative response sponsored by Senators Williams and Tower[20] in 1976 and reintroduced, as revised, in 1977 by Senators Williams, Proxmire and Javits[21] mandates specific disclosures by issuers of municipal securities prior to an offer or sale and annually thereafter in form and detail and in accordance with accounting standards prescribed by the Commission. Liabilities of participants in the distribution process are patterned after, but not as extensive as, those under the Securities Act.[22] Importantly however, the Commission is not empowered to review disclosure documents or to delay issues. Another bill[23] would remove most industrial development bonds[24] from the separate disclosure and liability provisions of the Williams Bill and subject them, as "conceptually indistinguishable from other corporate debt securities,"[25] to the full requirements of the federal securities laws.

18. S. 2574, 94th Cong., 1st Sess. (1975); H.R. 11044, 94th Cong., 1st Sess. (1975); H.R. 11534, 94th Cong., 2d Sess. (1976).

19. 15 U.S.C. § 77c(a)(2) (1970). The three bills, as introduced by Senator Eagleton and Representative Solarz, each would replace the present section 3(a)(2) exemption with a new section 3(d) empowering the Commission to exempt by rule or regulation municipal securities other than industrial development bonds. Other technical amendments to the Securities Act and the Securities Exchange Act are contained variously in the bills.

20. Municipal Securities Full Disclosure Act of 1976, S. 2969, 94th Cong., 2d Sess. (1976).

21. Municipal Securities Full Disclosure Act of 1977, S. 2339, 95th Cong., 1st Sess. (1977) [hereinafter "the Williams Bill"].

22. Section 11 of the Securities Act, 15 U.S.C. § 77k (1970), imposes civil liability on issuers, directors or partners of issuers, named experts and underwriters for material misstatements or omissions in registration statements filed in connection with distributions of nonexempt securities issues. These liabilities are subject to the defense of (a) knowledge of the purchaser prior to purchase, and (b) the defenses of persons other than the issuer based on "due diligence" in the preparation or investigation of statements in the registration statement.

Section 12, 15 U.S.C. § 77l (1970), permits suit by purchasers against their immediate sellers for (1) violation of the registration and prospectus delivery requirements of section 5, 15 U.S.C. § 77e (1970), or for (2) material untruths or omissions in any written or oral communication of which the seller either knows or should have known, with the burden of proof as to this later issue on the seller.

23. Industrial Development Bond Act, S. 3323, 95th Cong., 2d Sess. (1978).

24. Industrial Development Bonds are defined in note 107 *infra*.

25. 124 CONG. REC., S113388 (daily ed. July 20, 1978).

Against this background the Committee on Municipal Affairs of the Association of the Bar of the City of New York undertook the Local Finance Project to study the debt, budget and disclosure practices of municipalities in New York State. The Committee Report of November, 1978 concluded that state regulation was preferable to federal regulation as provided for in the Senate and House Bills described above and as called for by the Commission in its report on its investigation of New York City. The Committee Report set forth "Proposed Disclosure Legislation."[26] The proposed requirements with respect to financial and other disclosures comprise recommended revisions to New York's Local Finance Law[27] and General Municipal Law[28] in an attempt to construct a comprehensive system of financial disclosure by local government entities within the framework of existing state reporting mechanisms.

The Disclosure Proposals rely on three elements to achieve this goal: (i) a disclosure document (the "Official Statement") to provide investors information in connection with the issuance of obligations by a local entity, (ii) summarized periodic reporting (the "Summary Annual Report"), and (iii) timely independent examination of financial practices and accounts. No civil liabilities are created; rather enforcement and executive authority is vested in the office of the state comptroller. While present state requirements and the voluntary practices of localities already perform, to varying degrees, many of these functions, the Disclosure Proposals are designed to standardize practices in a manner least likely to disrupt or burden governmental operations.

This article will briefly survey the existing mechanisms — primarily stemming from federal law — that currently result in financial disclosure (such as it is) in connection with the offering and sale to the public of securities of New York municipal issuers.[29] As alternative models for regimes of municipal issuer financial disclosure, the MFOA Guidelines, the federal Williams Bill and Industrial Bond Act and New York's Disclosure Proposals will be described

26. PROPOSED FISCAL MONITOR LEGISLATION, *Proposals, supra* note 14, at 101-05 (Reprinted in Appendix C).

27. N.Y. LOCAL FIN. LAW §§ 51.00, 57.00, 60.00 (McKinney Supp. 1978).

28. N.Y. GEN. MUN. LAW §§ 30, 33 (McKinney 1977). Also proposed is a new § 31-a, PROPOSED FISCAL MONITOR LEGISLATION § 3, *Proposals, supra* note 14, at 121.

29. *See* pt. II. *infra*.

and compared.[30] Ultimately this article concludes that, although the isolated purpose of protecting investors in a municipal securities market that is largely national could most effectively be pursued by the imposition of uniform disclosure requirements through federal law, the Disclosure Proposals are not demonstrably inadequate to this purpose, and concludes finally that the intrusion into the affairs of the state and local governments of New York that would accompany the federal law approach makes the enactment of the Disclosure Proposals a far more attractive alternative.[31]

II. Federal Regulation of the Municipal Securities Market

Prior to 1975, only the antifraud provisions of the securities laws were applicable to municipal securities transactions.[32] Section 3(a)(2) of the Securities Act exempts municipal securities from the registration, prospectus delivery and disclosure requirements of that Act. Professionals dealing exclusively in municipal securities were exempted from the registration and financial responsibility requirements of section 15(a)(1)[33] and from the bookkeeping and recordkeeping requirements of section 17 of the Securities Exchange Act,[34] due to the exemption then contained in section 3(a)(12).[35] During this period there was growing evidence of illegal sales practices:

> Perusal of the Commission's complaints . . . reveals a disturbing pattern of professional misconduct by a significant number of broker-dealers. This pattern is characterized by unconscionable mark-ups, churning of customers' accounts, misrepresentations concerning the nature and value of municipal securities, disregard of suitability standards, and scandalous high pressure sales techniques. The selling practices of these firms involved all the characteristics of the classic 'boiler room' operation. These practices are intended to induce hasty investment decisions with respect to securities unfamiliar to potential customers. Furthermore, it appears that certain firms exerted extraordinary pressures on their salesmen to increase sales without regard to the welfare of the firm's customers. In some instances, bonds have been

30. *See* pt. III *infra*.
31. *See* pt. IV *infra*.
32. *See* note 3 *supra*. Sections 11 and 12(1) of the Securities Act, 15 U.S.C. §§ 77k, 77l(1) (1970), do not apply because registration under section 5, 15 U.S.C. § 77e (1970), is not required; section 12(2) of that Act, 15 U.S.C. § 77l(2) (1970), which applies whether or not a registration statement is employed, specifically exempts municipal securities.
33. 15 U.S.C. § 78o(a)(1) (Supp. 1978).
34. 15 U.S.C. § 78q (Supp. 1978).
35. 15 U.S.C. § 78c(a)(12) (1970).

promoted as general obligation bonds of the issuer whereas, in fact, they have been revenue bonds, sometimes in default.[36]

Nevertheless, the Commission was active in bringing actions against defalcating professionals under the "shingle theory"[37] developed under rule 10b-5. For example, in *Walston & Co. and Harrington,*[38] the Commission instituted an administrative proceeding against a registered broker-dealer and its divisional bond manager, alleging that the defendants' conduct violated the antifraud provisions of the securities laws. The broker-dealer and its manager made no independent investigation of the bond issue in question beyond a routine portfolio review, and the only information provided the broker-dealer's securities salesmen was contained in an offering circular adapted by the manager from a prior misleading offering circular issued by the principal underwriter. The salesmen relied on the information given and made recommendations that the bonds were "good" or "high-grade" or "secure" tax-free municipal bonds.

The Commission's decision held that firms participating in an offering and dealers recommending municipal bonds as "good municipal bonds" have a duty "to make diligent inquiry, investigation and disclosure as to material facts relating to the issuer of the securities and bearing on the ability of the issuer to service such bonds."[39] The Commission also held that "dealers offering such bonds to the public [must] 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."[40] Holding that the offering circulars did not

36. SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS S. REP. No. 75, 94th Cong., 1st Sess. 43 (1975).

37. In a variety of circumstances professionals who sell public securities are said to make implicit representations to their customers. The SEC has maintained that "a broker-dealer who goes into business . . . impliedly represents that he will deal fairly and competently with his customers and that he will have an adequate basis for any statements or recommendations which he makes concerning securities." Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir.), *cert. denied,* 321 U.S. 786 (1943). *See also* Berko v. SEC, 316 F.2d 137 (2d Cir. 1963); Kahn v. SEC, 297 F.2d 112 (2d Cir. 1961); Sanders v. John Nuveen & Co., 524 F.2d 1064, 1071 (7th Cir. 1975), *vacated and remanded,* 425 U.S. 929 (1976).

38. [1966-1967 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,474 (1967).

39. *Id.* at 82,944-45.

40. *Id.* at 82,945.

meet this disclosure criterion, the Commission held that the broker-dealer and its manager willfully violated and willfully aided and abetted violations of section 17(a) of the Securities Act and sections 10(b) and 15(c)(1) of the Securities Exchange Act.[41]

In another administrative proceeding[42] the Commission took the position that "[the antifraud] provisions contemplate, at the least, that recommendations of a security made to proposed purchasers shall have a reasonable basis and that they shall be accompanied by disclosure of known or easily ascertainable facts bearing upon the justification for the representations."[43] Additionally, the Commission has taken the position that a broker-dealer who sells a security exempted from the registration requirements of the Securities Act may incur a greater obligation to determine the suitability of the investment because the customer is not afforded the added protection of the registration process.[44] Overall between 1971 and 1975 the Commission brought injunctive actions against seventy-two defendants to halt fraudulent municipal securities practices.[45]

Based on evidence developed in these and other actions, in 1975 Congress determined to subject underwriters and broker-dealers of municipal securities to the full panoply of direct federal regulation.[46] The exemption in section 3(a)(12) of the Securities Exchange Act[47] was narrowed to provide that municipal securities would no longer be deemed "exempt securities" for purposes of the broker-dealer registration requirements and the antifraud provisions relating to the over-the-counter market contained in section 15,[48] the self-regulatory rules of section 15A[49] (except for certain subsections thereof) and inclusion in the nationwide clearance systems provided for in section 17A.[50] All municipal securities dealers, including

41. *Id.* at 82,946.

42. Best Securities, Inc., 39 SEC 931 (1960).

43. *Id.* at 934.

44. SEC Securities Act Release No. 4445, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 22,753 (1962). An extensive discussion of the "suitability" doctrine is set forth in 6 L. LOSS, SECURITIES REGULATION, 3708-27 (Supp. 1969).

45. *See* note 36 *supra*.

46. *See* note 11 *supra*. *See generally* Note, *Legislation: Securities Act Amendments of 1975*, 29 OKLA. L. REV. 462 (1976).

47. 15 U.S.C. § 78c(a)(12) (Supp. 1978).

48. 15 U.S.C. § 78o (Supp. 1978).

49. 15 U.S.C. § 78o-3 (Supp. 1978).

50. 15 U.S.C. § 78q-1 (Supp. 1978).

banks buying and selling other than for their own account,[51] were required to register under section 15B(a)(1).[52] In addition, section 17 of the Securities Exchange Act[53] was amended to provide that records of municipal securities professionals be subject to Commission inspection.

Carried over from section 15A was the concept of a self-regulatory association to which all brokers and dealers would belong. Section 15B(b)(1)[54] established the Municipal Securities Rulemaking Board (hereinafter "the MSRB") and empowered it to adopt rules concerning, among other things, professional qualifications, fair trading, arbitration of claims, form and content of published quotations and recordkeeping practices. To date, the MSRB has adopted a series of Administrative, Definitional and thirty-five General Rules covering much of the ambit of the statutory mandate.[55] Pursuant to rule G-32[56] concerning new issues, a broker or dealer must furnish its customer, at the time the confirmation of sale is sent, a copy of any disclosure statement prepared by the issuer. The Commission is empowered to enforce MSRB rules by order, censure, suspension and revocation of registration.[57]

As a result of the 1975 amendments municipal securities professionals became subject to the full arsenal of the Commission's enforcement powers, including administrative discipline, equitable actions, and possible criminal prosecution. While liability in damages may be limited by the application of the scienter requirement of *Ernst & Ernst v. Hochfelder*[58] to actions brought by private parties, the Supreme Court explicitly left open the question whether

51. Section 3(a)(30) of the Securities Exchange Act, 15 U.S.C. § 78c(a)(30) (Supp. 1978).

52. 15 U.S.C. § 78o-4(a)(1) (Supp. 1978).

53. 15 U.S.C. § 78q (Supp. 1978).

54. 15 U.S.C. § 78o-4(b)(1) (Supp. 1978).

55. The MSRB rules are published in the *Municipal Securities Rulemaking Board Manual* (CCH).

56. *Id.*, ¶ 3656.

57. Section 15B(c) of the Securities Exchange Act, 15 U.S.C. § 78o-4(c) (Supp. 1978).

58. Scienter was defined by the Court as "a mental state embracing intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1977). The First Circuit has defined "intent to deceive" as saying "something, that is expected to be relied on, that is not believed to be true, or, if strictly true, is hoped will be understood in an untruthful sense." SEC v. World Radio Mission, Inc., 544 F.2d 535, 540 (1st Cir. 1976). *See also* Sanders v. John Nuveen & Co., 554 F.2d 790, 792-97 (7th Cir. 1977).

scienter would be required in other actions.[59] Since that time the Courts of Appeals have split on the issue,[60] with the Second Circuit most recently deciding unequivocally in the negative:

> [T]he language and history of . . . [section 10(b) does] not require a showing of scienter in an injunction enforcement action brought by the Commission . . . . In view of the policy considerations underlying the securities acts it has been our view that the increased effectiveness of government enforcement actions predicated on a showing of negligence alone outweighed the danger of potential harm to those enjoined from violating the securities laws. . . . The essential nature of an SEC enforcement action is equitable and prophylactic, its primary purpose is to protect the public from harm, not to punish the offender.[61]

The amendments did not, however, revoke the exemptions accorded municipal issuers under the securities laws. Sections 15B(d)(1) and 15B(d)(2) specifiy that neither the Commission nor the MSRB is authorized to require any issuer, directly or indirectly, either to file before sale or to furnish afterwards any application, report, document or information.[62]

This continuing exemption for issuers raises disturbing questions for underwriters and broker-dealers. Under section 15B(d)(2), the MSRB may require municipal securities professionals to furnish to it and to prospective purchasers only that information as to issuers "which is generally available from a source other than such issuer."[63] Because issuers themselves are not to be held to any direct or indirect disclosure requirements, it can be argued that underwriters and broker-dealers should not be required to investigate or disclose any other then publicly available information. Alternatively, section 15(d)(2) can be narrowly construed as intended merely to prevent the MSRB from requiring any direct or indirect disclosure from an issuer; whatever disclosure and investigation compelled otherwise by the antifraud provisions of the securities acts (rather

59. 425 U.S. at 194 n.12.

60. *Compare* SEC v. Blatt, 583 F.2d 1325, 1333 (5th Cir. 1978) *and* Edward J. Mawod & Co. v. SEC, 591 F.2d 588, 595 (10th Cir. 1979) (requiring scienter) *with* SEC v. Arthur Young & Co., 590 F.2d 785, 787 (9th Cir. 1979) (court assumes negligence would suffice, without deciding) *and* SEC v. World Radio Mission, Inc., 544 F.2d 535, 540-41 (1st Cir. 1976).

61. SEC v. Aaron, [Current] FED. SEC. L. REP. (CCH) ¶ 96,800 at 95,128 (2d Cir. March 12, 1979).

62. *See* note 13 *supra*.

63. 15 U.S.C. § 78o-4(d)(2) (Supp. 1978).

than by MSRB rules) would still be required of underwriters and broker-dealers. The Commission asserted its intention to enforce this narrower construction in its first release concerning the 1975 amendments.[64] Under the "shingle theory,"[65] the due diligence requirements of section 11 of the Securities Act[66] have been read into the antifraud provisions.

For example, in *Bache Halsey, Stuart, Inc.*,[67] the Commission found, based on the offer of settlement from Bache Halsey, Stuart, Inc. ("Bache"), that Bache had been the underwriter for a $4.8 million industrial development bond offering to finance the modernization of a custom dyeing business. Following the offering Bache maintained a market in the bonds and purchased and sold the bonds to its retail customers. During this time Bache did not provide its customers with current information regarding the financial position of the company. In fact, the company's financial condition was deteriorating, and eighteen months after the offering the company filed a petition in bankruptcy.

The Commission further found that in connection with the original offering and with subsequent purchases and sales of the bonds in the after market, the defendants had directly and indirectly misrepresented material facts and failed to disclose material facts concerning among other things: (i) the lack of essential information about the security, (ii) the risks which arose from the lack of information, (iii) the failure to make an independent investigation of the security, (iv) the lack of an adequate and reasonable basis for recommending the security, (v) the failure to disclose facts which were known and those which were reasonably ascertainable, (vi) the lack of reasonable basis for making a market and establishing the market price for the security, (vii) the safety and risk of an investment in the security, (viii) the adverse financial condition of the company and (ix) "other statements and omissions of similar purport and object."

Based on the foregoing, the Commission concluded that Bache and one of its principals violated section 17(a) of the Securities Act

64. Securities Exchange Act Release No. 11,876 (Nov. 26, 1975).

65. *See* note 37 *supra*.

66. 15 U.S.C. § 77k (1971).

67. Securities Exchange Act Release No. 12,847, *reprinted in* [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,748 (1976).

and section 10(b) of the Securities Exchange Act and rule 10b-5 promulgated thereunder.[68] In connection with the settlement, a sixty-day injunction against all trading by Bache of industrial development bonds was suspended subject to a partial reimbursement by Bache of customer losses and the establishment of internal operating procedures to safeguard the public investing in industrial development bonds.[69]

In the Matter of Lawrence A. Luebbe (Benchmark Securities, Inc.),[70] the president of a broker-dealer was found to have violated the antifraud provisions by recommending and selling general obligation bond anticipation notes issued by a California public agency without having made a reasonable and diligent inquiry into the issuer's financial condition. Respondent's explanation that he had relied on oral statements from a municipal securities dealer regarding the issuer's assets and liabilities was rejected as an inadequate substitute for review of reliable written financial data. Although respondent also argued that current financial reports were not available, the Commission answered that under those circumstances the notes should not have been sold at all.

Under the theories of these and other decisions,[71] underwriters and broker-dealers are held to duties of investigation and disclosure comparable to those imposed on their counterparts in the corporate securities market without any accompanying disclosure obligations on the part of municipal securities issuers. Exposed to liabilities of the sort exemplified by these decisions,[72] municipal securities industry professionals have extracted increased disclosures from issuers.[73]

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68. *See* note 3 *supra*.

69. A private action arising from the same transaction is Scarfarotti v. Bache & Co., 438 F. Supp. 199 (S.D.N.Y. 1977).

70. Admin. Proc. File No. 3-5175, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,348 (1977).

71. Other recent Commission actions against broker-dealers include Charles Michael West, Admin. Proc. File No. 3-5255, Securities Exchange Act Release No. 15,454 (Jan. 2, 1979); Midwest Securities Co., Admin. Proc. File No. 3-5391, Securities Exchange Act Release No. 14,919 (July 3, 1978); Richard C. Flick, Admin. Proc. File No. 3-5256, Securities Exchange Act Release No. 14,629 (April 3, 1978).

72. *See generally* Doty, *Application of the Antifraud Provisions of the Federal Securities Laws to Exempt Offerings: Duties of Underwriters and Counsel*, 15 B.C. IND. & COM. L. REV. 393 (1975); Johnson & Wheeler, *Securities Law Duties of Bond Counsel*, 1976 DUKE L.J. 1205.

73. *See* Klapper & Pappas, *Wall Street is Forcing Cities to Disclose More When Floating Bonds*, Wall St. J. June 30, 1977, at 1, col. 1.

One study conducted in 1976 compared the disclosures made in offering statements of issues sold in October and November of 1975 to those in May and June of 1976.[74] While that study may have come too closely upon the publicity surrounding New York City in 1975 to reflect solely the legal developments described in this article, nevertheless its findings reflect what its authors describe as a dramatic increase in the overall level of voluntary disclosure.[75]

III. Disclosure By Issuers

There seems to be widespread agreement among members of the municipal securities industry, government regulators and commentators that mechanisms and standards for disclosure by municipal issuers must be created to "provide the basis for a clearer understanding by issuers and other participants in the municipal securities markets of their responsibilities and . . . to assure that public disclosures by municipalities are reliable and accurate."[76]

A. The Municipal Finance Officers Association's Guidelines

Comprehensive disclosure proposals were released in December 1976 by the Municipal Finance Officers Association.[77] The MFOA's *Disclosure Guidelines for Offerings of Securities by State and Local Governments*[78] are not intended to be legally binding, but "represent information that usually should be included in official statements because it would be relevant to investors on most occasions for most issuers."[79] Because of the many differences in the size of municipal issuers and the terms and provisions of municipal se-

74. Peterson, Doty, Forbes & Bourque, *Searching for Standards: Disclosure in the Municipal Securities Market*, 1976 DUKE L.J. 1177.

75. *Id.* at 1196.

76. Securities & Exchange Comm., *Final Report in the Matter of Transactions in the Securities of the City of New York, reprinted in* [Current] FED. SEC. L. REP. (CCH) ¶ 81,936 at 81,244 (Feb. 5, 1979).

77. The Municipal Finance Officers Association ("MFOA") is an organization representing various issuers of municipal securities.

78. The Disclosure Guidelines (hereinafter "the MFOA Guidelines") were followed by "Guidelines for Use by State and Local Governments in the Preparation of Yearly Information Statements and Other Current Information" and "Procedural Statements in Connection With the Disclosure Guidelines for Offerings of Securities by State and Local Governments and the Guidelines for Use by State and Local Governments in the Preparation of Yearly Information Statements and Other Current Information" (May 1978).

79. MFOA Guidelines, *supra* note 78, at Preface and Introduction.

curities, the MFOA Guidelines do not exhaustively list all disclosure items; rather they call for concise, complete and accurate presentation of those matters material to the type of issue to be made available in an official statement preceding the issue of a municipal security.[80] With allowance for these variations, the MFOA Guidelines contemplate: (1) a cover page and introduction cross-referencing the most salient details of the issue; (2) a description of the securities being offered, including use of the funds raised and provisions for repayment; (3) background information regarding the issuer, such as population and economic data, legal government structure, services and facilities (and regarding the "enterprise" central to a revenue bond data encompassing facilities, feasibility reports, operations, customers, legal structure and officers); (4) descriptions of debt structure, debt service requirements and legal debt and tax limits; (5) financial information as to operations for each of the last five years and as to assets and liabilities for the two most recent years, descriptions of accounting practices, budgetary processes, and tax collection procedures, detail pertaining to valuation of taxable property, cash flow supporting interim borrowing or derived from nonrecurring revenue sources, pension plan liabilities and other specific information, as well as basic financial statements for the last two years prepared in accordance with generally accepted accounting principles;[81] (6) descriptions of material legal proceedings and other legal matters; (7) ratings information and (8) other matters, including provision for distribution of the official statement and other pertinent documents.

While early data indicates some measure of acceptance of the MFOA Guidelines by municipal issuers,[82] the American Bar Association Committee on State and Local Government's Subcommittee on Municipal and Governmental Obligations has criticized the basic approach.[83] Rather than relying on a pre-offering official state-

80. *Id.*

81. As suggested by the following sources: AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AUDITS OF STATE AND LOCAL GOVERNMENT UNITS (1974); NATIONAL COUNCIL ON GOVERNMENTAL ACCOUNTING, AUDITING, AND FINANCIAL REPORTING (1968).

82. *See* Peterson, Doty, Forbes & Bourque, *Searching for Standards: Disclosure in the Municipal Securities Market*, 1976 DUKE L.J. 1177, 1182-204.

83. Letter from Richard B. Smith, of the American Bar Assoc. to the MFOA (Feb. 5, 1976). *See* Note, *Disclosure by Issuers of Municipal Securities: An Analysis of Recent Proposals and a Suggested Approach*, 29 VAND. L. REV. 1017, 1035-37 (1976).

ment, the ABA urges emphasis on the preparation of a comprehensive annual report to be supplemented by a shorter document in relation to a particular issue. This mechanism is incorporated in legislation introduced in the Congress in 1976[84] and 1977.[85]

B. The Williams Bill

The Williams Bill would amend the Securities Exchange Act, principally by adding a new section 13A. This section would require issuers with aggregate outstanding municipal securities exceeding $50,000,000 to prepare, but not to file with the Commission, annual reports and reports of events of default containing certain financial and other information.[86] In addition, issuers would also be required prior to the offer or sale of new municipal securities to prepare a distribution document including such data from the annual reports as the Commission may prescribe, along with specified additional information concerning the particular offering.[87] The Bill requires that the periodic reports and distribution document be made available to investors upon request and, in the latter case, to brokers and dealers.[88] The Commission is directed to create an advisory committee including representatives of municipal issuers, whose recommendations as to exemptions, accounting standards and disclosure

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84. The Municipal Securities Full Disclosure Act of 1976, S. 2969, 94th Cong., 2d Sess. (1976).

85. The Municipal Securities Full Disclosure Act of 1977, S. 2339, 95th Cong., 1st Sess. (1977) (hereinafter cited as Williams Bill).

86. Williams Bill, *supra* note 85, § 13A(b)(1) contains the reporting requirement. Section 13A(b)(2) enumerates items to be included, encompassing descriptions of: the issuer's structure, facilities and operations; material changes in operations; borrowing policies and trends, debt structure, legal limits and any defaults in the past twenty years; taxing authority, legal limits, tax structure and collection experience for the past five years, major taxpayers and other revenue sources including Federal or other governmental assistance; material demographic and economic data and trends; legal proceedings; budget data and procedures; pension plan liabilities and holdings of issuer securities by associated trusts or funds and financial statements for up to the last five years. Financial statements would be required to be audited and reported on by independent certified public accountants, a qualified independent or licensed accountant, or an examiner from an independent state agency. Sections 13A(b)(3) and 13A(b)(4) authorize the Commission to add to these requirements.

87. The Williams Bill requires the following information in addition to that provided in the annual report: amount and price of securities offered; identity of underwriters, nature of underwriting arrangements and remuneration of underwriters; other costs and expenses of the issue; purposes of the funds; terms and provisions of the offered securities; counsel's opinion; ratings statement plus other items as required by the Commission. *Id.* § 13A(c)(2).

88. *Id.* § 13A(f).

items, along with those of the MSRB, are to be considered by the Commission.[89] The Commission is granted extensive authority to prescribe by rule or regulation the accounting standards and practices to be followed in the preparation of financial statements, as well as the detail and form of such statements.[90]

In addition, the Williams Bill expressly imposes civil liabilities on issuers, experts, underwriters and broker-dealers to purchasers of municipal securities for material untrue statements or omissions in the distribution document, other communications and annual reports.[91] The liabilities are similar to those provided in sections 11 and 12 of the Securities Act[92] and section 18 of the Securities Exchange Act.[93] Various differences from pre-existing legislation pertaining to corporate securities are worth noting. The exception contained in section 11(b)(3)(A) of the Securities Act[94] to the general duty of reasonable investigation as to parts of the registration statement "purporting to be made on the authority of a public official document or statement" is not, for obvious reasons, carried over to new section 13A as to documents or statements of the issuer. Due diligence requirements of underwriters are made to depend upon

89. *Id.* § 13A(n).

90. *Id.* § 13A(e).

91. Section 13A(g)(1) enables any purchaser of a municipal security to sue the issuer (but not officers or employees thereof), experts and underwriters. Section 13A(g)(2) establishes the responsibilities of the various offering participants to assure the accuracy of the distribution document which, if discharged, provide defenses to investor suits. Issuers, underwriters in negotiated offerings and experts are absolved if they had, "after reasonable investigation, reasonable grounds to believe and did believe . . . that the statements . . . were true and that there was no omission to state a material fact . . . necessary to make the statement [*sic*] not misleading." In the case of municipal securities sold through competitive bid underwriting, the underwriter would be held to a lesser standard requiring only that it had no reasonable ground to believe and did not believe that there were untrue statements or omissions in the distribution documents with no apparent obligation to investigate. Section 13A(g) (3)-(7) duplicate provisions of section 11(c)-(e) relating to the standard of reasonableness and to timing issues. Section 13A(h) corresponds to section 12, and section 13A(i) to section 18 of the Securities Exchange Act. Section 13A(1) provides a statute of limitations comparable to section 13 of the Securities Act. Section 13A(m) provides for concurrent state and federal court jurisdiction comparable to that provided in section 22(a) of the Securities Act, except that suits against the issuer are restricted to those district or districts where the issuer is located. Finally, sections 13A(g)(8) and 13A(i) provide that these express civil actions are exclusive.

92. 15 U.S.C. §§ 77k, 77l (1970).

93. 15 U.S.C. § 78r (1970).

94. 15 U.S.C. § 77k(b)(3)(A) (1970).

whether the issue is negotiated or purchased through competitive bidding.[95] In the latter case a requirement of independent investigation by underwriters "would be unreasonably expensive and unduly disruptive."[96] Unlike corporate issuers under section 11, a municipal issuer would not have absolute liability for any defective disclosure contained in the distribution document and would be liable only for failure to investigate properly the statements originated by it.[97] Officers and employees of the issuer would not be held personally liable.[98] Finally, another defense for all offering participants provided in the Bill conditions the right of recovery on proof that the plaintiff acquiring the security relied upon the alleged untrue statement in the distribution document or relied upon the distribution document and did not know of the alleged omission, but permits such reliance to be established without proof that the purchaser read the distribution document.[99]

The Bill does not provide for Commission staff review of municipal securities distribution documents (or annual reports), recognizing that such review would be outside the Commission's area of expertise, would require a considerable increase in its budget and might raise constitutional problems if a delay in the Commission's review prejudiced a public sale of securities the proceeds of which were to be an essential part of the issuer's budget.[100] In addition, the

95. *See* note 91 *supra*. The large majority of municipal securities (79% in 1975) are underwritten through the competitive bidding process. The laws of many states require competitive bidding, and even in states permitting negotiated sales that method is not generally employed except for revenue bond and similar offerings. Generally the issuer prepares any offering documentation without participation by underwriters, who may win the underwriting on bid issues no more than 25% of the time. The time pressures of this process, the volume of issues, the difficulty in obtaining much of the background data, as well as the complexity of the factors pertinent to the financial status of a municipality and the relative safety of municipal issues have all contributed to limiting the independent investigation and participation in the preparation of offering documentation by underwriters. The Bill, in eliminating the underwriter's due diligence obligation in respect to competitively bid issues, reflects customary practice. *See Proposed Amendments to the Securities Exchange Act of 1934: Hearings on S. 2574 & S. 2969 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing & Urban Affairs*, 94th Cong., 2d Sess. (1976) (statement of the Dealer Bank Assoc. & Securities Indus. Assoc.).

96. 123 CONG. REC. S19,272 (daily ed. Dec. 1, 1977).

97. Williams Bill, *supra* note 85, § 13A(g)(2)(A).

98. 123 CONG. REC. S19272 (daily ed. Dec. 1, 1977).

99. Williams Bill, *supra* note 85, § 13A(g)(1)(c).

100. *See* Address by Roberta S. Karmel, Commissioner, Securities and Exchange Commission, to the Public Securities Association (Oct. 20, 1978).

Bill exempts from the annual report and disclosure document requirements (but not from the liability provisions) any municipal issuer that is required by state law to make disclosures "substantially similar" to those required by federal law.[101] Although this exemption is meant to be "automatic" in the sense that the state, and not the Commission, would determine the substantial similarity of federal and state-mandated disclosure requirements,[102] the Commission, as the ultimate arbiter of the content and form of all disclosures under the Bill, would establish the criteria to which state laws would have to conform.

C. The Industrial Development Bond Act

A second municipal securities disclosure bill was introduced in the Senate in 1978. The "Industrial Development Bond Act"[103] would, by incorporating the substantive provisions of rule 131[104] into Section 2(4) of the Securities Act[105] and by amending section 3(a)(2) of that Act,[106] subject industrial development bonds[107] to the full registration requirements of that Act.[108] Arguing that industrial de-

101. Williams Bill, *supra* note 85, § 13A(d).

102. 123 CONG. REC. S19271 (daily ed. Dec. 1, 1977).

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

104. 17 C.F.R. § 230.131 (1978).

105. 15 U.S.C. § 77b(4) (1970).

106. 15 U.S.C. § 77c(a)(2) (1970).

107. Industrial development bonds (or "industrial revenue bonds") are debt instruments issued nominally by a governmental entity to finance the construction or acquisition of a facility for ultimate use by a private business enterprise. The facility financed by such bonds is the subject of a contractual agreement (typically a lease) between the governmental entity and the private enterprise, providing for payments by the latter to the former in an amount calculated to fully sustain debt service requirements on the bonds. Principal and interest on the bonds is payable from the revenues received by the governmental entity under the terms of its contractual agreement with the private enterprise. The bonds are not backed by the general credit and taxing authority of the governmental entity in whose name the bonds are issued; the governmental entity is generally obligated on the bonds only to the extent of applying contract revenues received from the private enterprise to the payment of bond principal and interest.

124 CONG. REC. S11,391 (daily ed. July 20, 1978) (Statement of the Securities & Exchange Comm.).

108. Currently almost all industrial revenue bonds are designed to qualify for the section 3(a)(2) exemption. This exemption is drawn in terms of reference to section 103 of the Internal Revenue Code of 1954, as amended, which distinguishes, principally, among different purposes to which the funds are put. In those cases where an industrial development bond does not qualify under these provisions, the "industrial or commercial enterprise" involved is

velopment bonds are "conceptually indistinguishable from other corporate debt securities," the Commission maintained in its statement to Congress in support of the bill that "investors in industrial development bonds which are payable from the profits of a commercial enterprise should not be accorded fewer protections than those provided to investors in other corporate bonds . . ."[109] However, certain industrial bonds issued under specified conditions generally involving essentially governmental projects[110] would continue to be exempt from the Securities Act.

The bill would also amend the Securities Exchange Act and the Trust Indenture Act of 1939[111] to delete certain exemptions under these laws. As "issuers" under new Section 2(4) of the Securities Act, non-governmental participants (generally the lessee) in the industrial development bond could become subject to the reporting provisions of section 13 of the Securities Exchange Act[112] through the application of section 15(d) of that Act.[113] The SEC would be empowered to suspend trading under section 12(k) of the Securities Exchange Act[114] to enforce the periodic reporting requirement. The exemption in section 304(a)(4) of the Trust Indenture Act[115] would be restricted comparably to that in section 3(a)(2) of the Securities Act, thereby subjecting such bonds to the filing and qualification provisions of the Trust Indenture Act.

One troubling aspect of the bill is that underwriters would be required to conform to the full "due diligence" standard of section 11 of the Securities Act.[116] The lesser standard provided in the Williams Bill for competitively bid offerings is not carried over.[117]

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considered to be the issuer of a "separate security" subject to the provisions of the Securities Act, the Securities Exchange Act and the Trust Indenture Act, pursuant to rule 131 under the Securities Act, 17 C.F.R. § 230.131 (1978), and rule 3b-5, 17 C.F.R. § 240.3b-5 (1978) under the Securities Exchange Act.

109. 124 CONG. REC. S11,388 (daily ed. July 20, 1978).

110. Such as are currently exempted by rule 131(b), 17 C.F.R. § 230.131(b) (1978).

111. 15 U.S.C. §§ 77aaa-77bbb (1970) (hereinafter "the Trust Indenture Act").

112. 15 U.S.C. § 78m (Supp. 1978).

113. 15 U.S.C. § 78o(d) (Supp. 1978).

114. 15 U.S.C. § 78l(k) (Supp. 1978).

115. 15 U.S.C. § 77ddd(a)(4) (1970).

116. 15 U.S.C. § 77k (1970).

117. *See* text accompanying notes 95-96 *supra*.

D. The New York Disclosure Proposals

As an alternative to federal regulation under the Williams Bill, or to provide mechanisms to qualify for the state regulation exemption provided therein, New York State legislation has been proposed by the Committee on Municipal Affairs of the Association of the Bar of the City of New York (the "Disclosure Proposals"). The report of the Committee, in reaction to the financial difficulties of New York City and other localities,[118] proposes extensive reforms to state law in the areas of (1) limiting local debt and mandating repayment within certain periods, (2) requiring disclosure to investors and (3) establishing fiscal monitoring by the state comptroller. Like the Williams Bill, the Disclosure Proposals require timely independent examination of financial statements presented to the public in both pre-distribution and periodic reports; however, these public reporting obligations are carefully meshed with existing and proposed fiscal monitoring mechanisms in ways that lessen the burden on local issuers and supplement state control over local financing.

Existing New York State legislation requires, in connection with a public issue of securities, the filing of a Notice of Sale supplying data relevant to the particular obligation being sold[119] and of a Debt Statement specifying debt-contracting power.[120] A system of annual reports is prescribed, providing a detailed analysis of operations in a format fixed by the comptroller.[121] In addition, the comptroller's office conducts periodic audits.[122]

However, as a result of staff shortages the comptroller's audits are performed only infrequently. The content and form, moreover, of the required filings are not generally informative to investors.[123] The Notice of Sale and Debt Statement do not permit meaningful comparisons of issuers and securities, while the material included in the annual reports is frequently too detailed and segmented to be of use to investors determining whether to purchase or hold municipal securities. As a result, market pressures have forced many local

118. *Proposals, supra* note 14, at 59-60.
119. N.Y. LOCAL FIN. LAW §§ 58.00, 60.00(e) (McKinney 1968 & Supp. 1978).
120. N.Y. LOCAL FIN. LAW § 109.00 (McKinney Supp. 1978).
121. N.Y. GEN. MUN. LAW Art. 3 (McKinney 1977).
122. N.Y. GEN. MUN. LAW §§ 33-38 (McKinney 1977).
123. *Proposals, supra* note 14, at 93.

entities to go beyond existing legal requirements.[124]

The Disclosure Proposals contemplate the filing of an Official Statement with the state comptroller prior to the sale of municipal securities.[125] Copies of the Official Statement are to be made available upon request.[126] While the comptroller must receive the Official Statement prior to the public sale date, review by the comptroller is not required and the comptroller would not be empowered to delay the sale because of any defective disclosures.[127] No new liabilities are created,[128] nor would failure to file or to meet prescribed informational requirements affect the validity of the securities issued.[129] The burden on local issuers of preparing the Official Statement would be offset by the proposals for circulation by the Comptroller of prototype forms keyed to the type and size of the entity issuing the securities[130] and for incorporation by reference (and attachment to the Official Statement) of relevant portions of the Summary Annual Report discussed below.[131]

The Disclosure Proposals do not attempt to fix by statute a detailed listing of the information which would be included in the Official Statement. The Committee Report, pointing to the variations among issuers subject to the law and to the many forms of debt obligations issued, as well as the continuing evolution of disclosure demands and norms, calls instead for a flexible format to be prescribed by rule or order of the comptroller.[132] In prescribing the informational content of the Official Statement, the comptroller is directed to consider (and permitted to adopt entirely) "voluntary disclosure standards promulgated by national organizations of local governments."[133] This provision refers to the MFOA Guidelines dis-

124. *Id.*

125. PROPOSED DISCLOSURE LEGISLATION §§ 2, 3, *Proposals, supra* note 14, at 115-18 (Reprinted in Appendix B).

126. *Id.* The Committee Report expects distribution patterns will be established by underwriters and dealers. *Proposals, supra* note 14, at 101.

127. *Proposals, supra* note 14, at 97-98.

128. PROPOSED DISCLOSURE LEGISLATION §§ 3, 4 *Proposals, supra* note 14, at 115-18 (Reprinted in Appendix B).

129. *Id.*

130. *Id.*

131. *Id.*

132. *Proposals, supra* note 14, at 109.

133. PROPOSED DISCLOSURE LEGISLATION §§ 2, 3, *Proposals, supra* note 14, at 115-18 (Reprinted in Appendix B).

cussed above.[134] Financial statements in the Official Statement are to be prepared in accordance with the State Uniform System of Accounts[135] or with generally accepted accounting practices, but need not be audited.[136]

The comptroller is empowered to grant exemptions from the requirement to file an Official Statement by rules or orders of general or particular applicability. The comptroller is directed to consider "(a) the aggregate principal amount of the bonds to be issued; or (b) the nature of the offerees and the number and value of the purchasers of such bonds."[137] The Committee Report urges exemption when the cost of preparing the Official Statement disproportionately outweighs the informational benefits afforded a limited group of investors in a short-term or limited size offering.[138]

In addition, the Disclosure Proposals would supplement the existing provision for filing annual reports with the comptroller[139] by requiring the preparation and filing of a Summary Annual Report summarizing the more detailed financial information in the annual report and including narrative descriptions of material developments and trends. The Summary Annual Report is designed to enable investors to compare different issuers and present against past financial conditions. The comptroller is empowered to prescribe the form and content of the Summary Annual Report[140] and to exempt by rule or order.[141] It is expected that much of the financial data can be drawn from annual reports already on file in the comptroller's Office, which might also assist in the development of pertinent demographic and economic data.[142]

The Summary Annual Report must be filed within sixty days (four months in the case of New York City)[143] after the close of the

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134. *See* text accompanying notes 77-82 *supra*.

135. Prescribed by the comptroller pursuant to N.Y. GEN. MUN. LAW § 36 (McKinney 1977).

136. PROPOSED DISCLOSURE LEGISLATION §§ 2, 3, *Proposals, supra* note 14, at 115-18 (Reprinted in Appendix B).

137. *Id.*

138. *Proposals, supra* note 14, at 98.

139. N.Y. GEN. MUN. LAW § 30 (McKinney Supp. 1978).

140. Proposed General Municipal Law § 31-a(3).

141. *Id.* at § 31-a(8).

142. *Proposals, supra* note 14, at 99.

143. N.Y. GEN. MUN. LAW § 30(5) (McKinney 1977).

fiscal year if the report contains unaudited financial statements, in which case the comptroller will audit the financials within six months.[144] Alternatively, a locality would be permitted up to 150 days after the close of the fiscal year to report if the financial statements were audited by independent certified public accountants.[145]

Unlike the Williams Bill, the Disclosure Proposals do not delineate investigatory responsibilities of underwriters and broker-dealers, nor do they create statutory liabilities for issuers, experts, or securities professionals. In addition, the Disclosure Proposals would permit a municipal issuer to submit unaudited financial statements subject to examination by the state comptroller's office. With these exceptions the basic approaches are much the same: integrated periodic and pre-distribution reporting, exemptive and prescriptive authority vested in a single body and the absence of preissuance review of disclosure documents.

IV. Conclusion

Whether the Disclosure Proposals should be enacted into law is a question that invites further definition. It may be urged, for example, that disclosure legislation would be more effective if it established disclosure standards and commanded their enforcement in greater detail than is the case with the Disclosure Proposals. Legislation, however, like politics, is the art of the possible, and the Disclosure Proposals do take a number of steps in the direction of providing informational protection to investors and potential investors in New York municipal securities. It thus seems clear that their adoption is desirable from the narrow, but not unimportant, viewpoint of assuring fairness to unsophisticated investors.

If this were the only matter of concern, one could argue that the objective could be more effectively pursued by federal legislation. The market for municipal securities is largely national (although the tendency of states to limit state tax exemptions to their own securities has some localizing effect). Uniformity of disclosure practices, including accounting standards, should facilitate comparisons among municipal securities on a nationwide basis.

Further, to the extent that the investors in need of protection are

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144. Proposed General Municipal Law § 33(2).

145. *Id.* at § 31-a(5).

distributed nationwide, it can be argued that the federal government is a more appropriate sovereign to afford such protection. Presumably the investors New York should concern itself with protecting are New Yorkers, who presumably need protection with respect to Californian, as well as New York, municipal securities.

The foregoing should serve to underline that investor protection, *per se,* is not the central governmental purpose of the Disclosure Proposals, but is rather the means to accomplish a quite different purpose: the protection of the capital markets to which New York municipal borrowers must have more or less constant access. Viewed from this perspective, it seems clear that the State of New York has a more immediate and compelling interest in regulating issuer disclosure with respect to New York municipal issuers than does the federal government.

Municipal issuers do not, as a general proposition, engage in interstate commerce. Access to capital markets for business corporations of national or transnational scope is obviously an appropriate matter for federal concern. Comparable access for municipal issuers seems primarily, in contrast, to be an appropriate matter for state concern.

State government seems also to be the appropriate arbiter between the need for regulation with respect to disclosure by local government issuers in order to protect access to capital markets and other needs of local government issuers, such as freedom from unnecessary regulatory and financial burdens in connection with local government borrowing, and coordination of such borrowing with operational and capital needs. Not only are local government entities themselves the creatures of state law, but also the entire authority for municipal debt issuances derives from state constitutions and statutes. To a much greater degree than is the case with corporations, municipal borrowing is subject to state regulation. Such fundamental elements as aggregate debt limitations, tax or other resources available to service debt, uses of proceeds, repayment terms and procedures for debt issuance, as well as accounting and budgetary process, are all mandated and monitored by state authorities. The generally permissive posture of state corporation statutes is not carried over to municipalities; state officials already have considerable responsibility and experience in relation to local financing and reporting.

For these reasons, it is submitted that the Disclosure Proposals are clearly preferable to expansion of the role of the Commission in state and local government financing. The federal registration process can often consume up to 10% of the proceeds of a corporate issue.[146] Application of comparably detailed and expensive disclosure requirements to the typically smaller but more numerous municipal issues would add considerably to the cost of capital in a time of mounting taxpayer dissatisfaction with the cost of local government.[147] The Disclosure Proposals' provisions for state auditing, integration with existent fiscal monitoring reporting and state preparation of prototype reports would help to contain disclosure costs.

Finally, even without pre-distribution review of disclosure documents, the Williams Bill provisions raise constitutional uncertainties. The federal imposition of pecuniary liabilities on state issuers for materially untrue statements or omissions remains questionable under the eleventh amendment and associated principles of sovereign immunity.[148] To the extent these protections were not available to municipalities, a state government might be compelled to issue securities on behalf of its localities. The resulting dislocation of intrastate relations, as well as the changes in state and municipal reporting and monitoring practices necessarily required to conform to SEC disclosure requirements might also raise serious problems under the tenth amendment as interpreted in *National League of Cities v. Usery*.[149] This argument was raised by New York City in a suit brought to enjoin the SEC from proceeding with its recently completed investigation of the city's finances:

> [To] impose upon states, municipalities, other local governmental bodies and their officials the everchanging standards under the federal securities

146. *Proposed Amendments to the Securities Exchange Act of 1934: Hearings on S.2969 and S.2574 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 2d Sess. 320 (1976) (statement of R. Doty).

147. *Id.* at 44 (statement of H. Kapnick), 115 (statement of J. Phillips), 127 (statement of R. Kezer), 156-166 (statement of R. Carver).

148. A detailed discussion of these questions is beyond the scope of this article. *See* Note, *Disclosure by Issuers of Municipal Securities: An Analysis of Recent Proposals and a Suggested Approach*, 29 VAND. L. REV. 1016, 1048-54 (1976); Comment, *Federal Regulation of Municipal Securities: A Constitutional and Statutory Analysis*, 1976 DUKE L.J. 1261, 1288-310.

149. 426 U.S. 833 (1976). *See* Comment, *Federal Regulation of Municipal Securities: A Constitutional and Statutory Analysis*, 1976 DUKE L.J. 1261, 1310-19.

> laws of disclosure, scienter, causation, materiality and the like, as evolved from time to time by the SEC and the federal courts, would seriously interfere with the ability of such officials to act as political and governmental leaders and, consequently, with the ability of states and their political and governmental subdivisions to function as sovereign entities. The imposition of such standards would result in state and local officials being required to explain and justify to federal officials myriad local governmental and political decisions and their acts (or failures to act) and statements (or failures to make statements) with respect to such decisions. It would thereby seriously affect (i) the manner in which fundamental policy choices are made involving the governing of states and local governments, and (ii) the substance of those choices. As a consequence, state and local government policies regarding the manner in which state and local governments structure delivery of those governmental services which their citizens require would be displaced by federal action.[150]

New York surpasses all other states in the dollar amount of governmental securities outstanding. New York local governments (excluding the state government) had over $25 billion of debt outstanding at the end of fiscal 1975. This figure represents 17% of the debt outstanding of all local governments nationwide.[151] These statistics highlight the obvious fact that New York local governments have a strong interest in protecting their access to the market by preserving investor confidence. The Disclosure Proposals would provide for sufficient disclosure of financial and other information within the context of state fiscal regulation in a manner least likely to disrupt or burden governmental operations. Existing federal antifraud provisions, as exemplified in the *Bache*[152] and *Luebbe*[153] decisions, should be sufficiently potent spurs to the adequate participation of underwriters, broker-dealers and counsel in the disclosure process.

150. Complaint in City of New York v. SEC, 76 Civ. 3307 (S.D.N.Y. filed July 27, 1976), *reprinted in* [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,667 at 90,279-80 (1976).

151. 15 THE BOND BUYER'S 1976 MUNICIPAL FINANCE STATISTICS 35 (1977).

152. *See* text accompanying notes 67-69 *supra*.

153. *See* text accompanying note 70 *supra*.